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VICARIOUS AND CORPORATE CIVIL LIABILITY

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Abstract

Vicarious liability is the strict liability of a principal for the misconduct of her agent. This chapter reviews six areas of commentary on vicarious and corporate civil liability. It begins by formulating the standard case for vicarious liability based on the likely insolvency of the firm's culpable agents in the face of massive liability for business torts. Next, it addresses cost considerations that militate against imposing vicarious liability on the corporation in some circumstances, and the relationship between corporate liability the structure of liability imposed on corporate agents. Two additional sections of the article review alternatives to traditional vicarious liability regimes, including alternative liability rules for corporate principals (notably a negligence rule) and alternative targets for liability besides the firm (notably top corporate managers). Finally, the chapter reviews recent literature on the distinction between corporate civil and criminal liability. It concludes that the case made out thus for distinguishing between these too forms of corporate liability is weak.
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1. Introduction

'Vicarious liability' is the absolute liability of one party - generally the legal 'principal' - for misconduct of another party - her 'agent' - the actor whose activities she directs. As such, traditional vicarious liability is a form of strict secondary liability, in contrast to secondary liability imposed on principals or other parties under a duty-based standard such as negligence. In the common law, the legal doctrine of *respondent superior* is the principal vehicle for holding principals liable for the torts and other delicts of their agents. Under this doctrine, principals are jointly and severally liable for the wrongs committed within the 'scope of employment' by agents whose behavior they have the legal right to control ('servants') (Restatement (Second) of Agency, 1958, §§2, 219, 220, 229).

Most corporate liability for torts, and in the United States for crimes as well, is vicarious liability imposed under *respondent superior* or a similar doctrine.

To be sure, corporate liability may also be direct, as when the independent actions of several corporate agents cumulatively result in a business tort, although no single agent is individually culpable. But even in this case, the liability of corporate principals is best conceptualized as vicarious liability for the failure of the firm's management to supervise its employees.

An overview of the literature on vicarious and corporate civil liability must address at least six areas of commentary: (a) the standard case for strict vicarious liability; (b) the factors militating against vicarious liability; (c) the interaction between vicarious liability and the structure of liability for agents; (d) alternatives to a strict vicarious liability standard; (e) alternative targets for vicarious liability; and (f) the choice between civil and criminal corporate liability.

2. The Standard Case for Vicarious Liability

The initial issue raised by a regime of vicarious liability for torts is the Coasian question: why should an allocation of liability between principals and agents matter if these parties are able to reallocate liability among themselves by agreement? The fundamental analysis of vicarious liability, developed with the aid of principal-agent models by Kornhauser (1982) and Sykes (1981, 1984), looks to the insolvency of agents and to limitations on the ability of the parties to shift liability as the basic conditions favoring vicarious liability. As a general matter, Kornhauser (1982), Sykes (1984) and Shavell (1987) agree that vicarious liability for ordinary torts is more likely to increase social welfare as the disparity between agent assets and the magnitude of prospective tort liability increases. By contrast, where tort liability would leave both principals and agents solvent and the costs of negotiating between principals and agents are slight, vicarious liability is likely to have few efficiency consequences (for example, Kornhauser, 1982, pp. 1351-1352; Sykes, 1984, p. 1241).

Given that principals can satisfy prospective tort liability but agents cannot, vicarious liability may or may not be efficient. Consider first the considerations that weigh in favor of vicarious liability when agents are insolvent but corporate principals are not.

To begin, vicarious liability is increasingly likely to be efficient as principals have greater ability to monitor or otherwise control agent risk-taking. The analysis is straightforward. Absent vicarious liability, personal liability gives insolvent agents insufficient incentive to take care, since they lack the wealth to pay tort damages (Sykes, 1981, p. 168; Shavell, 1987, pp. 170-171). Moreover, their principals have no incentive to urge greater care, since the only liability cost faced by principals (in the absence of secondary liability) is the wage cost of offsetting the expected liability of their agents. Thus, insolvent agents under a regime of purely personal liability will lead firms to take too little care and to initiate too much risky activity or misconduct. By contrast, principals who are vicariously liable and face the full expected cost of tort damages will seek to control their agents to ensure optimal precautionary measures.

The traditional doctrine of *respondent superior* is fully in accord with this analysis since it appears to tie vicarious liability explicitly to the principal's costs of monitoring or otherwise controlling employee behavior (Landes and Posner, 1987, p. 208). For example, agency law determines the principal's tort liability based not only on her capacity to monitor her agent's actions but also on her ability to contractually alter her agent's incentives, as when the scope of employment rules condition vicarious liability on whether the culpable agent acted, at least in part, to benefit his principal (Restatement (Second) of Agency, 1958, §228(1) (c)).

Apart from inducing principals to control agent misconduct through monitoring and preventive measures, vicarious liability can also force principals to internalize the costs of misconduct when agents are judgment-proof. In the private sector, at least, forcing firms to internalize the costs of misconduct that accompany their productive activity leads, other things being equal, to an efficient scale of production by bringing the private costs of production into line with the social costs (for example, Shavell, 1980; Kramer and Sykes, 1987, p. 286). Thus, even if corporate principals cannot control caretaking by agents, vicarious liability can ensure that they at least face the full expected costs of accidents or wrongdoing, and thus do not undertake too much risky activity - providing, of course, that their agents are also strictly liable for the underlying harms at issue (Polinsky and Shavell, 1993).

As Shavell (1987, pp. 173-174) notes, moreover, several other considerations favor a rule of corporate vicarious liability as well, especially when contracting between principals and agents is constrained and there are limitations such as solvency on the effective liability faced by agents. First, principals may be better informed than agents about accident risks, or better able to limit these risks by reorganizing the workplace. Second, principals - and particularly firms - may be better able to monitor and discipline agents than the courts. Thus, vicarious liability may be socially advantageous if principals are less likely than courts to err in reviewing agent conduct. Third, principals may be more attractive targets of liability as a consequence of what Kornhauser (1982, pp. 1370-1371) terms the problem of 'multiple agents'. That is, an outside plaintiff may find the task of determining which of a firm's many agents has caused a tort extremely costly, even when one of the firm's agents is clearly responsible. But if the firm faces liability, it may be able to locate and discipline the culpable agent - or, even if it cannot, it may be able to reduce tort costs through other means such as training programs or screening measures. Fourth, as most commentators acknowledge, shifting liability to principals under a vicarious liability rule is likely to reduce risk bearing costs, at least in the paradigmatic case where agents are risk averse or insolvent, principals are firms, and victims are risk-averse individuals (for example, Kramer and Sykes, 1987, p. 278; Chapman, 1996).

Finally, in addition to the justifications for vicarious liability resting on the assumption of rational, utility-maximizing actors, some commentators have proposed justifications based on limited or defective rationality, particularly on the part of corporate agents (for example, Croley, 1996; Schwartz, 1996a). In these accounts, defective rationality blunts the incentive effects of liability on wayward agents, much as insolvency, or external constraints on sanctions, limits the power of liability to deter agents in more conventional accounts of vicarious liability.

3. Factors Militating Against Strict Vicarious Liability

Although the standard considerations favoring vicarious liability make a persuasive case in many circumstances, they also point to several factors that militate against vicarious liability. Agents who are well capitalized, especially in relationship to their putative principals, are better left to bear full personal liability for business torts on both incentive and risk bearing grounds. As Shavell (1987, p. 174) argues, outside the conventional context of large enterprises and their employees, 'there is no natural presumption' about the comparative capitalization of principals and agents - or about the ability of principals to observe the loss avoidance behavior of agents. Imposing liability on principals who cannot monitor their agents is unlikely to reduce accident costs and, as Sykes (1984, p. 1249) notes, may actually decrease safety by lowering the expected liability of agents for their own negligence. Finally, most commentators agree that whatever the advantages of vicarious liability, it clearly increases administrative costs by including additional defendants in tort actions.

Even in the context of large firms, where the case for vicarious liability is generally strongest, it is arguably inappropriate under some circumstances. One example arises when senior managers intentionally release fraudulent information into the capital market in order to protect their jobs or secure personal benefits. As Arlen and Carney (1992) note, vicarious liability may have little deterrent effect when top managers charged with supervising the firm act on their own behalf in committing misconduct, particularly when these managers are in an end game because the firm faces likely bankruptcy. Further, the risk-bearing rationale for imposing liability on the firm rather than on its agents is weak for such self-conscious misconduct because managers can avoid risk of liability simply by refraining from making misleading statements. Finally, the firm liable for damages inflicted by its top managers on a subset of its own investors has perverse consequences. Absent strong evidence that such liability leads managers to monitor one another, its effect is simply to shift assets (net of litigation expenses) from one class of innocent investors to another.

Arlen (1994) also identifies a second circumstance in which holding firms vicariously liable for the intentional wrongdoing of agents can generate perverse incentives and increase enforcement costs. In cases where misconduct is difficult to detect, the firm may enjoy a comparative advantage over outsiders in monitoring for it. Yet the firm will not monitor optimally under a vicarious liability regime - and may not monitor at all - if the information that the firm acquires can be used to increase its own probability of incurring liability. The reason is straightforward: increased monitoring lowers the firm's expected liability costs by raising its ability to deter or prevent misconduct, but increased monitoring also raises the firm's expected liability costs by increasing the probability that, should misconduct occur, the firm will be held liable for it. Although Arlen (1994) directs her analysis to corporate crimes, the 'potentially perverse' effect that she identifies clearly extends to vicarious civil liability for torts that may be difficult to detect without monitoring by the principal.

A related observation, made in Arlen and Kraakman (1997, pp. 712-717), is that a credibility problem may arise where strict vicarious liability is used to induce firms to monitor or investigate misconduct. The nub of the problem is that, absent a commitment device such as reputation, firms may not have an incentive to actually monitor, or to investigate and report misconduct after it has occurred. While credible threats to implement these measures would deter misconduct, the measures themselves add nothing under a vicarious liability rule except enforcement costs and enhanced liability risks for firms. The danger, then, is that some firms may not be able to make credible enforcement threats - even if they intend to carry them out - because wayward agents rightly suspect that actually implementing these enforcement measures would be acting against interest. By contrast, an element of duty-based liability such as a negligence rule can assure the credibility of enforcement threats, just as it can overcome the perverse effects associated with traditional vicarious liability (Arlen and Kraakman, 1997, pp. 717-718).

Lastly, a novel set of problems associated with strict vicarious liability arises in the context of government bodies and certain non-profits that are not subject to ordinary market constraints. While the aims of inducing optimal caretaking, self-policing, and efficient risk-bearing arguably support vicarious liability for such non-market entities just as they do for business corporations, the argument for this liability rule based on the need to regulate activity levels does not (see Kramer and Sykes, 1987, pp. 278-283). It is simply unclear how cost internalization affects the scale of the non-market enterprise - it might yield too much or too little activity (Kramer and Sykes, 1987, p. 286). For this reason, a duty-based or negligence-based liability regime might be preferred to strict vicarious liability for non-market entities such as cities (Kramer and Sykes, 1987, p. 294) - just as it might sometimes be preferable for rival firms where perverse incentive and credibility problems are severe.

4. The Interaction between Principal and Agent Liability

An important question in the literature concerns the relationship between vicarious liability and the regime under which the principal's agent incurs personal liability. Vicarious liability is a form of strict liability: the principal is absolutely liable for the delicts of the agent *as if* the principal actually were the agent. Moreover, the agent and the principal share exactly the same liability: the principal simply steps into the shoes of the agent. Yet both of these dimensions of the traditional vicarious liability regime are open to challenge in many circumstances.

Consider first whether the agent and the principal should face the same liability. In the standard case where the principal is an enterprise, the agent is an employee, and the agent's actions trigger significant liability, a rule of vicarious liability generally makes the enterprise rather than the agent liable as a practical matter (Kraakman, 1984a; 1984b). At most, the culpable agent faces the loss of his job and the risk of losing limited assets in a civil lawsuit. Chapman (1996) argues that this shift from individual to enterprise liability protects firms from the agency problem of overcompliance that might otherwise arise as managers sought to reduce their risk of personal liability.

As Polinsky and Shavell (1993) observe, however, the opposite problem may also arise: the firm may not be able to administer private sanctions severe enough to induce its employees to take optimal care where the social costs of torts are large. Thus, it may be appropriate to not only sanction employees but to administer criminal sanctions such as fines and imprisonment, even when the firm remains liable for only civil damages. Polinsky and Shavell (1993) propose criminal liability for employees, then, not because employees are inherently blameworthy, but rather because their limited assets may insulate them from the contractual sanctions and civil suits at the disposal of firms. Of course, if the firm's agents become criminally liable, the firm must pay wages to compensate its employees for their greater liability costs and its own vicarious liability should be reduced accordingly. Failure to reduce the firm's liability in this fashion would distort its activity level and undesirably discourage consumption (Polinsky and Shavell, 1993, p. 241).

Next, consider whether firms and agents ought to face liability under precisely the same circumstances as they currently do under a traditional regime of vicarious liability. Polinsky and Shavell (1993, pp. 251-253) argue that vicarious liability may often be, in effect, underinclusive, because firms should be strictly liable for harms associated with their production processes while their employees ought to be liable only under a negligence standard. One argument offered by Polinsky and Shavell (1993) is that a negligence standard offers a stronger incentive for caretaking than strict liability does when agents are partially insulated from liability by limited assets. Other arguments for a negligence standard include its value in economizing on costly criminal sanctions such as imprisonment, and its potential value in limiting the risk-bearing costs of risk averse corporate agents.

A different issue associated with holding agents and principals liable in precisely the same circumstances arises when principals are vicariously liable for the negligence of agents - as distinct from facing strict liability for the underlying misconduct (as Polinksy and Shavell, 1993, propose). Because a negligence standard governs much of tort law, firms are often strictly liable for employee negligence under the traditional vicarious liability regime. But establishing the negligence of corporate employees who act deep within the enterprise may be extremely difficult without the assistance of the corporate principal itself. As Chu and Qian (1995) point out, this juxtaposition of corporate liability and monitoring leads to a familiar problem: vicarious liability gives the principal a powerful incentive to withhold monitoring evidence from the court precisely because the principal cannot be vicariously liable unless its agent is found negligent in the first instance. This effect parallels Arlen's (1994) analysis of possible perverse effects associated with vicarious corporate criminal liability insofar as it turns on the difficulty of detecting misconduct (here the agent's negligence) without enlisting the cooperation of the principal. If the corporate principal is made strictly liable for the harm regardless of the agent's negligence (as proposed by Polinsky and Shavell, 1993), the incentive of the corporate principal to withhold information about the negligence of its agents may be mitigated. Yet it will not be eliminated entirely as long as monitoring by the corporate principal increases the probability of corporate liability (Chu and Qian, 1995, p. 320).

5. Negligence and Composite Vicarious Liability Regimes

As the preceding discussion indicates, a traditional regime of strict vicarious liability is a relatively rigid rule that, in some circumstances, may fail to satisfy one or both of the fundamental objectives of tort law: providing for the internalization of tort costs and for the optimal regulation of precautionary measures. In most cases strict vicarious liability is congruent with a policy of forcing firms to internalize tort costs. In fact, when principals cannot monitor their agents' behavior, the only justification for vicarious liability is the internalization of tort costs and the concomitant regulation of activity levels. It is possible, however, that principals may be in a position to prevent some forms of misconduct that are not properly assigned to the marginal costs of enterprise production. In this case a negligence rule that imposes liability only when principals fail to take reasonable steps to prevent misconduct may dominate strict vicarious liability, precisely because such a rule does not charge the full cost of misconduct to the firm (Sykes, 1988, pp. 577-579).

In the more conventional case where tort costs are appropriately assigned to the enterprise, a chief drawback of traditional strict liability is the perverse monitoring incentive analyzed by Arlen (1994) and Chu and Qian (1995): that is, the risk that principals will not monitor their agents optimally because doing so might increase their risk of incurring vicarious liability. Here too, as was suggested in Section 3 above, a negligence standard imposing liability only on principals who fail to take reasonable monitoring steps is a natural solution to the risk of inadequate monitoring under a strict liability regime.

There are, however, important drawbacks to a regime of 'negligence-based' vicarious liability, as it is termed by Kramer and Sykes (1987, p. 283). For example, a negligence standard will not regulate activity levels efficiently by assuring that firms fully internalize the costs of their torts. In addition, a negligence regime is arguably poorly suited for inducing firms to undertake other kinds of measures to prevent misconduct - such as reorganizing production processes - that do not involve monitoring or affect the principal's risk of incurring liability.

In the case of intentional torts and crimes, Arlen and Kraakman (1997) discuss three types of 'mixed' liability regimes that are designed to induce corporate principals to undertake appropriate monitoring measures (and possibly to report agent misconduct as well) while simultaneously encouraging preventive measures and assuring that firms internalize the full costs of their agents' misconduct. The first type includes regimes that, through use immunity or privilege doctrines, attempt to insulate corporate principals from any increase in their probability of prosecution arising from their internal monitoring and investigatory efforts. An example is coupling strict liability for environmental harms with an environmental audit privilege, to ensure that firms retain their incentives to undertake such audits. The second type is a regime of strict liability with a variable sanction that declines to offset any increase in the expected liability that a firm would otherwise from monitoring for employee misconduct. Finally, the third type includes 'composite' regimes that combine a negligence rule to regulate corporate monitoring and investigation of misconduct with a residual element of strict liability to ensure that corporate principals adopt preventive measures and internalize the costs of agent misconduct. Here an example is the liability regime created by the US Federal Sentencing Guidelines for corporate crimes (see Arlen and Kraakman, 1997, pp. 745-752).

Arlen and Kraakman (1997) argue that the range of mixed vicarious liability regimes - extending from evidentiary privileges through adjusted sanction regimes to composite regimes - are increasingly costly to administer effectively but are also increasingly likely to satisfy the multiple enforcement objectives of a vicarious liability regime. To be sure, some commentators oppose any resort to a negligence standard to supplement strict liability (as is necessary in a composite regime) on the grounds that judicial error in administering the standard will inevitably create liability in excess of the social cost of misconduct (Fischel and Sykes, 1996, pp. 328-329). This effect, however, can be ameliorated by downwardly adjusting the composite liability regime's residual liability level.

It follows that the traditional American rule of strict vicarious liability is well-suited to the ordinary cast in which the costs of agent misconduct are appropriately charged to the principal and misconduct is unlikely to escape detection. Whenever one of these conditions fails, however, strict vicarious liability may be dominated by either negligence-based vicarious liability or a mixed regime that includes elements of both strict and negligence-based liability.

6. Reaching Beyond the Principal: Alternative Liability Targets

Traditional vicarious liability makes the legal 'principal' liable for her agent's torts. But other actors besides the principal may also be in a position to monitor safety precautions or thwart third-party misconduct: for example, senior managers within the firm who supervise lower-level employees; or the lawyers, accountants and underwriters who facilitate fraudulent public issues of securities. In fact, secondary liability (if not necessarily traditional strict vicarious liability) for the torts and delicts of primary wrongdoers is a common legal control strategy well outside the domain of principal-agent relationships.

In some cases, the secondary liability of parties other than the organizational principal or enterprise serves as a backstop for traditional vicarious liability. For example, Kraakman (1984a, 1984b) argues that the personal liability of corporate managers for garden-variety torts protects against the possible inadequacy of corporate assets to satisfy the firm's liability. Thus, in a reversal of the traditional justification for vicarious liability discussed above in Section 1, Kraakman (1984a, pp. 869-871; 1984b) suggests that most personal liability of managers for corporate torts should be understood as protecting tort victims against undercapitalized *firms* rather than agents, since well-capitalized firms invariably insulate their managers from liability through insurance or indemnification contracts.

In some cases, however, the law blocks the indemnification of managers for their own misconduct or extends liability for corporate misconduct to a broader circle of influential actors beyond the group of top managers, such as outside directors and accountants associated with companies. Kraakman (1984a, 1984b) describes this as a 'gatekeeper strategy' that is designed to augment potentially inadequate levels of liability imposed on the firm itself. Thus, just as vicarious corporate liability can enhance legal controls over judgment-proof agents, so in extreme cases the personal liability of corporate managers, directors, and even outside directors can partially offset the inadequacy of corporate liability.

In addition, the potential uses of secondary liability, whether civil or criminal, and the value of the gatekeeper strategy, extend well beyond the corporate enterprise. An important research agenda turns on identifying contexts where these liability strategies are or are not cost effective. Kraakman (1986) examines several considerations bearing on the costs and benefits of imposing secondary liability on a contracting party in order to deter or prevent the misconduct of the counter-party to the contractual relationship. The chief enforcement tool at the disposal of a private 'gatekeeper' is the power to withhold goods, services, or facilitation from a counter-party engaged in risky or suspect behavior, just as the principal's chief incentive device in the traditional agency relationship is the threat to fire an agent who engages in risky behavior. Moreover, whether gatekeeper liability is likely to prevent misconduct depends in part on the same considerations that contribute to an effective regime of vicarious liability, such as the assets and the expertise of the gatekeeper relative to those of the potential tortfeasor. But especially in the case of intentional misconduct, the efficacy of gatekeeping turns in large part on how easily would-be wrongdoers can contract around honest gatekeepers who withhold their services from suspect endeavors (Kraakman, 1986, pp. 66-74).

Several commentators have undertaken more particularized assessments of the costs and benefits of gatekeeper liability for individual classes of strategic gatekeepers. For example, Franzoni (1996) examines gatekeeper enforcement of tax laws through imposing liability on auditors. Choi (1998) offers a skeptical analysis of the costs and benefits of gatekeeper liability imposed on underwriters in the securities market. Jackson (1993) and Wilkins (1993) consider gatekeeper liability imposed on lawyers in the context of banking regulations.

7. Corporate Civil Liability versus Criminal Liability

The vicarious liability regime that accounts for most corporate liability in the United States makes no distinction between civil and criminal liability. It is well-accepted that when corporate agents commit crimes within the scope of their employment, firms can be criminally prosecuted on a theory of vicarious liability - just as firms are vicariously liable for the civil torts of their agents. Recent literature on vicarious liability, however, questions the value of imposing specifically criminal liability on corporate principals, as distinct from imposing vicarious *civil* liability for the criminal acts of corporate agents.

The critique of corporate criminal liability proceeds on several fronts. Fischel and Sykes (1996, pp. 322-324) point out that the specifically criminal sanction of incarceration is unavailable against corporations, and that the criminal law objective of incapacitating criminals though incarceration makes little sense in the context of corporate liability. Equally important, Fischel and Sykes (1996) argue, criminal sanctions are uncalibrated to the level of harm associated with crime, which may be appropriate to penalties imposed on individuals but is inappropriate to penalties operating on the corporate level.

Criminal penalties imposed on individuals for intentional crimes such as murder create little risk of overdeterrence: less murder is always better. But penalties imposed on the corporate level lack this character, precisely because they are corporate penalties. Corporations are, in Fischel and Sykes's (1996, p. 323) phrase, 'webs of contractual relationships consisting of individuals who ban together for their mutual economic benefit'. Corporate crimes typically involve actions committed by some corporate agents without the knowledge and approval of others. It follows that the primary function of penalties imposed on the corporate level is not to deter in the conventional sense but to induce firms to monitor their agents and prevent crimes: that is, the classic justification for vicarious liability (see Fischel and Sykes, 1996, p. 324; Parker, 1996). The baseline penalty imposed on the corporation, then, should be civil liability equal to the social cost of crime discounted to reflect its probability of detection.

A second critique of corporate criminal liability does not question penalty levels per se but asks: why prefer criminal penalties over equivalently scaled civil liability? The feature that arguably distinguishes criminal sanctions on the corporate level - social stigma and reputational loss - render these penalties less predictable and more costly than parallel civil penalties (see Karpoff and Lott, 1993; Khanna, 1996, pp. 1501-1512). Moreover, in most cases, the administration costs of criminal prosecution are likely to be larger than the costs of civil lawsuits by government agencies (Khanna, 1996, pp. 1512-1531).

In light of these multiple critiques of corporate criminal liability, the justification for vicarious criminal liability for corporate principals - or principals more generally - remains an important topic for future research. If no plausible justification can be found, the implications for law reform are clear: vicarious corporate liability should be decriminalized.

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