

ORGANIZATIONAL INCENTIVES TO CARE ABOUT THE LAW

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I

INTRODUCTION

The moral personality of the corporation, like that of other organizations, has long posed a number of theoretical and practical challenges. Many of the legal questions raised by organizations are complex but resolvable by careful technical analysis. Such questions—for example, how to incorporate a business or a nonprofit endeavor, what are the perils of the general partnership, what are the consequences of acquisition via merger—are answerable within the ambit of legal rules specific to organizations. In contrast, it is often difficult to explain how duties and rights, created outside the sphere of organizational law itself, might intelligibly be applied to a person¹ that is purely the invented creature of compliance with legal form. Many crimes, for example, require a particular mental state, which presupposes a sentient actor. Such challenges aside, organizations frustrate the strategies of law enforcement in ways that natural persons do not. As H.L.A. Hart observed in 1954, “it is not the legal personality but the ‘moral’ personality of organised groups that perplexes most: these exist apart from legal rules”²

In this essay I explore the fit between agency doctrine and the propensity of organizations to obey or disregard the law. Organizational culture and practice, I argue, often reflect how the organization as a principal has shaped its

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1. The term “person” applies to corporations as defined by statute. See, e.g., MODEL BUS. CORP. ACT § 1.40(9), (16) (1984).

2. H.L.A. Hart, *Definition and Theory in Jurisprudence*, 70 LAW Q. REV. 37, 55 (1954), reprinted in H.L.A. HART, *ESSAYS IN JURISPRUDENCE AND PHILOSOPHY* 21, 42-43 (1983) [hereinafter HART ESSAYS]. Hart’s essay is a critique of developing legal theory “on the back of definition.” *Id.* at 41, reprinted in HART ESSAYS, *supra*, at 25. Many of Hart’s specific examples demonstrate that asking the question “What is a corporation?” is not a helpful starting point for fitting corporations into the general legal structure. Instead, Hart argued that legal consequences are best ascribed to corporations through a process of reasoning by analogy. See *infra* note 50. For a useful elaboration of the implications of Hart’s essay, see Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565 (1993).

agents' incentives and preferences. Much of the essay examines two dimensions of the moral personality of the organization: its vicarious liability for criminal acts committed by its employees and other agents, along with the incentives that vicarious liability creates; and the extent to which the organization's governing body bears responsibility to exercise control over employees and other agents that is sufficient to deter and detect wrongful conduct. My specific examples concern business corporations, but the issues are endemic to the conduct of activity by organizations in general. Moreover, questions surrounding vicarious liability are interrelated with questions about the proper role of a governing body. In the corporate context, how to define "the corporation" and specify its boundaries is a common element. For example, when do shareholders have responsibility to exercise control? Does "the corporation" for this purpose encompass the relationship between parent corporations and their subsidiaries? In contrast, separate questions of definition look inward to the corporation's internal governance structure. Vicarious liability treats the corporation as a principal with a duty to control its employees and other agents. The line between vicarious and direct liability is increasingly blurry. The principal's duty to exercise control has been expanded by tort law doctrines such as nondelegable duty, with the effect that the principal's duties of control are not lessened when the individual actor is not an employee.

The concrete focal point for much of this essay is the Delaware Court of Chancery's 1996 opinion in *In re Caremark International Inc. Derivative Litigation*.³ Events underlying the case call into question the proper role of directors within the internal structures through which a corporation exercises control, and the circumstances under which directors should be accountable to shareholders when they have been remiss in this respect.⁴ In *Caremark*, the court stated that corporate directors have an affirmative duty to monitor other organizational actors who are situated deeper within the organization.⁵ I consider at some length the specific implications and limits of this duty, beginning, however, with a somewhat broader perspective grounded in the law of agency as it applies to corporations. I argue that the corporation, like any principal in an agency relationship, defines the incentive structure within which its agents act. While its control over individual actors is never perfect, the corporation establishes organizational rewards and sanctions for activity that shape how its agents interpret and otherwise respond to the instructions they are given. Although the principal's ability to define its agents' incentives is a significant justification for imposing vicarious liability on principals for their agents' wrongful acts, and for expanded doctrines like nondelegable duty, the leading critique of vicarious liability does not reflect the import of the principal's ability to shape its agents' conduct.⁶ I do not articulate any general rule as to when vicarious

3. 698 A.2d 959.

4. *See id.* at 961-66.

5. *See id.* at 971 (stating the test of liability as "lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight . . .").

liability is justifiable, nor do I propose any expansion in vicarious liability beyond that reflected in well-settled case law.⁷

Caremark provides a concrete instance to consider the interplay between duties and remedies that are conventionally treated as matters of internal corporate governance, and duties and liabilities imposed on the corporation as a principal in an agency relationship. I argue that the content of directors' duty to monitor should reflect the incentives the corporation has created for its employees and agents. However difficult it may be to formulate a satisfactory rule of liability for directors' failure to monitor, directors are ultimately accountable for the corporation's culture. Under present law, though, the effectiveness of that accountability may be undercut by roadblocks to shareholder derivative litigation, which apply even when the corporation's senior management has been complicit in wrongdoing that led to massive losses for the corporation. Thus, I propose an adjustment to the business judgment rule, with the objective of achieving a better fit between the rule and the substantive point of imposing a duty to monitor on directors. In particular, I argue that it is inappropriate to apply a presumption of good faith to directors when the corporation's senior management has been implicated in criminal wrongdoing.

II

VICARIOUS LIABILITY

A. Events Underlying *Caremark*

The basic factual scenario involved in *Caremark* is a useful starting point.⁸ The corporation provided health care services, deriving a major portion of its revenues from Medicare, Medicaid, and private health insurers.⁹ As a recipient of payments from Medicare and Medicaid, *Caremark* was subject to an extensive set of complex federal statutes and regulations, including the statute colloquially known as the Anti-Referral Payments Law ("ARPL").¹⁰ ARPL makes it a federal felony to

knowingly and willfully offer[] or pay[] any remuneration (including any kickback, bribe, or rebate) directly or indirectly, overtly or covertly, in cash or in kind to any person to induce such person

(A) to refer an individual to a person for the furnishing or arranging for the furnishing of any item or service for which payment may be made in whole or in

6. See generally Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994).

7. See, e.g., *New York Central & Hudson R.R. Co. v. United States*, 212 U.S. 481 (1909) (corporation vicariously liable for crimes committed by employees and other agents when acting within scope of employment or agency); *In re Atlantic Fin. Management, Inc.*, 784 F.2d 29, 31-32 (1st Cir. 1986), cert. denied sub nom *AZL Resources, Inc. v. Margaret Hall Found., Inc.*, 481 U.S. 1072 (1987) (stating that a principal can be vicariously liable for tortious misrepresentations of agents, on basis that agent had actual or apparent authority to make representation, or on basis of agent's status).

8. 698 A.2d at 961-69.

9. See *id.* at 961.

10. See *id.* at 961-62.

part under subchapter XVIII [Health Insurance for Aged and Disabled] of this chapter or a State health care program¹¹

The specified penalty upon conviction is a fine not to exceed \$25,000 or imprisonment for not more than five years.¹² Following a multi-year investigation, Caremark and two of its officers were among a group of defendants indicted for violations of ARPL.¹³ Caremark settled with the federal government by pleading guilty to one count of mail fraud, presumably attributable to conduct that occurred incident to acts alleged to violate ARPL, and by paying a combined amount of \$164.4 million, inclusive of criminal fines and payments to resolve civil claims.¹⁴ The settlement agreement stipulated that no senior executive of Caremark “participated in, condoned, or was willfully ignorant of wrongdoing”¹⁵ Subsequently Caremark paid an additional \$98.5 million to settle disputes with private payors aggrieved by the business practices that led to the ARPL problems.¹⁶

What is relevant for our immediate purpose is that ARPL clearly defines a crime that requires specific intent, that is, the statute requires that the defendant have acted “knowingly and willfully.”¹⁷ Moreover, conduct violates the federal mail fraud statute only if it is knowing and only if the defendant willfully participates in the scheme.¹⁸ In *Hanlester Network v. Shalala*, the Ninth

11. 42 U.S.C. § 1320a-7b(b)(2) (1994). The quoted text is as written at the time of Caremark’s offenses; amendments that would not change the outcome of the case have since been made. See 42 U.S.C.A. § 1320a-7b(b)(2) (West Supp. 1997).

12. See *id.* § 1320a-7b(a).

13. See *Caremark*, 698 A.2d at 963-64. Also indicted were a physician who allegedly received \$1.1 million to induce him to distribute a human growth hormone drug marketed by Caremark, as well as a physician who allegedly received \$134,600 for patient referrals. See *id.* at 964. Not surprisingly, ARPL prohibits soliciting or receiving payments in contravention of the statute, in addition to its prohibition of offering or making payments. See 42 U.S.C.A. § 1320a-7b(b)(1) (West Supp. 1997).

14. See *Caremark*, 698 A.2d at 965 n.10.

15. *Id.* at 965 (emphasis omitted). It may be that as a consequence of this stipulation, coverage became available under a policy of director and officer (“D&O”) liability insurance when coverage would otherwise have been excluded. The stipulation would be helpful in enabling Caremark to indemnify its senior executives’ litigation expenses because it is consistent with a conclusion that the senior executives did not fail to act in good faith. See DEL. CODE ANN., tit. 8, § 145(a) (Supp. 1996); see also *infra* note 96. Indeed the Delaware statute mandates indemnification when the actor has been successful “on the merits or otherwise” in defending against the action or proceeding. DEL. CODE ANN., tit. 8, § 145(c) (1991). Although the language they use is nonuniform, D&O policies typically insure the corporation against its liability arising from indemnification as well as providing direct coverage to directors and officers as insured persons. See JOSEPH WARREN BISHOP, JR., *THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE* § 8.04 (1981 & 1997 Supp.). The D&O carrier itself is not a party to settlement negotiations like those in *Caremark*, of course, although the outcome of negotiations may determine the carrier’s liability under the D&O policy. Scholars recognize the impact of insurance coverage on litigants’ strategic incentives in other contexts. See Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721 (1997); Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 356-59, 363-64 (1990). I am indebted to Kent Syverud for bringing this point to my attention.

16. See *Caremark*, 698 A.2d at 966.

17. 42 U.S.C.A. § 1320a-7b(b)(2) (West Supp. 1997).

18. A defendant has violated the mail fraud statute, 18 U.S.C. § 1341 (1994), if the defendant “devised or intend[ed] to devise any scheme or artifice to defraud, or for obtaining money or property

Circuit interpreted ARPL's language to require the defendant to know that conduct is prohibited by the statute and to have specific intent to disobey the law.¹⁹ Based on its interpretation of ARPL, the Ninth Circuit held that individual investors in a partnership, who did not authorize or approve representations contrary to ARPL by the partnership's agent, did not themselves violate ARPL.²⁰ Caremark's settlement, in contrast, appears to be premised on corporate vicarious liability, and in a relatively pristine form at that, given the stipulated absence of wrongdoing engaged in or authorized by the corporation's senior management or directors. The settlement also presupposes that an individual actor's specific intent and knowledge may be imputed to the corporation even when the actor is not in a position of central executive authority.²¹ Instead, the dispositive question is whether employees or other agents of Caremark violated the mail fraud statute or APRL while acting within the scope of their actual or apparent authority on behalf of the corporation (such as by making agreements with physicians).

B. Organizational Incentives and Vicarious Liability

As it happens, federal criminal law has long embraced vicarious corporate liability for criminal misconduct, even when the offense requires a showing of specific intent, so long as the crime is not one a corporation is incapable of committing and the individual actor's conduct occurred within the scope of the employment or agency.²² The measurement of "scope" encompasses the

by means of false or fraudulent pretenses, representations, or promises" This language implies a scienter requirement.

19. 51 F.3d 1390, 1400 (9th Cir. 1995).

20. *See id.* at 1400-01.

21. If the agent has power to bind the principal concerning a matter or has a duty to provide information to the principal, knowledge that the agent obtains imputes to the principal. RESTATEMENT (SECOND) OF AGENCY § 272 (1958). If the agent obtained the knowledge while acting adversely to the principal, the agent's knowledge does not impute to the principal. *See id.* § 282(1). Nonetheless, the agent's knowledge does impute to the principal when the agent appeared to a third party to be acting for the principal's benefit, *see, e.g., In re Lloyd Securities, Inc.*, 153 B.R. 677, 683 (E.D. Pa. 1993), or when the principal knowingly benefited from the agent's fraud, *see In re Maxwell Newspapers, Inc.*, 164 B.R. 858 (Bkr. S.D.N.Y. 1994). *See also* RESTATEMENT (SECOND) OF AGENCY § 282 (2)(b) & cmt. f (1958) (regarding agent's appearance of acting for principal's benefit); *id.* § 282(2)(c) & cmt. h (regarding principal knowingly benefiting from agent's fraud).

22. *See New York Central & Hudson R.R. Co. v. United States*, 212 U.S. 481, 493-95 (1909). The Court did not give examples of "crimes, which in their nature cannot be committed by corporations." *Id.* at 494. The number of such crimes is likely to be small, given the corporation's liability for criminal acts committed by its human agents who act within the scope of their actual or apparent authority. Even some sexual crimes may be committed by corporations. *See, e.g., State v. Zeta Chi Fraternity*, 696 A.2d 530, 537 (N.H. 1997) (corporation vicariously liable for prostitution). Bigamy might be an example of a crime that cannot be committed by a person other than a human actor him or herself, but perhaps that example is plausible only because it is difficult to imagine a board of directors or high managerial agent directing or authorizing an agent's bigamous marriage in connection with the agent's services to the corporation. *But see* JOHN SMITH & BRIAN HOGAN, CRIMINAL LAW 188 (8th ed. 1996) (leading English commentators observe that it is "quite inconceivable" that a corporate officer would "commit within the scope of his employment . . . bigamy, rape, incest and, possibly, perjury"). Smith and Hogan concede that often, though, a corporation may be secondarily liable even in otherwise inconceivable instances of criminal misconduct. *See id.* at 188 n.5 (managing director of "an incorporated Marriage Advisory Bureau negotiates a marriage which he knows to be bigamous").

agent's apparent as well as actual authority.²³ Whether the corporation benefited from the agent's conduct is, at most, treated as an evidential fact, not an operative requirement for vicarious liability; it suffices that the agent's motive is only in part to benefit the corporation, a standard consistent with the coincident presence of self-interested motives.²⁴ That the corporation prohibited the conduct is not a defense, although the fact that the agent contravened a specific prohibition may help establish that the agent lacked any motive to benefit the corporation.²⁵ Federal criminal law is thus in marked contrast with the Model Penal Code, which requires complicity at high levels within the corporation.²⁶ The principle of vicarious liability within federal criminal law also contrasts with the complicity requirement—comparable to the Model Penal Code—imposed by federal common law for vicarious liability for punitive damages in civil litigation.²⁷ High-level complicity is relevant, however, at the penalty phase in federal prosecutions, a point discussed below.

Given its stringency, it is not surprising that the federal doctrine of vicarious liability has attracted criticism. The Federal Sentencing Guidelines have had the effect of enhancing the fines paid by corporate violators compared with

23. This principle is applicable as well to noncriminal misconduct. *See, e.g., American Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 568-74 (1982) (agent of professional society acting with apparent authority binds society even though agent did not act with intention of benefiting society; society liable in private action for treble damages due to agent's violation of antitrust laws).

24. *See United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1004 (9th Cir. 1972) (fact that employee violated instructions is not a defense to corporation's liability for criminal violation of antitrust laws, nor is employee's motive; employee testified he violated instructions and participated in illegal boycott due to "anger and personal pique"); *see also* RESTATEMENT (SECOND) OF AGENCY § 228(1)(c) (1958) (defining scope of employment of servants). At least for purposes of vicarious civil liability, the principal is liable for the misrepresentations of an agent acting with apparent authority, even when the agent acted solely for the agent's own purpose, unless the third party has notice of the agent's self-interested purpose. *See id.* § 262. For an example of a recent application of this doctrine, *see Grease Monkey Int'l Inc. v. Montoya*, 904 P.2d 468 (Colo. 1995). Vicarious liability for fraud is examined further in the text accompanying note 69 *infra*.

25. *See SARA SUN BEALE ET AL., FEDERAL CRIMINAL LAW: WHITE COLLAR CRIME, DRUG OFFENSES, FORFEITURE & GENERAL PROVISIONS* §§ 11.01-.05 (forthcoming 1998).

26. *See* MODEL PENAL CODE § 2.07(1)(c) (Proposed Official Draft 1962) (corporation may be convicted for commission of an offense that was "authorized, requested, commanded, performed or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment"). European standards for imputing criminal liability to a corporation vary but, in general, are more narrowly cast than the federal principle in the United States. *See V.S. Khanna, Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1490-91 (1996). Recent English cases treat as matters of statutory construction whether legislation criminalizing conduct should apply to a corporation, as well as whose act should for this purpose count as the act of the corporation. *See Meridian Global Funds Management Asia Ltd. v. Securities Comm'n.*, [1995] 2 App. Cas. 500, 507 (P.C. 1995) (appeal taken from New Zealand).

27. Many federal circuits follow the rule stated in RESTATEMENT (SECOND) OF TORTS § 909 (1958), which makes an award of punitive damages against a principal appropriate when the principal authorized or ratified the agent's act or when an agent in a managerial capacity acted within the scope of employment. *See, e.g., Muratore v. M/S Scotia Prince*, 845 F.2d 347, 355 (1st Cir. 1988). The original federal rule was narrower, making the principal vicariously liable for punitive damages only when the principal authorized or ratified the agent's conduct. *See Lake Shore & Mich. S. Ry. Co. v. Prentice*, 147 U.S. 101, 114-16 (1893).

pre-guidelines sanctions.²⁸ Additionally, vicarious liability for criminal acts seems to strain the assumptions that underlie agency. In particular, in the absence of complicity at high levels, vicarious liability often taxes the corporation and its shareholders with the consequences of conduct that the corporation itself has prohibited. The misfeasant agents, that is, have contravened the instructions of their principal. How, one might wonder, can such conduct be within the scope of an agent's authority; by establishing that it prohibited the conduct, has the corporation not established that the agent's motivation was other than serving the corporation's interests? Moreover, lower-level employees and agents do not personify the corporation as its senior management might in many respects be thought to do.²⁹

The answer—or at least part of the answer—stems from the corporation's ability to define the incentive structure within which its agents act. As an organization, the corporation defines rewards and penalties; by doing so it creates incentives for agents to act in ways that promise rewards conferred by the organization. These incentives can be so strong that they mute the message otherwise conveyed by the organization's instructions to its agents.

Consider two examples, neither entirely hypothetical. A pizza business markets its home delivery service as especially rapid, telling prospective customers, "Delivery within 30 minutes of your order or the pizza is yours for free." Delivery people are told "Never exceed the speed limit. Never run red lights." If they are also told "You pay for any free pizzas," the drive-legally instruction competes with the agent's financial self-interest, and some agents may either determine to ignore the driving instructions or they may, less directly, tend to over-estimate their skill to drive illegally but still inflict no injuries on others.³⁰ Indeed, this example does not presuppose that the management of the

28. Compare Mark A. Cohen, *Corporate Crime and Punishment: A Study of Social Harm and Sentencing Practices in the Federal Courts 1984-87*, 26 AM. CRIM. L. REV. 605, 618 tbl. 6 (1989) (prior to Sentencing Guidelines, median fine against corporate violators represented 13% of social harm caused by violation and median total sanction represented 33% of social harm) with Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practices in Federal Courts, 1988-90*, 71 B.U. L. REV. 247, 260 tbl. 6, 276 (1991) (total sanctions for corporate violators now approach social harm).

29. Lower-level agents and employees have circumscribed authority to act on behalf of the corporation, which limits the extent to which the corporation is bound to the consequences of their acts. See HANNA F. PITKIN, *THE CONCEPT OF REPRESENTATION 124-26* (1972). Professor Pitkin's analysis is based on a distinction between the concepts of agency and representation. See *id.* An agent, in her sense, is the "tool or instrument" through which the principal acts, while a representative is an embodiment of the principal. *Id.* at 125. This distinction is not grounded in the law of agency, which simply recognizes degrees of authority among agents. For example, in the terminology used by the Restatement (Second) of Agency, any employee is a "servant," and "ship captains and managers of great corporations are normally superior servants, differing only in the dignity and importance of their positions from those working under them." RESTATEMENT (SECOND) OF AGENCY § 220, cmt. a (1958).

30. Indeed, a defendant may be vicariously liable in tort for the negligent acts of third parties when the defendant creates a foreseeable risk that such negligent conduct will occur. See *Weirum v. RKO General, Inc.*, 539 P.2d 36, 40 (Cal. 1975) (radio station liable for wrongful death of plaintiff's decedent negligently forced off highway by adolescent listener to station; station sponsored chase contest that rewarded first contestant to locate peripatetic disc jockey driving conspicuous red automobile).

pizza business intends for its agents to disregard the driving instructions. The example thus does not involve the phenomenon of instructions that the agent reasonably understands the principal intends or means to be ignored. The organization's incentive structure has consequences for agents' conduct separate from management's intentions.³¹

Separately, consider a business that compensates its employees exclusively on the basis of the sales revenue they generate, paying them a percentage of each sale amount. If prospective customers for the product or service are likely to be influenced by what the salesperson tells them, the employer's instruction to its sales force to tell nothing but the truth may compete with incentives that the compensation structure creates to misstate material facts in order to enhance sales volume. In its *Caremark* opinion, the court notes incidents in recent business history, involving Salomon Inc., Kidder Peabody, and Prudential Insurance, in which agents' misrepresentations led to enormous financial and reputational losses for their firms.³² In all three instances, the firms were members of industries that reward employees on the basis of revenues generated individually through trading or selling, an incentive structure that with regularity produces rogue agents who underestimate the risk that illegal conduct will be detected and penalized.³³

What the examples illustrate is that complying with the law may operate as a binding constraint on the agent. A constraint "binds" if it affects the agent's choice, and in the examples, complying with the law and the principal's instruc-

31. The real-life principal on which this example is based, Domino's Pizza, dropped its 30 minute guarantee after a jury awarded \$79 million in punitive damages to a plaintiff injured by a Domino's delivery person. See Jonathan Hadley Koenig, *Punitive Damages "Overkill" After TXO Production Corp. v. Alliance Resources: The Need for a Congressional Solution*, 36 WM. & MARY L. REV. 751, 752 n.7 (1995). Cf. RESTATEMENT (SECOND) OF AGENCY § 236, cmt. a, illus. 1-3 (1958) (torts committed by servants while driving may be within scope of employment even though servant had non-work-related agenda when driving at work).

32. In re *Caremark Int'l Inc. Derivative Litig.*, 698 A.2d at 968 (Del. Ch. 1996).

33. For a discussion of this phenomenon, see Jerry W. Markham, *Guarding the Kraal—On the Trail of the Rogue Trader*, 21 J. CORP. LAW 131 (1995). Professor Markham notes that it is difficult to formulate an overall compensation structure that both rewards traders who earn short-term trading profits and rewards those who are concerned with the firm's long-term safety. *Id.* at 145. For an illuminating discussion of the difficulties of effective supervision in such an environment, see Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 648 (1996). As it happens, Prudential Insurance and its agents, in the wake of the scandal mentioned in *Caremark*, fell into serious dispute over the terms of Prudential's contract with its unionized employee-agents. See Leslie Scism, *Prudential Insurance, Agents Dispute Contract Over Higher Production Quotas*, WALL ST. J., Nov. 25, 1997, at A4. Some agents argued that the company's proposed contract, by tying eligibility for additional compensation to new sales, created incentives for agents to evade the company's compliance procedures and business standards. See *id.*

Extensive literature in economics analyzes the role of incentives and other generic problems in principal-agent relationships generally. See, e.g., Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983); Milton Harris & Artur Raviv, *Optimal Incentive Contracts with Imperfect Information*, 20 J. ECON. THEORY 231 (1979); Bengt Holstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership and Job Design*, 7 J.L. ECON. & ORG. 24 (1991) (special issue); Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 AM. ECON. REV. 134 (May 1973); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979).

tions to obey the law restrict the agent's ability to accomplish the results that are rewarded by the principal's incentive and compensation systems.³⁴ These are situations in which the justification for imposing vicarious liability on the principal is compelling and in which vicarious liability may appear even to be a form of direct liability, given the reasonableness of expecting the principal to take special care to monitor agents' behavior in such situations.

Moreover, some agents who engage in criminal misconduct are not rogues at all, but agents who act as a consequence of pressures created by the organization's incentive and control systems. The organization may formally instruct the agent not to violate the law, but the agent may also understand that a failure to achieve specified results will lead to termination or to other sanctions. The agent's violation of the law can be seen as the consequence of either the agent's understanding that the principal intends that compliance with the law should be sacrificed if necessary, or of ambiguity in the principal's overall message to the agent.³⁵

A salutary consequence of vicarious liability is that it encourages organizational principals, like corporations, to strive for clarity in the messages conveyed to agents. An agency relationship is in many respects a private system of norms, in which the principal defines for the agent the acts of the agent that the principal will treat as its own. The principal communicates its wishes and directions to the agent, which the agent in turn interprets. Third parties who interact with the agent observe the relationship and the principal's conduct, forming inferences about the agent's authority. Agency's intellectual distinctiveness stems from its focus on relationships in which one person is a representative of another and has a duty to account for the use made of the representative position. The legal definition of agency encompasses the principal's right to control the agent and the agent's fiduciary duty toward the principal.³⁶ Although agency relationships result from voluntary association between the principal and the agent, the legal consequences are distinct from the simple consequences of contract because the principal has the right to direct the agent and because the agent's duties are those of a fiduciary.³⁷

34. This argument may help explain why nonprogressive commission structures are prevalent for agents in some industries. In the second example, the legality example would bind the agent even more sharply if the percentage paid to the agent increased with the dollar amount of the transaction. See Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters, and Other Agents' Rewards*, 36 J.L. & ECON. 503, 504-05 (1993) (noting that real estate agents typically are paid a nonprogressive commission rate).

35. This point has long been evident to courts. As the Ninth Circuit observed in 1972, in upholding a conviction for criminal violations of the Sherman Act, such violations "are a likely consequence of the pressure to maximize profits that is commonly imposed by corporate owners upon managing agents, and, in turn, upon lesser employees," making it probable that "generalized directions to obey the Sherman Act, with the probable effect of foregoing profits, are the least likely to be taken seriously." *United States v. Hilton Hotels Corp.*, 467 F.2d at 1000, 1006.

36. See RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

37. The common law of agency treats the agent's fiduciary status as a defining element of the relationship. For a recent example, see *In re Daisy Systems Corp.*, 97 F.3d 1171, 1178 (9th Cir. 1996) (fiduciary relationship should be presumed to exist if trier of fact finds that investment bank acted as agent of client). See also *Arthur D. Little Int'l, Inc. v. Dooyang Corp.*, 928 F. Supp. 1189, 1207-08 (D.

As a fiduciary whose role is to act on behalf of the principal, the agent may not benefit through the relationship without the principal's consent. The agent's fiduciary posture supplies an interpretive benchmark for instructions the agent receives from the principal, a benchmark that obliges the agent to interpret instructions reasonably in light of the principal's interests known to the agent.³⁸ The principal effects its control over the agent through language and other forms of expressive conduct. The agent's duty as a fiduciary to interpret the principal's instructions reasonably in light of the principal's interests is an integral element of the principal's right of control. It assures the principal that the agent may not evade control, or pursue self interest, through the interpretive strategy of exploiting gaps or unclarity in the principal's instructions.³⁹

The principal's right of control is a corollary of the agent's role as a representative of the principal. As a consequence, the principal's tasks in exercising control are simplified because the principal need not develop and articulate fully contingent statements of its instructions that spell out what the agent should and should not do under all imaginable contingencies. The fiduciary character of the relationship means that the principal does not bear the risk that its stated instructions contain gaps that the agent is free to exploit in a fashion that is either self-interested or oriented to serving interests other than those of the principal.

The legal consequences of agency also, of course, encompass the agent's interactions with third parties. Doctrines of apparent agency and apparent authority hold the principal directly accountable for the results of reasonable third-party beliefs about the position or authority of the agent (or the apparent agent) based on appearances for which the principal is fairly responsible, re-

Mass. 1996) (if business consultant's relationship with corporation constituted agency relationship, consultant would have duty to disclose any conflict of interest and all facts it knew would reasonably affect principal's judgment whether to consent to dual agency).

38. Fiduciary doctrine tends to be more restrictive in the controls it imposes on the pursuit of self-interest than is most contract doctrine, even that developed under the aegis of doctrines of good faith. See Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 629-30 (1997).

39. To be sure, the law of agency enables the principal to consent to conduct on the agent's part that would otherwise amount to a breach of fiduciary duty by the agent. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 388 (1958) (unless otherwise agreed, agent may not profit in connection with transactions conducted on behalf of principal without giving such profit to principal); *id.* § 389 (unless otherwise agreed, agent may not deal with principal as an adverse party in transaction connected to agency without principal's knowledge); *id.* § 393 (unless otherwise agreed, agent may not compete with principal concerning subject matter of agency); *id.* § 395 (unless otherwise agreed, agent may not use or communicate confidential information relayed by principal or acquired in connection with agency, for his own benefit or for benefit of others in competition with principal). But see *id.* § 390 (agent who deals as adverse party with principal, to knowledge of principal, has duty to deal fairly). The principal's consent to self-dealing by the agent does not destroy the agent's fiduciary status, as it bears on the agent's duty to interpret the principal's instructions so as to best achieve the principal's interests. In contrast, in many contexts governed by principles applicable to arms-length contractual relationships, courts protect parties who interpret contract language to serve their own interests. Such protection is especially strong when the contract language is embedded in a debt security. See, e.g., *Morgan Stanley & Co. v. Archer Daniels Midland Co.*, 570 F. Supp. 1529 (S.D.N.Y. 1983) (issuer of debentures free to interpret redemption language to benefit from post-issuance drop in interest rates, despite showing that it had no expectation of early redemption when it issued debentures).

ardless of the principal's private understanding with the agent or apparent agent, or restrictions that the principal has privately imposed on the agent. Third parties who interact with the agent draw inferences about the extent or nature of the agent's authority to do particular acts; even when an agent acts wrongfully toward a third party, the agent may reasonably appear to be acting within the scope of authority granted by the principal, or with the principal's acquiescence, and may thus appear to represent the principal in the particular interaction. Agents who are apparently authorized to speak on the principal's behalf import the weight of the principal's reputation into statements they make on its behalf.

Agents' misconduct—whether tortious or criminal—often stems from self-interested motives. If the principal is vicariously liable for its agents' misconduct, the principal bears the risk that agents will ignore the principal's instructions in circumstances where compliance would jeopardize the agent's success within the organization's incentive system.⁴⁰ That is, vicarious liability acknowledges the principal's distinct role in defining its agents' preferences. In contrast, contemporary critics of vicarious liability tend to omit the definitional role that the principal plays in an agency relationship. Professor Jennifer Arlen, a critic of vicarious liability, writes that

[c]orporate crimes are not committed by corporations; they are committed by agents of the corporation. These agents are rational self-interested utility maximizers who commit crimes in order to benefit themselves. In pursuit of his own self-interest an agent may commit a crime that incidentally benefits the corporation, but this is not its purpose.⁴¹

This analysis embodies a misleadingly narrow view of the factors in play in any principal-agent relationship. While the principal's benefit and the agent's self-interest are relevant, it is important not to ignore the principal's right to define incentives and otherwise control the agent's conduct.⁴² In particular, the principal defines the rewards and sanctions that shape the agent's perception of self-interest.⁴³ Characterizations like Professor Arlen's may also reflect an in-

40. See Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 653 (1996) (noting that thought processes of managers who commit securities fraud will be affected by "organizational setting in which their actions are embedded").

41. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 834 (1994).

42. Characterizing the corporation as a "nexus of contracts" is not especially helpful when the question is how to define the consequences of the agent's misconduct. See Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 323 (1996) (observing that "offenses that are labeled 'corporate crimes' inevitably involve harmful actions by some corporate actors without the knowledge or consent of other contracting parties within the firm"). By definition, some "contracting parties" who do not have rights of control, such as the corporation's creditors, neither know about nor do they assent to corporate actors' misconduct. It is also an intriguing question whether the government counts as a "contracting party" in this context. As well, it is helpful to keep in mind that some recent instances of criminal misconduct involved senior officers and directors. See, e.g., Kurt Eichenwald, *The Tale of the Secret Tapes*, N.Y. TIMES, Nov. 16, 1997, at 1 (detailing involvement of vice chairman of Archer Daniels Midland Co. in criminal price-fixing conspiracy).

43. The principal occupies this definitional role even when the principal simply acquiesces in a would-be agent's proposed incentive scheme. The law of agency, that is, presupposes that most principals, in accepting the terms of an offer made by a would-be agent, are capable of evaluating the risks

tensely individualistic view of human nature that excludes external influences—like those created by a principal—from the explanatory framework.

Vicarious liability also encourages an organization to use skill in selecting agents. By using care, the organization may avoid hiring would-be agents whose incurable roguishness will be resistant to the organization's control. In evaluating the effects of imposing vicarious liability, it is helpful to reflect on the actual organizational traits of large business corporations, many of which do not function according to classical models of formal bureaucracy. Such models postulate tight organizational control over individual actors, close attention to articulating and following orders, extensive written documentation, and depersonalized separation between specific individuals and the offices and authority they hold. In contrast, in many real-world business corporations, authority is personalized to individuals, written documentation is disfavored, and managers focus on personal survival in a fluid and perilous environment. Credit in such organizations flows upward while detail and blame are pushed downward, which tends to distance organizational superiors from bad news and guilty knowledge contained deeper in the organization.⁴⁴ Vicarious liability creates incentives for the organization's senior management to devise systems and patterns of interaction with those lower in the hierarchy that will trump these organizational traits. All of these organizational traits, of course, reflect the acts of human beings. That such acts occur in an organizational context enhances the likelihood that they will influence the acts of other human beings. Recognizing this possibility is not the same as anthropomorphizing an organization, but it does explain why an organization's traits could justify the ascription of blame.⁴⁵ An organization's ability to define tasks narrowly, and to limit the

the proposal would create for exercising control over the agent thereafter. This presupposition does not apply when the prospective principal and the prospective agent have a relationship of trust and confidence, such that the prospective principal relies on the prospective agent to deal fairly. See RESTATEMENT (SECOND) OF AGENCY § 390, cmt. e (1958).

This structure may lack descriptive bite in some situations, though. Some agents—like CEOs of many corporations—appear to personify the corporation, *see supra* text accompanying note 29, and also to act without significant constraint imposed by the corporation's board of directors. For an extreme example, see *Grimes v. Donald*, No. CIV.A. 13358, 1995 WL 54441 at *5, *9 (Del. Ch. Jan. 11, 1995), *aff'd*, 673 A.2d 1207 (Del. 1996) (employment agreement explicitly assured chairman and CEO that directors would not “unreasonably interfere” with his work; CEO's good faith determination of “unreasonable interference” defined to be constructive termination, which entitled CEO to severance benefits). Likewise, agents who are professionals, like lawyers, may also act without significant client-imposed constraint once they are retained. To introduce a better fit between terminology and reality, Professor Eric Orts has proposed characterizing some agents as “quasi-principals.” Eric W. Orts, *Shirking and Sharking: An Economic and Legal Theory of the Firm* 21 (Oct. 7, 1997) (unpublished manuscript on file with author). Professor Orts does not propose to lessen the duties applicable to quasi-principals, only to recognize the fact of their *de facto* authority and power. In any event, a signal trait of a “quasi-principal” may well be the practical ability to define the relevant incentive structure, subject to the principal's acquiescence.

44. See ROBERT JACKALL, *MORAL MAZES: THE WORLD OF CORPORATE MANAGERS* 20-21 (1988). The federal Sentencing Guidelines appear to reinforce this tendency. See *infra* text accompanying notes 73-78.

45. In contrast, some scholars assume that moral condemnation is appropriate or intelligible only when its object is a human being. See, e.g., Paul H. Robinson, *The Criminal-Civil Distinction and the*

knowledge possessed by individual actors, creates the capacity to elude criminal sanctions that turn on the combination of a particular state of mind with particular acts.

Furthermore, vicarious liability works to strengthen the social meaning associated with criminalization. The concept of social meaning encompasses “all the ways in which the law creates and shapes information about the kinds of behavior that members of the public hope for and value, as well as the kinds they expect and fear.”⁴⁶ At first it might seem counterintuitive to posit that vicarious liability has such an effect, because vicarious liability presupposes that the principal’s own conduct—separate from that of its agents—would not constitute, authorize, or ratify the criminal acts. Vicarious liability acknowledges that organizations—and principal-agent relationships more broadly—have the capacity to define their own social meaning, distinct from that ascribed to conduct by broader institutions of civil society.⁴⁷ A regime of vicarious liability emphasizes to an organization’s senior management the importance of effectively translating the social meanings defined by broader society into the organization’s own norms.

An additional sense of social meaning might reflect the fairness of ascribing legal consequences to a particular person. Professor Dan Kahan argues that it is fair to “satisfy the public demand” for criminal punishment of corporate misconduct, even supposing that compensatory damages are sufficient to redress any injury, if the corporation has subordinated environmental protection to profits.⁴⁸ But surely fairness, as scholars of social meaning use the term, implies limits. Consider in this light the long-standing distinction drawn by federal law between vicarious liability for employees’ criminal misconduct and vicarious liability for punitive damages in civil litigation.⁴⁹ In contrast to the broad principle applicable to criminal misconduct, only high level complicity, or liability stemming from the act of a managerial agent, warrants vicarious liability for punitive damages. The level of generalized social disapproval is less for con-

Utility of Desert, 76 B.U. L. REV. 201, 211 n.40 (1996) (“[L]egal fictions can neither feel nor deserve moral condemnation; only people can.”).

46. Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 351 (1997).

47. A rich genre of first-person accounts of business behavior exemplifies this point. The financial services industry has generated memorable accounts written by authors no longer in the industry. These accounts incorporate exposés into narratives that also feature coming-of-age and personal confessional elements. See, e.g., MICHAEL LEWIS, *LIAR’S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET* (1989); FRANK PARTNOY, *F.I.A.S.C.O.: BLOOD IN THE WATER ON WALL STREET* (1997). *Liar’s Poker* is best known for its title incident, involving an offer of a \$10 million dollar bet on serial numbers on dollar bills between the CEO of Salomon, Inc. and one of its best bond traders. See LEWIS, *supra*, at 14-17. In *F.I.A.S.C.O.*, skeet shooting plays a large role in the author’s recounting of his experiences in the derivatives department at Morgan Stanley. See PARTNOY, *supra*, at 14, 99-108. Within the department, selling a derivative to a customer, when the derivative was structured to be more likely advantageous to the firm than to the client, was known as “ripping the client’s face off.” *Id.* at 61. Partnoy compares the firm to “a militia . . . a savage cult.” *Id.* at 91.

48. Dan M. Kahan, *Social Meaning and the Economic Analysis of Crime*, J. LEGAL STUD. (forthcoming 1998).

49. See *supra* text accompanying note 27.

duct that has not been criminalized, and the social meaning of civil litigation—even when directed at conduct generally viewed as odious—is less than that invoked by prosecution by the government. Substantive standards for the imposition of punitive damages tend to require a degree of malice or outrageousness, or at least of willful misconduct, that may tend in many instances to distance the defendant from the principal.⁵⁰ In contrast, by requiring that the agent have acted at least in part to benefit the corporation, the federal standard for vicarious liability for criminal misconduct ties the agent to the corporation.

Vicarious liability thus reflects, in many ways, the principal's right and presumed ability to define meaning within the context of an agency relationship. The principal defines roles for agents and specifies the work that they are authorized to do, thus defining for the agent the acts that the principal will treat as its own. The principal's right to control the agent enables the principal to instruct the agent after the agent's role has been defined.⁵¹ In the agent's interactions with third parties, agency doctrines like apparent authority hold the principal to a reasonable interpretation of appearances that the principal has permitted or facilitated. The principal's vicarious liability is not boundless, however. Limitations on the principal's capacity to exercise control help explain the limits on vicarious liability.

C. The Boundaries of Control

A brief return to the facts detailed in the *Caremark* opinion is instructive. The court characterized the corporation as one with “a decentralized management structure,” including 7,000 employees and ninety branch operations.⁵² After the government began its investigation, Caremark took steps consistent with greater centralization.⁵³ It published a revised, centrally drafted guide and set of contract forms for employee interaction with physicians and instituted a

50. Professor Hart's treatment is illuminating. See Hart, *supra* note 2, at 56-59, reprinted in HART ESSAYS, *supra* note 2, at 43-47. Hart argued that when we ascribe legal consequences to a corporation, we are not treating it as a fictitious person. See *id.* at 57-59, reprinted in HART ESSAYS, *supra* note 2, at 44-47. We are, instead, drawing an analogy to a living person. See *id.* Courts must then assess the force of the analogy: “Judges . . . in a case-law system, have to decide how far the analogies latent in the law permit them to extend to corporations rules worked out for individuals when justice seems to demand it.” *Id.* at 57-59, reprinted in HART ESSAYS, *supra* note 2, at 47. By implication, Hart's approach does not limit the blameworthiness of conduct to natural persons, nor does it dictate any sharply-drawn distinctions between vicarious liability for criminal misconduct and for civil judgments and penalties. Hart's approach presupposes that an individual principal might justifiably be blamed for the acts of the agent. In other respects, the distinction between civil and criminal proceedings and consequences is not stable. See Carol S. Steiker, *Punishment and Procedure: Punishment Theory and the Civil-Criminal Procedural Divide*, 85 GEO. L.J. 775, 782-84 (1997). This lack of stability is not new. Ancient legal systems featured extensive overlaps between crime and tort, such that distinctions between them were often unnecessary. See James Lindgren, *Why the Ancients May Not Have Needed a System of Criminal Law*, 76 B.U. L. REV. 29, 56 (1996).

51. The right to give instructions on an interim basis is embedded in the legal definition of an agency relationship. See RESTATEMENT (SECOND) OF AGENCY § 1 (1958) (agent acts on behalf of principal, who has the right to control the agent).

52. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 962 (Del. Ch. 1996).

53. See *id.*

policy requiring regional office approval for each physician contract.⁵⁴ As it happens, employees evaded these control measures by having physicians execute the centrally furnished forms, which required physicians to perform specified services, all the while making it clear that payment from Caremark was in exchange for patient referrals and that the specified work need not be done.⁵⁵

Although Caremark's decentralized structure may have made it more difficult to control employee conduct, this practical consideration does not reduce the corporation's accountability for its employees' misdeeds. Decentralized management structures, in general, enable central management to set financially defined measures and goals for managers in operational units, and to determine whether the measures and goals have been met, well apart from detailed knowledge of operational matters. Decentralized operation does not redraw the corporation's legally relevant boundaries. In contrast, organizing business activity through separately incorporated entities has the presumptive effect of redrawing legal boundaries that specify the extent and scope of the duty to exercise control. Although the parent is accountable for its subsidiary's misdeeds if it authorizes and directs their commission, the subsidiary's distinct legal personality implies that the parent is not liable if it learns of wrongdoing on the subsidiary level but fails to exercise control to remedy the wrongdoing.⁵⁶ In this respect, the corporation's formally defined legal personality delimits the extent of its moral personality as well. But the boundaries of legal personality are not impermeable.

Suppose the parent corporation learns of subsidiary-level wrongdoing in which the responsible actor is a director of the subsidiary. If the parent affirmatively exercises its voting power to reelect the director, it has done more than fail to correct the wrongdoing. It has affirmatively acted in such a manner that the wrongdoing is likely to continue or be repeated. The parent has not

54. *See id.* at 963.

55. *See* Thomas M. Burton, *Fee for Service: Caremark Faces Heat for Paying Doctors Who Sent It Patients*, WALL ST. J., Nov. 11, 1994, at A1.

56. *See In re American Honda Motor Co. Dealerships Relations Litig.*, 958 F. Supp. 1045, 1051-52 (D. Md. 1997). In general, the parent risks liability for the subsidiary's tortious misconduct only when the parent has exercised intrusive operational control; the parent's capacity for domination, created by its stock ownership, does not suffice. *See* PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* § 6.02, at 114-15 (1987); *see also id.* § 10.02, at 187-91. The parent's liability is more likely in product liability cases and in cases in which successor liability concepts are applicable. *See* JOSÉ ENGRÁCIA ANTUNES, *LIABILITY OF CORPORATE GROUPS* 467-68 (1994).

Distinguished scholars find it curious that courts are so reluctant to hold a corporate parent liable for its subsidiary's obligations when the parent "possesses both the opportunity to control and the potential to share in residual earnings" generated by the subsidiary. *See* Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 5 (1994). Perhaps one explanation is that operations of a formally separate subsidiary, into which the parent does not intrude, might not reasonably appear to represent the parent or to import the parent's reputation into the subsidiary-level activities. The centrality of control to vicarious liability has been criticized in broader terms as reflecting factors that lack economic significance. *See* Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1265 (1984). The critique does not assign independent significance to the fact that the parties chose to structure their relationship in one manner rather than another, using generally available legal structures.

explicitly ratified the wrongful acts themselves, but it has affirmatively enabled the wrongdoer to retain the position in which the wrongful acts were committed. Depending on how widely knowledge about the wrongdoing is shared within the subsidiary, the parent may have communicated to those lower within the hierarchy that it is less than indifferent to wrongful conduct.⁵⁷

Questions about the boundaries of control are also relevant to the choice between rules that impose vicarious liability and rules that embody a negligence standard. Agency law differentiates among degrees of control: If a principal has the right to control the physical acts through which the agent carries out the work, the principal is vicariously liable for physical harms caused by the agent's negligence within the scope of employment.⁵⁸ In contrast, a more generalized right to control that does not encompass the specifics of the agent's execution of the work ordinarily does not make the principal vicariously liable for the agent's negligent physical acts.⁵⁹ If an organization does not have the right to control someone, like an independent contractor, the organization's duty is in most instances simply to use care in selecting the contractor.⁶⁰ An employer, however, has the right to control its employees' conduct in their discharge of work-related activity. A negligence standard for employer liability focuses energies on detecting and correcting employee misconduct but does not penalize the employer for misconduct that it could not be expected to detect, an expectation that weighs the costs of detection against the magnitude of the employee's wrong. Vicarious liability, in contrast, focuses energies on prevention, on systematic and proactive efforts rather than discrete reactions to specific known instances of misconduct.

A rule of vicarious liability obviates the need for courts to make difficult fact-specific assessments of whether the employer acted reasonably, leaving it to the employer to determine how best to control its employees' conduct. The need to assess whether a principal acted reasonably—and whether its overall message to its agents adequately conveyed directives to obey the law—places the court in a stance of official skepticism toward organizations, skepticism often warranted by the failure of organizational mechanisms to select and control agents. Likewise, in situations where vicarious liability blurs into direct liability—such as those in which the principal is subject to a nondelegable duty of

57. For a discussion of problems of organizational credibility in deterring misconduct, see Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 712-17 (1997).

58. See RESTATEMENT (SECOND) OF AGENCY § 243 (1958).

59. See *id.* § 250. A principal is, however, subject to liability for an agent's tortious misrepresentations that induce third-party reliance regardless of the principal's degree of control over the agent. See *id.* § 257. It is thus misleading to assert, as does one secondary authority, that a principal will not "[n]ormally . . . incur liability" for the torts of an agent unless the agent is an employee over whose physical actions the principal has a right of control. HAROLD G. REUSCHLEIN & WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* § 49, at 102 (2d ed. 1990).

60. See RESTATEMENT (SECOND) OF AGENCY § 213 cmt. d, illus. 1 (1958). Even though the principal does not have a right of detailed control over the actor's conduct, the principal is liable to a third party injured by the actor when the principal owes the third party a nondelegable duty of protection or care. See *id.* § 214.

care—the determination of how best to discharge that duty is left to the principal, not the court.⁶¹

The capacity to exercise control is also a determining factor in whether any particular association of people should be treated as an organizational principal for a wide range of legal purposes.⁶² If an association is so loosely structured that individual actors are not subject to control, it is hard to identify individual members' acts with the association, and the risk of liability for the organization may not be an effective deterrent to individual actors' misconduct.

Imposing vicarious liability on an employer may be most effective in achieving greater deterrence when the particular form of employee misconduct is amenable to clear definition and prohibition. The employer's ability to send a clear and unequivocal message depends on its ability to define the conduct to be prohibited. The *respondet superior* principle, which makes the employer vicariously liable for employee negligence within the scope of employment, reflects the employer's right—and presumed ability—to direct the employee's physical execution of the work. The employer defines the work and how it is to be done. The federal principle of vicarious liability for employees' criminal wrongdoing may likewise reflect the employer's ability clearly to prohibit violations of the law. Complex regulations, like those in *Caremark*, or legal prohibitions that are themselves less than clear, test the employer's ability to communicate a clear message and may well require more extensive reporting and control systems to achieve compliance.⁶³ For example, it might be necessary to

61. *See id.* When a principal owes a nondelegable duty of care, the principal is liable for injuries caused by the actor's failure to exercise care, regardless of the actor's relationship to the principal. Nondelegable duties usually arise as a result of the principal's relationship to the plaintiff or as a result of the inherently dangerous nature of the work. *See, e.g.,* Jackson v. Power, 743 P.2d 1376, 1383-84 (Alaska 1987) (hospital has nondelegable duty to plaintiff to ensure absence of negligence in provision of emergency room services even when emergency room is staffed by independent contractors, not hospital employees).

62. *See, e.g.,* American Society of Mechanical Engineers v. Hydrolevel Corp., 456 U.S. 556, 593 (1982) (Powell, J., dissenting) (observing that nonprofit membership association that set professional standards had "no chain of delegated authority, from stockholders through directors and officers, in the typical voluntary association . . . [in which] members . . . exercise a far less structured control than the stockholders and directors of a commercial enterprise").

63. Internal difficulties in communicating a clear message help explain why it is likely that "highly indeterminate legal standards—such as those based on 'reasonableness' or 'good faith'—will have a less direct impact on firm behavior than we would like to think." 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, 169 (1997).

The same point can be made with regard to employer liability for sexual harassment. Although sexual harassment that violates Title VII is not a crime of the employer, the evolving federal law reflects comparable questions about the effective scope of employer control. A majority of the Seventh Circuit recently reasoned that an employer's inability to convey a clear message regarding sexual harassment that creates a hostile working environment should warrant assessing the employer's liability under a negligence standard as opposed to a vicarious liability standard, even when the perpetrator was the plaintiff's supervisor. *See* Jansen v. Packaging Corp., 123 F.3d 490, 493-94 (1997), *cert. granted sub nom* Burlington Indus., Inc. v. Ellerth, 118 S. Ct. 876 (1998). Agreement on this point is not uniform among the circuits. When the supervisor occupies a high level in the organization, the Second Circuit holds the employer liable for the supervisor's creation of a hostile work environment if the supervisor used actual or apparent authority to further the harassment, or the existence of the agency relationship otherwise aided accomplishing the harassment. *See* Torres v. Pisano, 116 F.3d 625, 634

instruct employees to refer all instances that are even slightly open to doubt to an organizational actor whose incentives are differently defined, like a lawyer.⁶⁴ This route will be less effective to the extent the lawyer is captured by a problematic organizational culture.

Rationales supporting these examples of vicarious liability may overlap, but they are not identical. The *respondeat superior* principle is consistent with the fact that much negligence is the product of lapses, not of intentional decisions to act carelessly. The principal's vicarious liability reflects the principal's ability to prevent many lapses by monitoring its agents⁶⁵; monitoring often has the function simply of reminding the agent to be attentive, much like the electronic signals and messages emitted by many new cars.

In contrast, intentional wrongdoing, whether criminal or tortious, is not the product of lapses. Much intentional wrongdoing, of course, consists of agents' own frolics and detours, acts entirely outside the scope of the agency relationship. On occasion, though, as the prior discussion argues, the agent's intentional wrongdoing is nurtured by the principal's definition of incentives for the agent. The principal's definition of incentives for its agents explains much of the frequency with which agents, in an "excess of zeal,"⁶⁶ overstep the bounds imposed by the principal or by society more generally. Other forms of intentional misconduct may reflect agency relationships in which the principal has acquiesced in agents' misconduct, or might reasonably be perceived either to have acquiesced or to have been less than diligent in discouraging it. Vicarious

(1997). The Eleventh Circuit, however, requires a much tighter fit between supervisory authority and harassment. See *Faragher v. Boca Raton*, 111 F.3d 1530, 1537-39 (1997) (employer not liable when supervisor creates hostile work environment but does not threaten employee with retaliatory acts within supervisor's authority), *cert. granted*, 118 S. Ct. 438 (1997). See generally David B. Oppenheimer, *Exacerbating the Exasperating: Title VII Liability of Employers for Sexual Harassment Committed by Their Supervisors*, 81 CORNELL L. REV. 66 (1995).

64. Cf. *Langevoort*, *supra* note 63, at 158-59 (if definition of scienter attributed information in disparate managers' possession to firm, corporations wishing to avoid liability for securities fraud stemming from systematic biases that shape internal communication of information would have incentive to bring persons not subject to same biases into disclosure process).

Another possible limit is whether the agent's misconduct has left tracks that are susceptible of detection by the principal. This limit would exclude *attempted* misconduct, like an offer of illegal remuneration under ARPL, if it did not require or trigger review within the organization. The limit, termed the "company act" doctrine, is suggested by Chief Judge Posner in a recent dissent to a Title VII case. See *Jansen*, 123 F.3d at 494. The "company act" doctrine does not appear to give much weight to a principal's ability to discourage or deter wrongdoing by its agents, emphasizing instead the presence or absence of ability to detect wrongdoing once it has occurred. If broadly applicable, the doctrine would narrow the effect of well-entrenched agency doctrines like apparent authority. Apparent authority emphasizes whether the third party reasonably believed in an appearance that the agent had the right to do a particular act, and whether the principal is accountable for that appearance, but not whether in committing the specific act the agent has left tracks discernible to the principal.

65. See Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 SO. CAL. L. REV. 1739, 1760-61 (1996). Professor Schwartz observes that liability rules may be more effective in influencing conduct of institutional defendants "than in affecting the choices made by ordinary-people plaintiffs." *Id.* at 1763. An organization's capacity to monitor its agents explains why it may be more responsive to the risk of liability than are "ordinary-people defendants." See Steven P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 S. CAL. L. REV. 1705, 1737 (1996).

66. RESTATEMENT (SECOND) OF AGENCY § 8A, cmt. a (1958).

liability underscores for the principal the need to convey a suitably sharp message to agents.⁶⁷

In many instances, vicarious liability for an agent's intentional tort turns on the relative closeness of connection between the wrongful act and an instrumentality used for wrongdoing that is also essential to the interests of the principal's own enterprise, as well as the risk of harm that the instrumentality itself presents. Although outcomes applying the common law of agency to intentional torts vary noticeably among jurisdictions,⁶⁸ the principal's vicarious liability for its agents' fraud is fairly uniform and absolute, even when the agent acted to serve only his own purposes, so long as the agent's communications with the victim reasonably appeared to be authorized.⁶⁹ The agent's ability to communicate on behalf of the principal is essential for the agency relationship to serve the principal's interest. The telephone in the hand of the broker, like the gun in the holster of the police officer,⁷⁰ is essential to the advantage the principal anticipates through the agency relationship.⁷¹

An organization's incentives to mount a proactive effort to deter criminal wrongdoing are considerably buttressed by the Federal Sentencing Guidelines

67. This point helps explain one of the apparent puzzles in agency law. Many cases acknowledge that "boys will be boys," Oppenheimer, *supra* note 63, at 87, who bring into the workplace an inevitable human propensity "for fun-making and emotional flareup" that may result in injury to third parties as well as fellow employees, Carr v. Wm. C. Crowell Co., 171 P.2d 5, 8 (Cal. 1946). How, then, can one sensibly conclude that "the employer controls the workplace"? Oppenheimer, *supra* note 63, at 93. At least to some degree, the workplace seems inevitably and predictably always to be out of control. The answer is that the principal conveys messages to its employees and other agents about the types of behavior that are absolutely prohibited and those that are prohibited or not, depending—on the identity of the perpetrator, the identity of the victim, the risk of public notoriety, and so forth. The Supreme Court has recently emphasized the importance of interpreting workplace behavior contextually, not literally. "The real social impact of workplace behavior often depends on a constellation of surrounding circumstances, expectations, and relationships which are not fully captured by a simple recitation of the words used or the physical acts performed." *Oncala v. Sundowner Offshore Servs., Inc.*, 118 S. Ct. 998, 1003 (1998). The employer's conduct is an integral element in the "constellation of surrounding circumstances" that employees perceive and that influences their conduct.

68. Compare *Andrews v. United States*, 732 F.2d 366, 370 (4th Cir. 1984) (applying South Carolina law) (employer's liability for employee's intentional physical tort limited to circumstances in which employee's motivation was at least in part to serve employer's intents) with *Mary M. v. City of Los Angeles*, 814 P.2d 1341, 1344 (Cal. 1991) (employee may be found to have acted within scope of employment for *respondeat superior* purposes when employee's misconduct represented a risk typical of or broadly incidental to employer's enterprise, even though the act was malicious in nature and did not benefit employer).

69. See RESTATEMENT (SECOND) OF AGENCY § 257 (1958).

70. See *West v. Waymire*, 114 F.3d 646, 649 (7th Cir. 1997) (dictum that employer would have *respondeat superior* liability for tortious misconduct of police officer, even when officer acts on frolic of his own not intending to further goals of employer, when misconduct is aided by appearance of intimidating authority with which employer has invested officer).

71. It is unsurprising that courts differ in how they assess the closeness of the connection between the agent's wrong and the agent's actually or apparently authorized responsibilities within an organization. In particular, cases diverge in applying the common law of vicarious liability to employers when the employee has committed a sexual assault on a victim brought into physical proximity with the employee in a professional, advisory, or custodial setting. For recent examples embracing relatively broad standards for employer liability, see *Doe v. Samaritan Counseling Ctr.*, 791 P.2d 344, 346-47 (Alaska 1990), *Mary M. v. City of Los Angeles*, 814 P.2d 1341, 1344 (Cal. 1991), *Samuels v. Southern Baptist Hosp.*, 594 So. 2d 571, 573 (La. App. 1992), and *Marston v. Minneapolis Clinic of Psychiatry and Neurology, Ltd.*, 329 N.W.2d 306, 309-11 (Minn. 1982).

as they apply to organizations. The Guidelines provide for a reduction in penalties otherwise applicable, if the offense occurred “despite an effective program to prevent and detect violations of law.”⁷² Penalties will also be reduced if the organization reported the offense prior to an immediate threat of revelation or of government investigation, or if it cooperated fully in the investigation.⁷³ Under the Guidelines, whether an organization’s program is effective—despite its failure to prevent or detect any particular offense—turns ultimately on a number of situation-specific factors and, in general, on whether the organization exercised “due diligence in seeking to prevent and detect criminal conduct by its employees and other agents”⁷⁴ It is noteworthy that the Guidelines create a rebuttable presumption that the organization’s program was not effective if an individual “within substantial authority personnel” participated in the offense.⁷⁵ Such personnel “exercise a substantial measure of discretion in acting on behalf of an organization.”⁷⁶ In contrast, a program, however effective it may generally be, will earn no reduction if “an individual within high-level personnel of the organization” or of a unit with two hundred or more employees, or an individual responsible for administering a legal compliance program participated in, condoned, or was willfully ignorant of the offense.⁷⁷

The Guidelines, in short, deem a program to be ineffective if senior management (or the compliance officer) is complicit in the offense, and create a rebuttable presumption of ineffectiveness based on the complicity of personnel who are in positions that allow them to exercise significant discretion. Managerial complicity tends to suggest that the corporation’s formal documentation of its compliance program would be belied by reality within the organization.⁷⁸ Despite their emphasis on organizational compliance measures, the Guidelines do not assign any specific role to a corporation’s directors, or to any organization’s governing board. The *Caremark* opinion thus fills a noticeable gap.

72. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f), at 305 (1997).

73. See *id.* § 8C2.5(g), at 396. The incentive created by the Guidelines to report individual offenders may strain relationships within the organization, especially within organizations that previously ignored various employee misdeeds or limited sanctions to internal ones. See Richard S. Gruner, *Towards an Organizational Jurisprudence: Transforming Corporate Criminal Law Through Federal Sentencing Reform*, 36 ARIZ. L. REV. 407, 434 (1994). These strains may be more severe because the Guidelines create incentives to blame violations exclusively on low-level nonmanagerial employees. See *id.* In this respect, the Guidelines mirror the organizational tendency to pull credit upward while pushing blame downward. See *supra* text accompanying note 38.

74. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 app. note 3(k), at 381 (1997).

75. *Id.* § 8C2.5(f), at 395.

76. *Id.* § 8A1.2 app. note 3(c), at 380.

77. *Id.* § 8C2.5(f), at 395. The Sentencing Commission, which drafted the Guidelines, considered and rejected a proposal that a corporation should not be vicariously liable at all unless the offense implicated its senior management. See Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 238 (1993).

78. See John C. Coffee, Jr., *Does “Unlawful” Mean “Criminal”?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 229 (1991).

III DIRECTORS AS MONITORS

A. Duty Articulated in *Caremark*

The doctrinal contribution of *Caremark* is to assign directors an explicit function in the corporation's control of its employees and other agents, with regard to compliance with the law. Directors have a duty "to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists" ⁷⁹ If a director breaches this duty, under some circumstances the director may be liable for losses suffered by the corporation. ⁸⁰ The duty articulated in *Caremark* runs counter to a broad reading of the Delaware Supreme Court's 1963 opinion in *Graham v. Allis-Chalmers Manufacturing Co.*, in which the Supreme Court stated it knew of "no rule of law which requires a corporate director to assume, with no justification whatsoever, that all corporate employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities." ⁸¹ The court's opinion in *Caremark* articulates three separate justifications for concluding that *Graham*, read broadly, does not represent current Delaware law. ⁸² First, the Delaware Supreme Court has since *Graham* stated in several opinions "the seriousness with which the corporation law views the role of the corporate board." ⁸³ Second, the Delaware corporation statute imposes an ultimate supervisory role on directors, which necessitates relevant and timely information. ⁸⁴ Third, the penalties imposed by the Sentencing Guidelines, along with the corresponding opportunities for penalty reduction, would be taken into account by "[a]ny rational person attempting in good faith to meet an organizational governance responsibility" ⁸⁵ The *Caremark* opinion additionally, however, explicitly states a high threshold for directors' liability: "Only a sustained or

79. In re *Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996). As it happens, the duty stated in *Caremark* is comparable to the duty articulated by Professor William L. Cary in his 1974 critique of Delaware corporate law. See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 80 YALE L.J. 663, 684 (1974). I owe this reference to Ed Labaton.

80. A limiting circumstance is whether the director's breach constituted a proximate cause of the loss. See *Caremark*, 698 A.2d at 970 n.27. The proximate cause concept as applied to directors' breaches of duty has occasioned controversy. In *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993), the supreme court, reversing the court of chancery, held that for purposes of rebutting the presumption created by the business judgment rule that directors acted with due care, it was not necessary for the plaintiff to establish that an injury resulted from the directors' failure to act with due care. See *Cinerama, Inc. v. Technicolor, Inc.*, Civ. A. No. 8358, 1991 WL 111134, at *17 (Del. Ch. June 24, 1991).

81. 188 A.2d 125, 130-31.

82. *Caremark*, 698 A.2d at 970.

83. *Id.* The court refers specifically to *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994). Another illustration is *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("[W]e are satisfied that in the broad context of corporate governance, including issues of fundamental corporate change, a board of directors is not a passive instrumentality.").

84. See *Caremark*, 698 A.2d at 970 (referring to DEL. CODE ANN., tit. 8, § 141(a) (1991)).

85. *Id.*

systematic failure . . . to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”⁸⁶ In the Court’s view, a lower threshold might disserve shareholders as a class by reducing the likelihood that qualified people will agree to serve as directors.⁸⁷ This consideration is presumably not applicable to the corporation’s officers, or to officers who also serve as directors; nothing in the court’s opinion addresses either the duties to monitor assumed by officers or the liability threshold applicable to officers.⁸⁸

Caremark’s practical significance is likely to turn on the meaning of good faith in this context. Although the court’s elaborate opinion uses the term “good faith” frequently, sometimes italicizing the words for emphasis, the opinion does not define the concept.⁸⁹ The factual context in *Caremark* itself meant that the court lacked concrete occasion to consider the content of directors’ duties when the board becomes aware that the corporation’s control structure has not worked. During the government investigations, *Caremark* had an internal audit plan and employed Price Waterhouse as an outside auditor.⁹⁰

86. *Id.* at 971.

87. *See id.*

88. As it happens, federal criminal law supports the imposition of vicarious liability on managerial employees who had “a responsible share in the furtherance of the transaction,” even employees who attempted to prevent the violation. *United States v. Park*, 421 U.S. 658, 670 (1975) (quoting *United States v. Dotterwiech*, 320 U.S. 277, 284 (1943)). *Park* is discussed in *Coffee*, *supra* note 78, at 213-15.

89. The court uses “good faith” at one point as a term opposed to “rationality.” *Caremark*, 698 A.2d at 967. In articulating its formulation of the business judgment rule applicable to decisions made by directors themselves, the *Caremark* opinion states that the rule forbids judicial assessment of the substantive merits of the directors’ decision if it resulted from a process that was “either rational or employed in a *good faith* effort to advance corporate interests.” *Id.* at 967 (emphasis in original). One might interpret this sentence to protect subjectively well-intentioned decisions by directors that are made in an idiosyncratic, inexplicable, or illogical manner. The full import of this interpretation is underscored by the duty to exercise judgment in an informed manner. *See id.* at 970; *see also* *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985).

In any event, the scope of this aspect of the business judgment rule as articulated in *Caremark* appears at odds with cases in which courts do review the merits of directors’ decisions, even when the directors appear to have acted without a conflicting self-interest. For a recent example, *see Brane v. Roth*, 590 N.E.2d 587 (Ind. Ct. App. 1992) (directors of grain cooperative breached duty of care by failing to hedge long positions in grain). *See also* *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982) (in rejecting recommendation of litigation committee that derivative suit be dismissed, court observes that business judgment rule would not protect a “no-win” decision by directors that exposed the corporation to substantially augmented risk without an increased measure of potential gain). The astute reader will note that neither of these cases comes from Delaware. Delaware cases do, though, recognize that nonconflicted (*i.e.*, “disinterested and independent”) directors might be liable for a decision “so egregious on its face” that the test of business judgment cannot be met. *See Aronson v. Lewis*, 473 A.2d 805, 815 (1984).

For a recent (and rare) case finding that circumstances alleged in the pleadings met this standard, *see Rothenberg v. Santa Fe Pacific Corp.*, Civ.A. No. 11749, 1995 WL 523599 (Del. Ch. Sept. 5, 1995) (directors offered favorably revised terms under an exchange offer for debentures to debenture holders who had already bound themselves by tendering in response to an earlier and less generous offer; sole contemporaneous explanation offered by directors was “fairness to our investors”). To be sure, one could try to accommodate the business judgment rule as stated in *Caremark* to these cases by treating them as instances in which directors were insufficiently informed. That treatment strains the actual analysis in *Joy v. North* and *Rothenberg*, which has an unmistakably substantive focus.

90. *See Caremark*, 698 A.2d at 963.

The board's Ethics Committee received and reviewed a report from Price Waterhouse concluding that Caremark's control structures had no material weaknesses.⁹¹ Additionally, management reported the introduction of other compliance measures to the board, including the dissemination of a new ethics manual and the introduction of an ethics hotline.⁹² In contrast, if directors learn of flaws in the control system, or of misconduct that has occurred despite a well-designed system, what constitutes a good faith response from directors?⁹³ Is it consistent with good faith for directors to rely on management's assurances that the problem will be fixed without inquiring about the details? Does good faith require directors to demand that known violators be sanctioned?

Even if directors are unaware of specific failures in the control system's operation, *Caremark* leaves open questions about the content of directors' duties, questions going in particular to whether directors have a duty to look behind the corporation's formal control and compliance systems. Have the directors acted in good faith if, assured that an effective system is in place, they rely entirely on management to implement it? Must directors insist on periodic reporting about experience under the system to the board as a whole, or to a committee of the board? It is interesting in this light that the settlement of the shareholders' derivative suit, approved by the court in *Caremark*, mandated duties to be performed by the board's Ethics Committee on an ongoing basis.⁹⁴ In any event, many questions remain open. Their significance is underlined by the fact that determinations of good faith carry substantial collateral consequences for directors. If directors have not acted in good faith, an exculpatory provision in the corporation's certificate of incorporation will not shield them from liability,⁹⁵ and the corporation may not indemnify directors against expenses they incur in the unsuccessful defense of litigation when the directors' underlying conduct was not in good faith.⁹⁶

91. *See id.*

92. *See id.*

93. Indeed, if a director learns that a federal felony has been committed, the director commits the separate federal crime of misprison of felony if the director "conceals and does not as soon as possible make known the [commission of felony] to some judge or other person in civil or military authority under the United States . . ." 18 U.S.C. § 4 (1994). Mere failure to report or make the underlying felony known does not constitute concealment for purposes of misprisoning the underlying felony, which requires an affirmative step. *See U.S. v. Warters*, 885 F.2d 1266, 1275 (5th Cir. 1989). Thanks to Roger Goot for calling this possibility to my attention.

94. *See id.* at 972; *see also* *In re Metropolitan Life Derivative Litig.*, 935 F. Supp. 286, 290 (S.D.N.Y. 1996) (settlement of derivative litigation required action of independent Sales Practices Compliance Committee of board of directors "with duties and powers related to sales practices compliance"; corporation's internal Ethics and Compliance Department to be required to communicate directly with board committee).

95. *See* DEL. CODE ANN., tit. 8, § 102(b)(7) (Supp. 1996).

96. *See id.* § 145(a), (b). These subsections define the corporation's power to indemnify. The subsections have been held to limit the corporation's ability to expand rights to indemnify through bylaw or contractual provisions. *See Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87, 92-93 (2d Cir. 1996). In particular, the corporation lacks power to obligate itself to indemnify when the would-be indemnitee's conduct was not in good faith. By statute, though, the corporation may purchase director and officer liability insurance as to circumstances in which it would lack power to indemnify. *See* DEL. CODE ANN., tit. 8, § 145(g) (Supp. 1996). Although D&O policies appear not to contain a specific ex-

Questions of good faith aside, whether a system is adequate should reflect an assessment by directors of the risks created by the corporation's own incentive system. As argued above,⁹⁷ the corporation may define an incentive system for its employees that supersedes the practical effect of instructions the corporation gives its employees. Additionally, the corporation's incentive system may tempt some agile-minded employees to attempt to outwit any compliance system. By statute directors are charged with ultimate managerial responsibility within the corporation,⁹⁸ a charge that should encompass reflection on both the risks of wrongful conduct that the corporation's own incentives and structures enhance, and on the adequacy of the corporation's mechanisms for controlling such risks. Along the same lines, ultimate managerial responsibility should encompass reflection on the challenges to control, as created by decentralized operation.

Substantive questions like these often surface with a procedurally colored tinge created by the structure of shareholder derivative litigation. In particular, in Delaware directors enjoy by virtue of the business judgment rule a presumption that in making a business decision they acted in good faith, on an informed basis, and with an honest belief that the action taken was in the corporation's best interests.⁹⁹ When, as in *Caremark*, the plaintiff's claim is that the corporation suffered loss due to its directors' failure to monitor, the plaintiff would have the burden of showing that the directors lacked good faith "as evidenced by sustained or systematic failure . . . to exercise reasonable oversight . . ."¹⁰⁰ In Delaware, the shareholder's derivative action would be dismissed if the plaintiff has failed to make a prior demand on the board that it take action, unless the plaintiff makes factually specific allegations that suggest a substantial likelihood that the directors are liable.¹⁰¹ Nor is the plaintiff entitled to take discovery to enrich the factual particularity of the complaint to surmount the demand hurdle.

clusion for claims arising from conduct not in good faith, policy coverage that reimburses the corporation for indemnification payments is limited to payments that are required or permitted by applicable law. See also *supra* note 15.

97. See *supra* text following note 20.

98. See, e.g., DEL. CODE ANN., tit. 8, § 141(a) (1991). *Caremark* explicitly encompasses directors within the corporation's control structure; as an employer, or principal, the corporation is a gatekeeper that supports its employees' activities. See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 55-56 n.6 (1986) (noting that control over employees' incentives is a powerful device to deter misconduct).

99. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

100. *Caremark*, 698 A.2d at 971.

101. See *In re Baxter Int'l Shareholders Litig.*, 654 A.2d 1268, 1269-70 (Del. Ch. 1995). If the plaintiff instead alleges that events associated with the misconduct injured the shareholders individually, other challenges await the nonderivative—that is, the direct—action. For example, if directors have not been candid in their disclosures to shareholders, damages are available "only in circumstances where disclosure violations are concomitant with deprivation to stockholders' economic interests or impairment of their voting rights." *Loudon v. Archer Daniels Midland Co.*, 700 A.2d 135, 147 (Del. 1997).

B. Reforming the Business Judgment Rule

This combination of circumstances is likely to strip the directors' duty to monitor of much practical significance, at least as an affirmative matter. Valuable though the business judgment rule is in many respects, in this context its presumptions create a hurdle that would only rarely be surmounted. Nonetheless, it is important to note the significance the duty to monitor may assume in the advice lawyers give their corporate clients. In an advisory context, the court's articulation of an affirmative duty to monitor lends substantial weight to counsel's recommendation to directors during the decisionmaking process.¹⁰² Some directors, though, may well ask what their actual risk of personal liability may be, an inquiry that makes salient the affirmative import of *Caremark*. To be sure, barriers to a successful derivative suit are not absolute. The plaintiff may pursue avenues other than discovery to obtain information and thus bypass the demand requirement. When the claim is that directors have failed to monitor, these routes may hold less promise than in other contexts.¹⁰³ The shareholder's statutory right to inspect corporate books and records is not likely to be of much assistance, for it is unlikely to yield information relevant to the directors' good faith in relation to monitoring.¹⁰⁴ Nor are reports filed with the SEC, often informative as to directors' self-dealing, likely to be useful. Even if the plaintiff somehow surmounts the demand hurdle, the plaintiff will still bear the burden of demonstrating the directors' lack of good faith.

Consider, however, an insight one might glean from the Federal Sentencing

102. Professor Rock argues that many Delaware opinions are written with this broader advisory audience in mind. See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 U.C.L.A. L. REV. 1009, 1095-96 (1997). Indeed, in advising their clients, lawyers may systematically tend to overstate legal risk. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997). Professors Langevoort and Rasmussen analyze the lawyer-client relationship as a quintessential agent-principal relationship in which overstating risk tends to serve the self-interest of the agent (the lawyer) to the detriment of the principal (the client). A moderately more charitable explanation for overstating risk is that the lawyer fears the client will ignore a more nuanced or modulated message, albeit one that more accurately assesses the legal risk. See *id.* at 415 (discussing "sharpening" a message to capture the client's attention). In particular, the lawyer may believe that the client (in organizational reality the human agent who interacts with the lawyer) will hear only what the client wants to hear, ignoring the qualifications or the bad news about limits and restrictions that accompany the good news about legal flexibility and permissiveness. Evidentiary doctrines reflect judicial awareness of the fact that clients may misremember, or only partially remember, what their lawyer told them. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 880 (Del. 1985) (court declines to find that advice purportedly given by lawyer was in fact given when defendant directors did not call as witness lawyer who gave advice at board meeting regarding proposed merger; court notes lawyer's firm participated in defense of shareholder lawsuit).

103. If, for example, a shareholder suspects the existence of a self-dealing transaction between the corporation and a director or controlling shareholder and seeks to challenge it, the corporation's accounting records will be helpful, as will be any report filed with the SEC pursuant to Regulation S-K, item 403, detailing the terms of the transaction. See generally 17 C.F.R. 229.403 (1998). Financial journalism may be a useful source of information as well.

104. The use of statutory inspection rights in this context is urged by *Rales v. Blasband*, 634 A.2d 927, 934-35 n.10 (Del. 1993). See also Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. REV. 69 (1997); Randall S. Thomas, *Improving Shareholder Monitoring and Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996).

Guidelines as they apply to organizations. The Guidelines deem an organization's compliance program to have been ineffective when the wrongdoing implicates a senior executive.¹⁰⁵ The Guidelines create a rebuttable presumption of ineffectiveness when a lower-level person with significant discretionary authority is complicit in the wrongdoing.¹⁰⁶ The Guidelines implicitly recognize that the effectiveness of compliance programs turns heavily on the discretionary decisions of managers, in particular decisions about whether to acquiesce in others' wrongdoing, and, short of that point, whether and how vigorously to investigate circumstances that appear problematic but may have an innocuous explanation. More broadly, senior management has the opportunity to define for the organization the meaning that will be ascribed to particular conduct. Corrupted by its own participation, management is not likely to be vigilant in detecting and addressing the wrongdoing of others. Nor is complicit senior management likely to be candid in its relationship with noncomplicit directors.

With moderate reworking, the business judgment rule would apply better to the duty to monitor that *Caremark* articulates for directors. If the plaintiff alleges facts demonstrating a sufficient likelihood of senior management's complicity in criminal wrongdoing, the presumption that directors acted in good faith should be inapplicable.¹⁰⁷ Instead, the directors should have the burden of establishing their good faith, and the plaintiff should be excused from making a demand on the board.¹⁰⁸ In the suit, directors might well be able to establish that they acted in good faith. But a presumption of good faith is inappropriate when senior management is complicit in criminal wrongdoing. Presumptions as a general matter usually reflect the difficulties of proving that a probable event in fact occurred.¹⁰⁹ If senior management is not complicit in the wrongdoing, it is probable that the corporation's directors acted in good faith, most likely re-

105. See *supra* text accompanying note 77.

106. See *supra* text accompanying notes 75-77.

107. If members of senior management have been indicted, the plaintiff by alleging that fact in the complaint would demonstrate a sufficient likelihood of complicity for this purpose.

108. Recent Delaware authority couples the demand requirement to the "powerful presumptions of the business judgment rule . . ." See *Rales*, 634 A.2d at 933.

Unlike Delaware, some jurisdictions require a prospective plaintiff to make a demand on the board prior to filing suit in all or virtually all instances. See, e.g., MODEL BUS. CORP. ACT § 7.42 (1984). Once the plaintiff makes the demand, the board may appoint a committee of directors to conduct an inquiry; if the committee "has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based" that maintaining the derivative suit is not in the corporation's best interests, the court must dismiss the suit. *Id.* § 7.44(a). If a majority of the board consists of independent directors at the time of the court's determination, the plaintiff has the burden of showing that the committee failed to conduct a reasonable inquiry in good faith. See *id.* § 7.44(d). A director does not lack independence for this purpose solely because the derivative suit names the director as a defendant. See *id.* § 7.44(c)(2). In this formulation, the concept of good faith does substantial work. The official comment defines "good faith" subjectively, to mean "honestly," quoting *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 800 (E.D. Va. 1982) (inquiry goes to "the spirit and sincerity with which the investigation was conducted, rather than the reasonableness of its procedures or basis for conclusion").

109. See 2 JOHN W. STRONG ET AL., MCCORMICK ON EVIDENCE § 343, at 580 (4th ed. 1992). For example, official actions by public officers are presumed to have been regularly and legally performed. See *id.* at 581.

lying heavily on senior management to transmit the appropriate message downward into the organization and to assure the efficacy of internal systems to detect and address wrongdoing. That directors acted in good faith is less probable when senior management is complicit in the wrongdoing. Directors are more likely to have been cavalier about compliance, or to have deferred to senior management's autocratic assertion of an entitlement to unquestioning deference, or have retained senior management once danger signals appeared. While the failure to ask questions and require satisfactory answers falls short of ratification of the underlying misconduct, it exemplifies conduct that may well not be in good faith.¹¹⁰

Allocating the burden to establish good faith to directors in these circumstances also emphasizes the inappropriateness of relying on the mere fact of the corporation's formal compliance system, or deferring to autocratic senior management, when directors themselves know that all is not well on the legal compliance front.¹¹¹ A powerful analogy may be drawn to directors' affirmative duties of vigilance and inquiry in fulfilling periodic disclosure obligations created by the federal securities laws. Directors who learn of serious misconduct by senior management—such as concealing a fraudulent self-dealing transaction—have a duty to take immediate action that effectively protects the interests of the corporation's investors.¹¹² Moreover, even in the absence of such specific knowledge of failure to disclose, a director who signs a disclosure document may rely on the company's procedures for determining the information that must be disclosed only when the director has a reasonable basis to believe "that those procedures have resulted in full consideration of those issues."¹¹³ If the disclosure in question concerns a dominant senior executive or the executive's close associates, greater attentiveness by other directors to the disclosure of those individuals is advisable.¹¹⁴

IV

CONCLUSION

The intellectual underpinnings of agency, along with its doctrinal consequences, are unifying elements among many otherwise disparate bodies of law. The principal's position within an agency relationship enables it to define a private system of meaning for the agent and for third parties who interact with the

110. See RESTATEMENT (SECOND) OF AGENCY § 91 (1958) (to ratify agent's unauthorized conduct principal must know material facts).

111. Directors' general right to rely on the advice and recommendations of officers, employees, committees, and persons external to the corporation is a right of good faith reliance, not absolute reliance. See DEL. CODE ANN., tit. 8, § 141(e) (1991); see also MODEL BUS. CORP. ACT § 8.30(c) (1984) (reliance not in good faith when director has knowledge that makes the reliance unwarranted).

112. See *In re Cooper Cos.*, Exchange Act Release No. 35,082 [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,472, at 86,065 (Dec. 12, 1994).

113. *In re W.R. Grace & Co.*, Exchange Act Release Nos. 39,156 & 39,157, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,963, at 89,897 (Sept. 30, 1997).

114. See *id.*

agent, a system that ascribes meaning to the agent's acts and to the principal's statements and other expressive conduct toward the agent and third parties. Agents who commit crimes in connection with the roles that their principal has defined for them may do so because the principal's incentive system has structured the agent's perception of self-interest to a degree that it supersedes the force of any instructions from the principal to obey the law. The incentive system, that is, transforms the principal's communication overall into a message that might be very different from the message the principal intended to convey. The same phenomenon explains many instances of the intentional tort of fraud committed by agents. The principal's ability to define its agents' incentive structures, and otherwise exercise control over agents, is a principal justification for imposing vicarious liability on a principal for its agents' wrongful acts, and a justification with unifying force among the varying circumstances that are relevant to the imposition of vicarious liability in particular circumstances. This justification, however, is subject to a number of limiting principles, among them the fact that the principal's right and capacity to exercise control are bounded, not limitless.

Agency provides a useful framework within which to view corporate governance. The underlying question raised by *Caremark* is whether—or the degree to which—directors should be treated as integral to the corporation as a principal in its relationships with employees and other agents. By assigning directors an explicit function in the corporation's exercise of its duty as a principal to control its employees and other agents, the *Caremark* opinion fills an otherwise embarrassing gap in the legal doctrine of corporate governance.¹¹⁵ Directors who monitor in good faith should consider the likely impact of the corporation's incentive system on its agents' conduct. The efficacy of the duty articulated in *Caremark* is however, vulnerable to the rigidities of the business judgment rule as it shapes derivative litigation. The pitfall of a duty to monitor that is largely aspirational is that the duty is likely to be taken seriously by directors who are suitably receptive to advice about their duties, but less likely to be taken seriously by directors who are not so inclined.

The principal's vicarious liability for the agent's misconduct is also compatible with viewing agency as a system of normative and linguistic meaning defined by the principal. Viewed in this light, the principal's vicarious liability for the agent's misconduct reflects the principal's right to control the agent, as well as, in many circumstances, the fact of economic integration between the agent's activity and the principal's interests. Vicarious liability compels the principal to accept responsibility for the agent's conduct. The principal is accountable for the agent's misconduct if it has not defined meaning for the agent with sufficient clarity, and the agent as a consequence misunderstands (or understands all too well) the overall import of the principal's instructions.

115. See also Principles of Corporate Governance: Analysis and Recommendations § 4.01 cmt. to § 4.01(a)(1)-(a)(2) cmt. c, at 164-68 (1994) (articulating principle that directors have an affirmative duty to monitor compliance with law).