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# Corporate Compliance with the Law in the Era of Efficiency

Cynthia A. Williams

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# CORPORATE COMPLIANCE WITH THE LAW IN THE ERA OF EFFICIENCY

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*In this Article, Professor Williams identifies and criticizes a theory of law (the "law-as-price theory") that suggests a corporation can either conform to the law or violate it while accepting the known consequences (risking paying penalties), and that either choice is an acceptable means for a corporation to fulfill its obligations as a citizen, particularly with respect to regulatory law. Professor Williams identifies the growing influence of the law-as-price theory of law in legal writing, corporate law reform efforts and judicial decisions, including a decision by the Supreme Court, and criticizes its underlying assumptions and practical implications. The Article connects this criticism of the law-as-price theory of corporate law compliance to the corporate social responsibility debate, concluding that the theory is premised upon a view of the corporation that fails adequately to consider the public obligations and responsibilities of public corporations in today's society and economy.*

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## I. INTRODUCTION

Fifteen years ago, Professor (now Judge) Frank Easterbrook and Professor Daniel Fischel set out the following proposition about corporate law compliance: "Managers have no general obligation to avoid violating regulatory laws, when violations are profitable to the firm . . . . We put to one side laws concerning violence or other acts thought to be *malum in se*."<sup>1</sup>

That statement, asserted in a footnote, was elaborated upon only briefly, again in a footnote:

[M]anagers do not have an ethical duty to obey economic regulatory laws just because the laws exist. They must

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1. Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1168 n.36 (1982) (citations omitted).

determine the importance of these laws. The penalties Congress names for disobedience are a measure of how much it wants firms to sacrifice in order to adhere to the rules; the idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so.<sup>2</sup>

Easterbrook and Fischel's view of corporate compliance with the law, which I call the "efficient breach" view, has obvious intellectual connections to some aspects of law and economics and to the theory of efficient breach of contract, expanded to include efficient breach of public law.<sup>3</sup> While many people might view Easterbrook and Fischel's theory of "efficient breach of public law" as lacking a sound legal and political foundation, a more plausible view (but one that is also flawed) is that of "efficient investment in compliance." That view suggests the maximum amount of money a firm should invest in order to comply with the law is determined by the maximum penalty for violations of a particular law, since it would be economically inefficient to invest more in compliance than one risks in fines.<sup>4</sup>

In this Article, I argue that the conception of law underlying "efficient breach" is similar to the conception underlying "efficient compliance," and that both understate the significance of law in a similar way, treating vast realms of law as simply a pricing scheme or set of tariffs on behavior. I call the underlying conception of law, which I am criticizing in this Article, the "law-as-price" view of law,

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2. *Id.* at 1177 n.57.

3. A rudimentary definition of the "efficient breach of contract" theory is that one party should breach a contract and pay damages if that party finds another economic opportunity so profitable that she will still profit after breaching, paying damages to the first promisee, and entering into a contract with the second promisee. *See, e.g., Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 750 (7th Cir. 1988) (Posner, J.) ("Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee's actual losses."); RICHARD POSNER, *THE ECONOMIC ANALYSIS OF LAW* 118-20 (4th ed. 1992) (explaining that efficient breach of contract occurs when the breaching party will still profit after compensating the other party for its expectation interest).

4. *See* David L. Engel, *An Approach to Corporate Social Responsibility*, 32 *STAN. L. REV.* 1, 43-45 (1979). The efficient-compliance view sounds much more plausible than the efficient-breach view because corporate managers do need to make investment decisions about corporate law compliance, and one would expect them to be affected by the penalties risked by non-compliance in making these decisions. Still, I argue below, this notion of "efficient investment in compliance," while perhaps correct at the margins, is problematic over the vast range of regulatory law because in many instances such an approach may lead to substantial under-investment in compliance (as judged by the social costs of law violations when penalties are too low). *See infra* notes 380-87 and accompanying text.



and I assert that both efficient breach and efficient compliance theories of corporate law compliance derive in important (yet different) ways from the law-as-price conception of law. Under this penalty-driven approach to law, what is of paramount importance about law are the penalties, either because the penalties form the basis for determining whether to obey the law or not (efficient breach), or because they form the basis for determining the law's importance and how much money a corporation should spend on compliance efforts (efficient compliance). Moreover, under the efficient breach theory a corporation may purchase the "right" to violate the law by simply risking paying the penalty.<sup>5</sup> As was pointed out almost fifteen years ago by Professor Robert Cooter, however, this "perspective is blind to the distinctly normative aspect of law, viewing a sanction for doing what is forbidden merely as the price of doing what is permitted."<sup>6</sup> Cooter's point seems relatively underappreciated in the literature, though.<sup>7</sup> If anything, the tendency

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5. For instance, the recently proposed settlement of states' claims against the tobacco industry contains penalties of up to \$2 billion a year if the rates of teenage smoking do not decline by specified percentages (30% in five years and 60% in ten years). See Robert Langreth, *Accord Is No Match for Power of Nicotine*, WALL ST. J., June 23, 1997, at B10. Some critics are concerned that "the industry, which racks up sales of more than \$45 billion annually in the U.S. alone, might simply settle for paying \$2 billion a year in fines as a cost of doing business." *Id.* (citing John Garrison, Managing Director of the American Lung Association).

6. Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1523 (1984).

7. Cooter made his statement as part of a larger point about the distinction between prices and sanctions. He maintained that the legal perspective had missed some of the power of the economic perspective by failing to recognize that some sorts of legal instruments *should* price rather than sanction behavior when the underlying behavior is productive but is nonetheless imposing social costs (such as manufacturing industries that also produce pollution), just as the economic perspective had missed some of the power of the legal perspective by failing to understand the normative basis of law. See *id. passim*. This fuller notion of the price/sanction distinction has been developed more recently in writings by Professor John Coffee, who argues that tort law generally prices behavior while criminal law sanctions it, and that criminal sanctions ought not to be overextended (as he believes they have been) into vast realms of regulatory law where the underlying behavior is socially productive. 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 (1991) [hereinafter Coffee, *Reflections*]; John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—and What Can Be Done About It*, 101 YALE L.J. 1875 (1992) [hereinafter Coffee, *Paradigms Lost*]. Yet neither Coffee nor Cooter is saying that once statutes or regulations exist that establish standards of behavior and that include penalties for non-compliance, individuals and corporations can treat the penalties as prices and purchase the "right" not to comply. See John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 794 n.11 (1984) [hereinafter Coffee, *Litigation and Corporate Governance*] (stating that the legislative intent of most regulatory law is not to establish a tariff but to prohibit certain behavior); Cooter, *supra* note 6, at 1523.

to equate sanctions with prices has become more pronounced since Cooter's article was published.<sup>8</sup>

A corollary of the tendency to treat sanctions as prices is a distinctly voluntaristic approach to law: a theory that posits one realm of true "mandatory" law, establishing limits on behavior, and a separate realm of "voluntary" law, setting out suggestions of desired behavior and a pricing scheme for the "right" not to meet those suggestions. This theory was succinctly described by Professor Stephen Pepper in a recent article in the *Yale Law Journal*:

The *malum in se/malum prohibitum* distinction appears, in older garb, to formulate the difference between law as true prohibition (that is, the identification of conduct not to be tolerated) and law as cost (that is, the identification of conduct to be penalized in some legal fashion, but which the citizen is still free to choose to do).<sup>9</sup>

Examples of conduct Pepper identified as within the realm of "law as cost" that a citizen is "still free to choose to do" included violating Environmental Protection Agency regulations that established standards for industrial discharges of chemicals.<sup>10</sup>

A voluntaristic approach to law is not confined to these (and other) academic discussions in the pages of the nation's law reviews, however. Consider the following language from a recent opinion by Judge Douglas Ginsburg for the Court of Appeals for the District of Columbia Circuit concerning Federal Aviation Administration ("FAA") sanctions for violations of air traffic control regulations:

The purpose of [making FAA sanctions publicly available] is obviously to give the public notice of what the law is so that each individual can act accordingly. Usually that means conforming to the law, but sometimes it means violating the law (or coming close and risking a violation) and accepting the known consequences of doing so—*especially where a regulatory rather than a moral or criminal norm is concerned*.<sup>11</sup>

The particular regulation at issue in that case was an air traffic safety regulation, indicating this is not a theory that proponents would

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8. See *infra* notes 125-226 and accompanying text.

9. Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 YALE L.J. 1545, 1576-77 (1995). Pepper ultimately concludes that most regulatory law is within the realm of law as cost. See *infra* text accompanying notes 106-24.

10. See Pepper, *supra* note 9, at 1576.

11. *Smith v. National Transp. Safety Bd.*, 981 F.2d 1326, 1328 (D.C. Cir. 1993) (emphasis added).

confine to record-keeping violations or to speeding on a deserted road in Nevada.

In this Article, I explore and criticize the "law-as-price" view of civil regulatory law. I argue that regulatory law should not be viewed as voluntary—not as something citizens are free to choose to ignore by accepting or risking the known consequences. As an aspirational theory about law, and about what we as members of society can expect from each other, the law-as-price theory is decidedly too thin. It both expects too little from its citizens, including its corporate citizens, and provides too much leeway for violations of the law under the rubric of important societal values such as "efficiency," "autonomy," or "the rule of law."<sup>12</sup> Law is functionally voluntary in the sense that each decision to follow the law is undertaken voluntarily, most often in private, and without the oversight of a personal police person requiring compliance and backing up that requirement with immediate state compulsion. But law is not voluntary in the sense advocated by the law-as-price view, at least not in any serious philosophical way. As members of society, we do not have the right to opt out of generally applicable laws or regulations by risking paying penalties, although we clearly have that power.

At the outset, though, it is important to ask whether the law-as-price view is even worth bothering to criticize. Easterbrook and Fischel's views, and those of Judge Ginsburg, are clearly extreme; surely few people would agree with the theory of efficient breach of public law. Moreover, at the time Easterbrook and Fischel first articulated their view, leading academics<sup>13</sup> and practitioners soundly rejected it under the auspices of the American Law Institute's Principles of Corporate Governance project (the "*ALI Principles*").<sup>14</sup>

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12. I will criticize this view in the specific context of corporate law compliance because that is the most interesting and important case to examine, particularly because it has long been recognized that corporate regulation essentially relies upon "corporate profit seeking under external legal constraints." Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 857 (1984). If the costs of violations of those external legal constraints can be treated as just one among many "factor" costs in the production of goods and services, then whether there is any effective corporate regulation is open to question.

13. See Coffee, *Litigation and Corporate Governance*, *supra* note 7, at 794 n.11 (stating that Easterbrook and Fischel's view misreads the legislative intent of most regulatory law, which is not to establish a tariff but to prohibit certain behavior); see also Cooter, *supra* note 6, at 1523 (criticizing scholars of the economics perspective for being blind to the normative value of law and suggesting a more balanced theory).

14. The American Law Institute (the "ALI") began its Corporate Governance Project in 1978. The project was intended to restate the law of corporate governance and provide recommendations for its future development. See Herbert Wechsler, *Foreword to AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND*

In 1982, section 2.01 of Tentative Draft No. 1, entitled "the Objective and Conduct of the Business Corporation," provided that "even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business[,] . . . is obliged, to the same extent as a natural person, to act within the boundaries set by law."<sup>15</sup> Mel Eisenberg, Chief Reporter for the *ALI Principles* since 1984 and Reporter for section 2.01, directly took issue with the Easterbrook/Fischel thesis in the commentary to section 2.01:

It is sometimes maintained that whether a corporation should adhere to a given legal rule may properly depend on a kind of cost-benefit analysis, in which probable corporate gains are weighed against either probable social costs, measured by the dollar liability imposed for engaging in such conduct, or probable corporate losses, measured by potential dollar liability discounted for likelihood of detection. This argument is premised on a false view of the citizen's duty in a democratic state. With few exceptions, dollar liability is not a "price" that can ethically be paid for

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STRUCTURE: RESTATEMENT AND RECOMMENDATIONS at vii, viii (Tentative Draft No. 1, 1982) [hereinafter Tentative Draft No. 1]. The final work product was not completed for 14 years. See AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) (as adopted and promulgated in 1992) [hereinafter ALI PRINCIPLES]. The Corporate Governance Project became both politically and doctrinally controversial, which is one reason the process was so protracted. See CHARLES HANSEN, A GUIDE TO THE AMERICAN LAW INSTITUTE CORPORATE GOVERNANCE PROJECT 1 (1995) (noting that after "fifteen years of effort and the production of seemingly countless drafts," the "final product is a mixed blessing"); Douglas M. Branson, *Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law*, 72 NEB. L. REV. 258, 262 n.10 (1993) (describing the "welter of controversy" surrounding the ALI project as "centered on the [political] right and captained by large law firm and in-house corporate counsel of *Fortune* 500 corporations"); William J. Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U. L.Q. 239, 239 (1988) ("The American Law Institute's . . . corporate governance project has generated the most heated debate in the history of that distinguished institution."); Lawrence E. Mitchell, *Private Law, Public Interest?: The ALI Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871, 872-73 (1993) ("The Principles lack a clear and coherent theory of the corporation. As a consequence of this failure, the Principles cannot, and do not, satisfy anyone.").

15. Tentative Draft No. 1, *supra* note 14, § 2.01. There were no significant changes in the language of section 2.01 between Tentative Draft No. 1 (1982) and Tentative Draft No. 2 (1984), unlike many other sections that were substantially revised between those two drafts. See *infra* text accompanying notes 129-82. Section 2.01 of the *ALI Principles* was adopted by the ALI in 1984. See AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 2.01(b) (Tentative Draft No. 2, 1984) [hereinafter Tentative Draft No. 2]; *Proceedings: 61st Annual Meeting*, 61 A.L.I. PROC. 511 (1984) (adopting section 2.01 of Tentative Draft No. 2, with technical amendments as discussed in the Proceedings, and subject to further consideration as necessary at a later date).

the privilege of engaging in legally wrongful conduct.<sup>16</sup>

Given that flat rejection, it may seem the theory has been fully repudiated in favor of a more encompassing vision of civic obligation and corporate social responsibility. That conclusion ought not be reached in haste. While few people would state the point as starkly as Easterbrook and Fischel have, nor even purport to agree with it as so stated, a diminished view of the moral compulsion of law seems endemic in recent legal writing and thinking, particularly in many "rational actor" accounts of law compliance,<sup>17</sup> and in various "positivist" or "libertarian" accounts of lawyers' ethical responsibilities.<sup>18</sup> Thus, for instance, in the *Yale Law Journal* article

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16. Tentative Draft No. 1, *supra* note 14, § 2.01 cmt. f. Section 2.01(b)(1), as finally promulgated by the ALI in 1992, contains the same black-letter language quoted above and very similar commentary. See *infra* text accompanying notes 49-67.

17. See Pepper, *supra* note 9, at 1600-01; see also Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1262 (1995) ("A rational actor will be deterred [from insider trading] only when the expected sanction associated with an offense exceeds the expected benefit."). In developing their model of the social value of disseminating knowledge about the actual likelihood of legal sanctions being applied, Bundy and Elhauge assume that legal actors are sanctions optimizers: "In deciding whether to engage in regulated conduct, the sanction optimizer is a Holmesian 'bad man' who considers only the actual level of expected legal sanctions and gives no independent weight to the fact that the conduct is legally prohibited or required." Stephen McG. Bundy & Einer Elhauge, *Knowledge About Legal Sanctions*, 92 MICH. L. REV. 261, 274 (1993). While Bundy and Elhauge recognize that some actors, whom they "characterize as 'law abiding,' tend to comply with what they understand to be their legal obligations regardless of the level of expected sanctions," the existence of this population does not enter into their model concerning when dissemination of truthful information about the law and probabilities of enforcement is a good thing. *Id.* at 275. For further discussion of rational actor accounts of law compliance, see *infra* notes 73-74.

18. Professor William Simon identified different models of lawyering in his article *The Ideology of Advocacy: Procedural Justice and Professional Ethics*, 1978 WIS. L. REV. 29, which he then modified in *Ethical Discretion in Lawyering*, 101 HARV. L. REV. 1083 (1988). As modified, Simon's typology draws a distinction between the "positivist/libertarian" approach and the "regulatory" approach to lawyering, with the libertarian lawyer seeking primarily to advance the client's individual goals, while the regulatory lawyer is more concerned with effectuating the substantive social ends of law. See Simon, *Ethical Discretion in Lawyering*, *supra*, at 1085-86. Advocates of the positivist/libertarian approach include Pepper and Joel Newman. See, e.g., Joel S. Newman, *Legal Advice Toward Illegal Ends*, 28 U. RICH. L. REV. 287 (1994) (arguing that lawyers providing accurate advice that helps a client violate the law ought not be prosecuted under canons of professional ethics, but prosecuted only if such advice could be interpreted as aiding and abetting the underlying violations); Pepper, *supra* note 9 (considering the multifaceted problem created for lawyers in providing accurate advice to clients that may lead the client to violate the law). Advocates of the regulatory approach include Robert W. Gordon and Richard W. Painter. See Robert W. Gordon, *Corporate Law as a Public Calling*, 49 MD. L. REV. 255 (1990) [hereinafter Gordon, *Corporate Law*]; Robert W. Gordon, *The Independence of Lawyers*, 68 B.U. L. REV. 1 (1988) [hereinafter Gordon, *Independence*]; Richard W. Painter, *The Moral Interdependence of*

quoted above, Pepper provided a sophisticated and nuanced analysis for practicing attorneys to use to determine how, and in which situations, to counsel clients about violating the law (while recognizing that this type of counsel vastly complicates the social structuring of behavior through law).<sup>19</sup>

In his article, Pepper asserted that three jurisprudential influences comprise the dominant American perspective on law today, and the perspective emphasized in American law schools. Those influences are: 1) a positivist separation of law and morality; 2) the notion that "law is at least as much a prediction of what officials with state power will do as it is verbal formulations that provide objectively determinable limits on conduct"; and 3) the process jurisprudence view, "emphasizing law as an instrument of private planning and structuring and deemphasizing law as limit."<sup>20</sup> Pepper recognizes that these jurisprudential influences are troubling in combination with a perception of the law as "merely indicating a potential cost, a penalty that one is free to incur and to discount by the probability of its enforcement."<sup>21</sup> And, he asserted, the reduction of law to a pricing scheme—the conflation of law as norm with law as potential cost—is substantially reinforced by law and economics, which perceives "legal limits and rules as just another 'cost' and clients as 'profit maximizers,' simply Holmes's 'bad man' dressed in modern clothes."<sup>22</sup> Pepper's analysis of the dominant jurisprudential conception of law, although perhaps overstated, describes a

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*Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507 (1994). For a middle position, see Jamie G. Heller, Note, *Legal Counseling in the Administrative State: How to Let the Client Decide*, 103 YALE L.J. 2503, 2504 n.7 (1994) (elaborating upon Simon's work and suggesting "full-picture" legal counseling to try to incorporate advantages of both libertarian and regulatory models). This Article is not directly concerned with the question of lawyers' professional responsibilities, but it does examine certain views of lawyers' professional responsibilities, particularly the "positivist/libertarian" approach, to explore the underlying conception of law inherent in those views. See *infra* text accompanying notes 105-24.

19. See Pepper, *supra* note 9, at 1599. Pepper does not necessarily embrace the Easterbrook/Fischel view of the law as a normative matter, but seemingly accepts it as a realistic description of the way people think about the meaning of law today. See *id.* at 1550-54; *infra* text accompanying notes 106-24.

20. Pepper, *supra* note 9, at 1552.

21. *Id.* at 1553.

22. *Id.* at 1553-54; see also Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) ("You can see very plainly that a bad man has as much reason as a good one for wishing to avoid an encounter with the public force, and therefore you can see the practical importance of the distinction between morality and law. A man who cares nothing for an ethical rule which is believed and practised [sic] by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money, and will want to keep out of jail if he can.").

conception that is much closer to the Easterbrook/Fischel position than it is to the ALI position.<sup>23</sup>

There is reason for interpretive caution with respect to the ALI position as well. As originally drafted, the exhortatory power of the general law compliance obligation of section 2.01 was complemented by other black-letter provisions that would have imposed specific, proactive fiduciary duties on the board of directors (and senior executive officers) to ensure that the corporation had a functioning law compliance structure, and to ensure that the corporation was being managed in accordance with its obligations under section 2.01 to obey the law.<sup>24</sup> Those specific fiduciary duties were immediately controversial, and were deleted or diluted in later drafts.<sup>25</sup> As ultimately adopted, the board's now-reactive law compliance obligations are relegated to comments to the black-letter law.<sup>26</sup> Other portions of the commentary on the *ALI Principles* suggest that the board can knowingly permit the corporation to violate some laws without causing much concern and without subjecting board members to full personal liability for damages to the corporation from those violations.<sup>27</sup> Thus, the ALI's ultimate seriousness about corporate law compliance bears further examination.

Moreover, in 1990, the American Bar Association Committee on

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23. I suggest this description is perhaps overstated because there may be no "dominant jurisprudential conception," but rather competing conceptions and various cross-currents of thought, such as critical legal studies, "new legal process" thinking, feminist jurisprudence, civic republicanism, liberal perfectionism, and the like, to name only a few candidates for potentially competing jurisprudential conceptions. Even within the realm of law and economics, which is the foundational theory in Pepper's description of the "dominant jurisprudential conception," there are current debates concerning expansions of and challenges to the rationality paradigm, *see, e.g.*, RICHARD H. THALER, *THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* (1992), and renewed attention being paid to the role of social norms in enforcement and deterrence, *see, e.g.*, Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996). *See generally* Gregory S. Crespi, *Teaching the New Law and Economics*, 25 U. TOL. L. REV. 713, 713 n.5 (1994) (reviewing recent articles that combine "classical" law and economics with more searching criticisms of the underlying normative assumptions of microeconomics). Yet it is undeniable that the paradigm Pepper describes is important, if not dominant, in how law is taught, and that law and economics has had a profound effect on the law and how we think about it. *See, e.g.*, ANTHONY T. KRONMAN, *THE LOST LAWYER: FAILING IDEALS OF THE LEGAL PROFESSION* 230-40 (1993) (arguing that law and economics has had a dominant and deleterious effect on how law is taught); Thomas S. Ulen, *Firmly Grounded: Economics in the Future of Law*, 1997 WIS. L. REV. 433, 434 ("Law and economics has been one of the most successful innovations in the legal academy in the last century.").

24. *See infra* note 129.

25. *See infra* notes 129-48 and accompanying text.

26. *See infra* notes 129-48 and accompanying text.

27. *See infra* notes 149-82 and accompanying text.

Corporate Laws (the "ABA Committee") revised the Model Business Corporation Act. I argue below that in its revisions the ABA Committee went even further than the ALI in undermining the notion that corporate compliance with the law is important.<sup>28</sup> Thus, in the Revised Model Business Corporation Act ("RMBCA"), the ABA Committee provided that corporations may fully exculpate members of their boards of directors for the costs to the corporation of even intentional violations of civil law.<sup>29</sup> In those revisions, and specifically in the "legislative history" thereto, the ABA Committee relied upon a central premise of the law-as-price theory: that criminal law is the only important mandatory law, and that intentional violations of civil law may not be problematic and may even be of social benefit in some instances.<sup>30</sup>

There is a more important reason, however, to examine the premises of the law-as-price theory of law: Both the "efficient breach" and the "efficient compliance" variants have started to have an effect on decided cases. This statement should not be interpreted to overstate the point. There are still very few decisions explicitly incorporating this normative view of what law is and what we can expect with respect to compliance. Almost all of them are authored by judges most influential in, or influenced by, conservative law and economics (such as Judges Richard Posner,<sup>31</sup> Frank Easterbrook,<sup>32</sup> Patrick Higginbotham,<sup>33</sup> and Douglas Ginsburg<sup>34</sup>), and so are unsurprising. Still, the potential of this jurisprudential approach to undermine society's ability to establish mandatory legal boundaries is profound, and therefore it is worthy of careful consideration. Moreover, in *Landgraf v. United Film Products*,<sup>35</sup> the Supreme Court was influenced by a variant of the law-as-price understanding of law,

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28. See *infra* notes 183-94 and accompanying text.

29. See *infra* notes 183-94 and accompanying text.

30. See *infra* notes 188-94 and accompanying text.

31. See, e.g., *Luddington v. Indiana Bell Tel. Co.*, 966 F.2d 225, 229 (7th Cir. 1992); cf. *Reyes-Hernandez v. INS*, 89 F.3d 490, 492 (7th Cir. 1996) (suggesting people rely on the level of sanctions in planning and conducting their lives).

32. Cf. *United States v. Shaw*, 26 F.3d 700, 701 (7th Cir. 1994) (rejecting reliance claim by deported, recidivist alien to 24 months jail time, versus 46 months, on the facts, while recognizing that Ex Post Facto Clause generally implies that "one may 'rely' on the maximum penalty when deciding whether to commit an offense").

33. See, e.g., *Landgraf v. USI Film Prods.*, 968 F.2d 427, 433 (5th Cir. 1992), *aff'd*, 511 U.S. 244 (1994).

34. See, e.g., *Branton v. FCC*, 993 F.2d 906, 911 (D.C. Cir. 1993); *Smith v. National Transp. Safety Bd.*, 981 F.2d 1326, 1328 (D.C. Cir. 1993).

35. 511 U.S. 244 (1994).



while rejecting a more normative understanding of legal obligation.<sup>36</sup> The jurisprudential underpinnings of that decision reveal a great deal about the way we think about law today and about the growing influence of law-as-price thinking.

For these reasons, then, it is important to examine this concept of law carefully, and map its influence to date. It is particularly important to examine it in the corporate context, in light of current public attention focused on at least some issues of corporate responsibility. If we cannot expect corporations to comply with the minimum standards of responsible behavior set forth in positive law when violations would be profitable,<sup>37</sup> nor expect them to orient their law compliance programs towards the substantive standards of the law notwithstanding penalties that are low or even trivial, then more refined discussions of corporate responsibility seem relatively pointless.<sup>38</sup>

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36. See *infra* notes 339-56 and accompanying text.

37. I refer to the law as setting forth "minimum standards" of corporate responsibility since many corporate actions that have potentially negative effects on society, communities, consumers, and employees are entirely legal. For instance, public attention has recently focused on the negative implications of cigarette companies heavily promoting smoking among teenagers, given that there is a 50% chance that the adolescent who takes up cigarette smoking permanently will die prematurely from smoking-induced diseases. See Regulations Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco Products to Protect Children and Adolescents, 60 Fed. Reg. 41,314, 41,318 (1995) (to be codified at 21 C.F.R. pt. 897) (proposed Aug. 11, 1995) (describing Food and Drug Administration ("FDA") findings of fact concerning restrictions on adolescent smoking). Until recent regulations promulgated by the FDA with respect to cigarette advertising, this promotional activity was legal. Indeed, it was required by the profit-maximizing norm: Because 82% of long-term smokers make the decision to smoke before age 18, see *id.* at 41,314, cigarette companies must appeal to these potential customers before age 18 to maintain their markets. Arguably, though, those actions are irresponsible from the perspective of society as a whole, or unethical from the perspective of the teenagers who became addicted to nicotine. See *infra* notes 426-30 and accompanying text.

38. See Christopher D. Stone, *Corporate Social Responsibility: What It Might Mean, If It Were Really to Matter*, 71 IOWA L. REV. 557, 559 (1986). In defining corporate responsibility, Stone concludes that at a minimum "it involves a *prima facie* obligation to obey the laws," and, beyond that, some institutional structure that provides the capacity for the organization to identify and reflect upon moral dilemmas. See *id.* One point that bears emphasis here, however, is that I am not suggesting that corporations in general do not make serious efforts towards law compliance; many, and perhaps most, do, depending in large measure on the corporate ethos of the individual corporation. See *infra* note 51 (listing sources). I am not even suggesting that the law-as-price theory actually plays an important role in the way decisions are made about obeying the law or instituting law-compliance systems in the real world. See *infra* note 396 (listing sources). Rather, the law-as-price theory is important as a theory about law compliance, even if it is incorrect about how these decisions are actually made, both because it has started to have an effect on decided cases and because it is illuminating how we as a society (or certain law professors within that society) think about law.

This Article proceeds as follows in examining these issues. In Part II and Part III, the Article describes some evidence of the law-as-price view in two different areas of legal concern: writing about law and corporate law reform efforts. Thus, in Part II, the Article describes a continuum of views about the meaning of civil statutes and regulations. First the Article describes the view of law held by the ALI Corporate Governance Project, at least as described in section 2.01, which actuates a "law-as-limit" view of law: that all law, including regulatory law, is to be understood as setting out mandatory standards of behavior, not a system of prices for the right to violate the law. Then the Article takes up the law-as-price view of Easterbrook and Fischel in more detail, which suggests a very narrow realm of truly mandatory law, coupled with a predominant realm of law-as-price, and advocates for deliberate, "efficient" breach of public law where it is profitable. Finally, the Article describes Pepper's intermediate view, which suggests that much of regulatory law can be understood as a pricing mechanism, rather than as establishing mandatory limits on behavior. In Part III, the Article describes actions of the ALI Corporate Governance Project and the ABA Committee on Corporate Laws that suggest a significant tempering of the law-as-limit view of section 2.01, and that, in some instances, suggest a view of law much closer to the intermediate view described above.

Having set forth some indication of the influence of these views of law on current thinking about law, this Article then turns to identifying its influence in the case law. Thus, in Part IV, this Article describes a number of decided opinions that reflect Easterbrook and Fischel's "efficient breach" theory. Part IV concludes with a criticism of the most extreme articulation of the "efficient breach" view of law, Easterbrook and Fischel's assertion that "managers not only may but also should violate the rules when it is profitable to do so," a view that also is strongly suggested in a number of Judge Ginsburg's opinions.<sup>39</sup> This criticism is in service of a larger point: that the "efficient breach" view of law undermines the social-structuring function of law in the realm of civil regulatory law, where we, in fact, need law most, and where we most need law to be understood as mandatory and as establishing behavioral limits.

Part V describes the Supreme Court's opinion in *Landgraf v.*

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39. Easterbrook & Fischel, *supra* note 1, at 1177 n.57. Judge Douglas Ginsburg relies upon a deliberate, "efficient breach" view of law in a number of his opinions for the Court of Appeals for the District of Columbia Circuit, particularly with respect to regulatory law. Those decisions are described in Part IV of this Article as well.

*United Film Products*<sup>40</sup> and its antecedents. In particular, this Article asserts that *Landgraf* incorporates the seemingly more plausible "efficient compliance" view of law that suggests the amount of money a corporation should invest in compliance with the law will be determined by the penalties for violations, rather than being determined by the level of investment necessary to meet the substantive standards the law sets forth. Section V concludes with an examination and critique of the implications of *Landgraf* and the notion of efficient compliance, and argues, in effect, for "inefficient" investment in corporate law compliance.

Finally, in Part VI, this Article connects these issues to the newly invigorated corporate social responsibility debate.<sup>41</sup> The work of both the ALI and the ABA Committee on Corporate Laws evidences the views of leading academics and practicing lawyers on the obligations of the corporation as a citizen and social actor, as exemplified by the seriousness with which those bodies treat the obligation of corporate boards and officers to ensure compliance with the law. Looking at the actions of those bodies from a critical perspective, one sees that law compliance is treated as a relatively unimportant part of the corporate governance equation. While this approach may make sense if one construes the corporation as wholly a matter of private concern for the purpose of generating private wealth, the concluding section of this Article suggests that this theoretical construction of the corporation does not comport with the realities of modern corporate power and concomitant responsibilities.<sup>42</sup>

Before beginning, though, one important caveat is in order. This Article is not an argument for why individuals or corporations have a *prima facie* obligation to obey the law, nor is it an analysis of the conditions under which legal systems command such obedience.<sup>43</sup>

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40. 511 U.S. 244 (1994).

41. See *infra* note 79 (describing the corporate social responsibility debate).

42. See Mitchell, *supra* note 14, at 872 (arguing that the ALI Principles failed to address whether the corporation is "the private domain of the stockholders or the subject of broader public concern").

43. Following the convention described by M.B.E. Smith, I refer to a *prima facie* obligation to obey the law, which Smith defines as follows: "[A] person S has a *prima facie* obligation to do an act X if, and only if, there is a moral reason for S to do X which is such that, unless he has a moral reason not to do X at least as strong as his reasons to do X, S's failure to do X is wrong." M.B.E. Smith, *Is There a Prima Facie Obligation to Obey the Law?*, 82 YALE L.J. 950, 951 (1973). The *prima facie* obligation to obey the law is not an absolute obligation, since it is well-recognized that the "right of the individual to dissent, to conclude that the obligation to obey is outweighed by other obligations, is the irreducible core of autonomy which authority can never invade." PHILIP SOPER, A

Those subjects have been developed in serious and thoughtful books by leading philosophers and students of jurisprudence.<sup>44</sup> Clearly those philosophical works provide the background assumption against which the law-as-price theory is being criticized: the law ought to be understood to impose a *prima facie* obligation to comply, even when unprofitable. But ultimately this Article has a more modest aim: to identify a way of thinking about the law that has been developed in the past fifteen years, to suggest evidence of the influence of that view in current thinking about the law and in the case law, and to criticize that view in the specific case of the corporation. It is inevitable that in writing about these subjects I brush up against the larger questions of political obligation, and it is also inevitable that the treatment of them here is cursory at best. Hopefully, the underlying project is important enough such that the inevitable simplifications of political theory will be forgiven.

As for nomenclature, the theory criticized here suggests that firms have a choice between meeting the standards of the law or deliberately violating the law and *paying* the penalties.<sup>45</sup> Yet this Article uses the phrase *risking* paying the penalties. There is probably not a single example in modern history in which a firm decided to discharge pollutants over regulated levels, for instance, and then immediately wrote a polite letter to the Environmental Protection Agency (the "EPA") enclosing a check for the penalties due; or churned securities accounts and then promptly "remitted the balance due and owing on all penalties thereby accumulated" to the affected securities owners' accounts and/or the government. These things do not happen,<sup>46</sup> in part because there are no clear and socially acceptable mechanisms for "paying the price" (since these are not, in fact, prices). Rather, part of the calculation to violate the law includes a calculation of the probability that the violation will go undetected; or if detected, that it will go unprosecuted for any one of

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THEORY OF LAW 77 (1984). I argue below that profit-maximizing does not suffice as a sufficient "other obligation" that may permissibly outweigh the *prima facie* obligation to obey the law. See *infra* text accompanying notes 227-93.

44. See, e.g., LON L. FULLER, *THE MORALITY OF LAW* (2d ed. 1969); H.L.A. HART, *THE CONCEPT OF LAW* (2d ed. 1994); DAVID HUME, *HUME'S MORAL AND POLITICAL PHILOSOPHY* (Henry Aiken ed., 1948); JOHN RAWLS, *A THEORY OF JUSTICE* (1971); SOPER, *supra* note 43.

45. See, e.g., Easterbrook & Fischel, *supra* note 1, at 1177 n.57; Engel, *supra* note 4, at 9; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1271 (1982); Pepper, *supra* note 9, at 1576-77.

46. Indeed, such consciousness of wrongdoing, and evidence of deliberate wrongdoing, would in many instances be the basis for imposing punitive damages in addition to compensatory damages and statutory penalties.

a plethora of reasons; or if prosecuted, that liability will not be established; or if liability is established, that the penalty will be lower than the profits obtained; or that the penalty will not be upheld on appeal in any event. Moreover, the probabilities at each of these stages can be, and in many cases will be, driven downward by actions by the corporation and the corporation's lawyers. So, although the theory may treat the question as one of "violat[ing] a law deliberately and pay[ing] the penalty,"<sup>47</sup> the reality is that of *risking* paying a penalty at best.

## II. THEORIES ABOUT THE MEANING OF LAW

### A. *Law-as-Limit*

One of the first debates engendered by the ALI Corporate Governance Project was with respect to section 2.01, "The Objective and Conduct of the Corporation." Crudely put, this was a debate between those who envisioned the corporation simply as an economic actor and those who envisioned it as both an economic and social actor.<sup>48</sup> The latter camp prevailed (at least in 1984), and in so doing articulated what I will call the traditional view of law-as-limit.

Thus, while subsection (a) of section 2.01 adopts wealth-enhancement as the primary object of the corporation, subsection (b) recognizes certain constraints on wealth-enhancement, including a mandatory obligation to comply with the law, a permissive power to take ethical considerations appropriate to the responsible conduct of the business into account, and a permissive power to make charitable contributions.<sup>49</sup> The law-compliance obligation of section 2.01(b)(1),

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47. Fischel, *supra* note 45, at 1271.

48. See 61 A.L.I. PROC. 421, 431 (1984) (statement of Dean David Ruder) (arguing against conception of the corporation as a social entity); *id.* at 454 (statement of Judge Jack Weinstein) (proposing that corporations ought to have social as well as economic responsibilities); *id.* at 454-55 (statement of Professor Melvin Eisenberg) (arguing that the purpose of the corporation is to make profits while acting "decently" towards employees and the community).

49. In its entirety, section 2.01 reads as follows:

Section 2.01 The Objective and Conduct of the Corporation

(a) Subject to the provisions of Subsection (b) and section 6.02 (Action of Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers), a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;

which is imposed on the corporation itself in favor of the shareholders, is distinct from any fiduciary duties owed by the officers or directors to the shareholders or the corporation, or duties owed by the corporation to the state or other third parties.<sup>50</sup> Rather, section 2.01(b)(1) imposes a new, specifically *corporate law* obligation on the corporation to obey the law, whether profits are enhanced thereby or not.<sup>51</sup>

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(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

ALI PRINCIPLES, *supra* note 14, § 2.01. Section 6.02 permits corporate directors to consider other constituents than shareholders (employees, consumers, the community) in deciding how to respond to unsolicited tender offers. *See id.* § 6.02.

50. *See id.* § 2.01 cmt. j (explaining that § 2.01 imposes obligations on the corporation itself, not its officers or directors); Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance*, 66 WASH. L. REV. 413, 471 (1991) (noting that under Tentative Draft No. 2, "[s]ection 2.01(a) imposes an obligation on the corporation itself, as distinct from a fiduciary obligation owed by corporate officers and directors" (footnote omitted)).

51. This invocation of an obligation placed on the corporation *qua* corporation, and not on the corporate agents, is interesting in its own right, and (to quote a Cravath litigator) "passing strange indeed." On one level, it may be an astute recognition that the corporation as an entity is more than just the sum of its parts, and that law compliance in the corporate entity requires organizational systems that act upon, and interact with, the individual corporate agents in a positive way to value, encourage, and reward following the law. On this view, corporate employees can be expected to respond to the corporate ethos and the law compliance systems that have been put into effect, so that the law compliance record of the corporate entity as a whole should be the focus of inquiry, not the law compliance record of individual employees, individual officers, or board members. *See generally* JAY S. ALBANESE, WHITE COLLAR CRIME IN AMERICA 82-84, 187-88 (1995) (examining enforcement and sentencing outcomes of regulatory offenses); MARSHALL B. CLINARD, CORPORATE ETHICS AND CRIME 91 (1983) (discussing middle-management's perspective on corporate ethics and crime); Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1124-25 (1991) (discussing studies of the "corporate ethos" of an organization and how that ethos affects law compliance within the corporation); Richard S. Gruner & Louis M. Brown, *Organizational Justice: Recognizing and Rewarding the Good Citizen Corporation*, 21 J. CORP. L. 731, 738 (1996) (discussing the impact of corporate compliance programs on law compliance and on firm performance). Indeed, the *United States Sentencing Guidelines* takes this approach in sentencing organizations. *See* U.S. SENTENCING GUIDELINES MANUAL § 8 introductory commentary (1995) ("Culpability generally will be determined by the steps taken by the organization prior to the offense to prevent and detect criminal conduct, the level and extent of involvement in or tolerance of the offense by certain personnel, and the organization's actions after an offense has been committed."). Conversely, this emphasis on the corporation *qua* corporation seemingly personifies the corporation apart from the individuals comprising it in a way that is quite inconsistent with much of modern corporate law scholarship. *Compare* William H. Simon, *Contract Versus Politics in Corporation Doctrine*, in *THE POLITICS OF LAW: A PROGRESSIVE CRITIQUE* 387, 389 (David Kairys ed., 1990) ("Much of the

In adopting the general law compliance obligation, the commentary and illustrations to the *ALI Principles* explicitly rejected the law-as-price theory of law.<sup>52</sup> The commentary suggests that while cost/benefit analysis may be proper when used by the legislature to make determinations about what the law should be, once that determination is made, "cost-benefit analysis [about] whether to obey the rule is out of place."<sup>53</sup> One example illustrating this antipathy to cost/benefit thinking about law compliance is a public trucking company with annual revenues of approximately \$5-7 million, which instructs its drivers to drive at seventy-five miles per hour (at a time when the speed limits were fifty-five miles per hour) because the relevant corporate decision-maker determines that this will increase the company's net earnings by \$400,000-\$500,000 annually.<sup>54</sup> The Reporter concludes, not surprisingly, that this decision represents a violation of section 2.01(b)(1).<sup>55</sup> Another illustration posits a manufacturing firm that is attempting to forestall unionization of its workforce, both by refusing to bargain with a newly elected union in some of its plants and by harassing supporters of the union in others.<sup>56</sup> The Reporter suggests that the corporate decision-maker knows that the conduct violates the National Labor Relations Act, but believes that a long time will pass before sanctions are imposed, and that the profits from operating a non-union shop will outweigh the ultimate sanctions. Again, not surprisingly, the Reporter concludes that this conduct involves a departure from the corporation's law compliance obligations.<sup>57</sup>

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modern history of corporation law has been preoccupied with a war against the naive view [personifying the corporation.]"), with Fischel, *supra* note 45, at 1273 ("A corporation . . . is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit."). One very practical implication of section 2.01's concept of corporate personality is that there is no possibility of corporate liability to the shareholders for a failure to meet the general obligation to comply with the law because the corporation cannot sue itself. Rather, an action for injunctive or other equitable relief is the only remedy for a violation of section 2.01. See *ALI PRINCIPLES*, *supra* note 14, § 2.01 cmt. j. It is unlikely that shareholders will have incentives to bring actions for purely equitable relief, since there would be no damages out of which to pay their attorneys.

52. See *ALI PRINCIPLES*, *supra* note 14, § 2.01 cmt. g ("With few exceptions, dollar liability is not a "price" that can properly be paid for the privilege of engaging in legally wrongful conduct."); *supra* notes 15-16.

53. *ALI PRINCIPLES*, *supra* note 14, § 2.01 cmt. g.

54. See *id.* illus. 10.

55. See *id.*

56. See *id.* illus. 8.

57. See *id.* Although this illustration is not surprising given the law compliance obligation of section 2.01, it probably sets a higher standard for corporate behavior than is generally observed in the marketplace, at least in some industries. The phenomenon of

Since the general law compliance obligation is comparable to the obligation of any individual to comply with the law, the commentary to section 2.01(b)(1) recognizes that there are certain limited instances in which compliance is not required, such as under the doctrines of necessity or desuetude.<sup>58</sup> But the commentary also shows that these concepts are to be construed narrowly. For instance, the commentary gives the example of a public utility that, despite diligent efforts, is unable to complete a modification of its plant in time to meet an air quality standard, where non-compliance would not threaten the health or safety of the community, and the only alternative to continuing to operate while the modifications are being made is a shut-down that would black out the community.<sup>59</sup> This example of necessity posits attempted compliance and assumes that ultimately the plant will be successful in meeting the air quality standards; it does not contemplate profit-maximizing calculations by a rational actor as the basis for non-compliance. Similarly, in describing the doctrine of desuetude, the commentary uses the illustrations of a retail clothing store in a major city that is open on Sundays, notwithstanding a local ordinance that prohibits stores from staying open on Sundays.<sup>60</sup> The illustration provides that “[t]he ordinance has fallen into disuse: it has not been enforced for many years; many retail businesses . . . follow a practice of staying open on Sunday; and community opinion favors the practice.”<sup>61</sup> The commentary concludes that this is not a departure from the

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“union busting” by engaging in just the kind of cost/benefit analysis the ALI decries is well known. As Pepper described it:

In labor law, lawyers specializing in the representation of management commonly suggest to employers wishing to fight a unionization effort or those attempting to “bust” an existing union that they violate provisions of the National Labor Relations Act (NLRA). . . . Adjudication by the National Labor Relations Board of allegations of unfair labor practices typically takes years, and the remedies are limited to back pay and reinstatement for specified workers who were the victims of the conduct. Once these facts about the law and its enforcement are laid before the employer, a simple cost/benefit analysis (frequently supplemented by the lawyer’s explicit recommendation) often leads the employer intentionally to violate the provisions of the NLRA.

Pepper, *supra* note 9, at 1592; see also Gordon, *Corporate Law*, *supra* note 18, at 260 (“[S]ince the late 1960s, company lawyers have helped managements break union organizing campaigns by such tactics as firing active organizers, stalling Labor Board action on complaints until the organizing drive is over, and then paying small fines, thus effectively nullifying the Wagner Act’s purposes of promoting fair elections and good faith bargaining.”).

58. See ALI PRINCIPLES, *supra* note 14, § 2.01 cmt. g.

59. See *id.*

60. See *id.* cmt. f, illus. 9.

61. *Id.*



Standards of section 2.01(b)(1).

As was remarked above<sup>62</sup> and has been extensively discussed elsewhere,<sup>63</sup> the ALI Corporate Governance Project was highly controversial, and early drafts were severely criticized by both the business community and academics within the law and economics movement.<sup>64</sup> As a result, there were dramatic changes between the black-letter law proposed in earlier drafts and that in the *ALI Principles* as ultimately adopted by the ALI membership in 1992. Section 2.01 emerged virtually unscathed in this process, though, as did its concept of the law-as-limit.<sup>65</sup> What changed dramatically,

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62. See *supra* note 14.

63. See, e.g., Coffee, *Litigation and Corporate Governance*, *supra* note 7, at 789-95 (describing different, conflicting strains of criticism of the ALI's initial drafts of the corporate governance project); Jonathan R. Macey, *The Transformation of the American Law Institute*, 61 GEO. WASH. L. REV. 1212, 1212-14 (1993) (variously describing the 14-year process of the corporate governance project as "bitter," a "battle," and an "epic struggle," and describing why ALI proposals that initially "reflected a deep hostility to the judgment and motives of corporate managers" were ultimately "modified significantly to reflect a somewhat more market-oriented point of view"); Mitchell, *supra* note 14, at 872 (asserting that during the 14 years that the *ALI Principles* were being written, corporate law debate evolved to question whether a publicly held corporation was the "private domain of the stockholders or the subject of broader public concern"; ALI failed to appreciate this change or reflect a coherent theory of the corporation). See generally Symposium, *American Law Institute's Corporate Governance Project*, 61 GEO. WASH. L. REV. 871 (1993) (presenting various arguments for the position that the ALI lost sight of the transformation of the law in doctrinal details); Symposium, *American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495, 495-871 (1984) (providing an overview of the Project).

64. In general, the earlier drafts were perceived by critics to have adopted more of an interventionist, lawyer-dominated model of corporate governance, mandating specific responsibilities for the board of directors, reducing the protection of the business judgment rule, and easing some of the burdens on plaintiffs and their attorneys bringing derivative actions and making those actions more difficult to dismiss. See HANSEN, *supra* note 14; THE BUSINESS ROUNDTABLE, STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (1983) [hereinafter BUSINESS ROUNDTABLE, STATEMENT]. The Business Roundtable is an organization composed of corporate officers of major Fortune 500 companies that promotes American business interests. See Macey, *supra* note 63, at 1213 n.5. Other observers disagreed with this assessment of the first draft: "[W]hen the substance of the ALI Principles of Corporate Governance is examined in detail, the criticisms appear thoroughly disproportionate to the modest, incremental changes proposed." Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 327 (1987).

65. The commentary rejecting the law-as-price view of the law was softened slightly between Tentative Drafts No. 1 and 2, however. Thus, Tentative Draft No. 2 has the following language added as compared to Tentative Draft No. 1:

These exceptions [to the norm of obedience to law, including necessity, desuetude, and breach of contract] are not exhaustive: for example, the de minimis principle applies here as elsewhere in the law, and there may be isolated

however, were the board's fiduciary duties and the enforcement mechanisms, including the potential for derivative liability, adopted to effect this concept of law and corporate responsibility.<sup>66</sup> At least in theory, though, the ALI concept of the law is a frankly normative one, rejecting the notion that the penalties for violating even the quintessentially regulatory, *malum prohibitum* laws, such as those establishing speed limits, can be treated simply as a cost of doing business.<sup>67</sup>

### B. *Law-as-Price*

Two of the most explicit academic proponents of the law-as-price view of law have been Judge Frank Easterbrook (formerly a law professor at The University of Chicago and now a judge on the Seventh Circuit Court of Appeals) and Professor Daniel Fischel. Easterbrook and Fischel recognize a narrow subset of laws that truly prohibit certain actions, a subset they would confine to violence and actions that are *mala in se*;<sup>68</sup> beyond that, their concept of the law is as a pricing mechanism, or tax upon various activities. Their concept of law incorporates the theory of "optimal sanctions," which assumes that "[t]he principal task in designing remedies is to establish the optimal level of violations."<sup>69</sup> Thus, "[t]he law establishes a price for the violation, and people then must decide how to respond to the schedule of penalties."<sup>70</sup> The major structural elements of their

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cases in which it is widely understood that liability is properly viewed as a price of noncompliance.

Tentative Draft No. 2, *supra* note 15, § 2.01 cmt. g. There is no elaboration upon, or examples of, those "isolated cases" in which liability is best understood as a price of noncompliance, nor was there any discussion of that language by the ALI membership.

66. See Part III.A, *infra* text accompanying notes 126-82 (discussing the change in fiduciary duties and enforcement mechanisms).

67. In addition to the ALI, there are a number of writers who rely upon a concept of law similar to the ALI's concept in their work on the ethical responsibilities of lawyers, and in particular who convey a normative sense of the meaning of law. See DAVID LUBAN, *LAWYERS AND JUSTICE* (1988); Gordon, *Corporate Law*, *supra* note 18; Gordon, *Independence*, *supra* note 18; Painter, *supra* note 18.

68. See Easterbrook & Fischel, *supra* note 1, at 1168 n.36.

69. *Id.* at 1156.

70. *Id.* at 1157. It is this view of penalties that was criticized so aptly by Cooter in *Prices and Sanctions*:

[A] sanction is a detriment imposed for doing what is *forbidden*, such as failing to perform an obligation. For example, a defendant in a tort dispute may be ordered to pay compensatory damages for an injury caused by his negligence, or a convicted criminal may be sentenced to jail.

In contrast, a price is payment of money which is required in order to do what is *permitted*. For example, a company may buy goods in the marketplace, but it must pay the seller's price. Similarly, individuals are permitted to earn

theory are those of conservative law and economics,<sup>71</sup> built upon a positivist jurisprudential foundation laid down by Oliver Wendell Holmes.<sup>72</sup>

One central tenet of Easterbrook and Fischel's view is that of rational-choice theory, which is also a central tenet of law and economics. Rational-choice theory is a general theory of decision-making.<sup>73</sup> It posits that people are rational, self-interested, utility maximizers using cost/benefit analysis to make decisions; it has been applied to numerous types of decisions, including decisions about obeying the law.<sup>74</sup> Further, rational-choice theory, as applied to law compliance, asserts that the costs of legal sanctions can be treated like prices in a theory of supply and demand affecting law compliance.<sup>75</sup> The law-as-price view of law is, in essence, rational-

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income, but obliged to pay taxes on their earnings.

These definitions of sanction and price are not always consistent with ordinary speech. Tax evasion is forbidden, but in casual speech people often say a fine is the price of tax evasion, when by these definitions it is a sanction.

Cooter, *supra* note 6, at 1524-25.

71. Thus, for instance, Easterbrook and Fischel are explicit about equating breaches of public law to "efficient" breaches of contract, a view of contract law developed by law and economics advocates: "Some antitrust violations are efficient, just as some breaches of contract are efficient." See Easterbrook & Fischel, *supra* note 1, at 1157.

72. See Holmes, *supra* note 22, at 458 ("But, as I shall try to show, a legal duty so called is nothing but a prediction that if a man does or omits certain things he will be made to suffer in this or that way by judgment of the court;—and so of a legal right.").

73. See Ulen, *supra* note 23, at 436. Rational-choice theory is a theory of decision-making that takes as its central premise the "economic man" of economic theory, "assuming that people behave as if they were purely rational calculators of their own gains and losses from alternative courses of action." JERRY L. MASHAW, GREED, CHAOS AND GOVERNANCE 3 (1997). Rational-choice theory has been used to examine a number of disparate types of human behavior: for instance, a quite-prevalent political theory today is called "public choice theory," which combines "mathematical deduction with some of the basic behavioral assumptions of micro-economics to produce theories of the behavior of voters, or representatives assemblies, or bureaucracies, and even of courts." *Id.* at 10.

74. See Ulen, *supra* note 23, at 442. Applying rational-choice theory to law compliance, Ulen asserts that rational, utility-maximizing criminals compare the costs and benefits of legal and illegal action by computing the expected benefits of illegal activity and the expected costs of the illegal activity (the probability of detection multiplied by the monetary value of the sanction that will be imposed, and the loss in reputation). If the expected benefits of illegal activity outweigh the expected costs, "the rationally self-interested criminal commits the crime . . . and refrains if the reverse is true." *Id.* This theory was first propounded in Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

75. As Judge Richard Posner has put this last point:

The Law of Demand doesn't operate just on goods with explicit prices. . . . The convicted criminal who has served his sentence is said to have "paid his debt to society," and an economist would find the metaphor apt. Punishment is, at least from the criminal's standpoint (why not from society's, *unless the punishment is*

choice theory interpreted not simply as a descriptive claim about how people respond to legal sanctions,<sup>76</sup> but as two, distinct normative claims.

The first normative claim is the one Cooter identified: that the sanctions for violating the law can be treated as the price to be paid for the "right" to violate the law.<sup>77</sup> Inherent in this view of law is the legal voluntarism claim: that particularly with respect to regulatory law, a person can either conform to the law or violate it while accepting the known consequences, and that either choice is an acceptable means for an individual or corporation to fulfill its obligations as a citizen. The second normative claim is that since people and corporations will, and possibly should, make decisions about compliance with law based on a "rational actor's" calculations of costs and benefits, their expectations about the likely outcome of violating the law or investing a certain amount in compliance ought to be recognized as settled expectations upon which they may legitimately rely.

Professor Daniel Fischel provided some greater amplification about the intellectual derivation of the law-as-price theory in an article in the *Vanderbilt Law Review*.<sup>78</sup> The article was published in 1982, at a time when there was a collision between the "Reagan

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*in the form of a fine?*), the price that society charges for a criminal offense. The economist is led to predict that an increase in either the severity of the punishment or the likelihood of its imposition will raise the price of crime and therefore reduce its incidence.

POSNER, *supra* note 3, at 5 (emphasis added). The normative equivalence Judge Posner is willing to draw between a punishment in the form of a fine and a price is a major component of the theory of law that is being criticized in this Article.

76. Even as a purely descriptive claim, rational-choice theory is open to question. While Judge Posner asserts that the expected severity of a penalty has a determinative bearing on criminals' decisions to violate the law, *see id.*, even if that assertion is true we ought not develop models of corporate behavior on the *a priori* assumption that people within corporations will act like criminals. Nor ought our models of law-compliance assume that adult actors, alone or within a corporation, necessarily demonstrate the most elementary moral thinking in making decisions about the law, being primarily concerned with expected punishments and being relatively unconcerned with more abstract ideas of fairness or duty or political obligation. *See* LAWRENCE KOHLBERG, *THE PHILOSOPHY OF MORAL DEVELOPMENT: MORAL STAGES AND THE IDEA OF JUSTICE* 17-22 (1981). According to Kohlberg's theory, children at the least advanced stage of moral development, the pre-conventional stage, are primarily concerned with expected punishments when deciding how to act. At more adult states of moral development, people are concerned with abstract notions of fairness, right and wrong, categorical imperatives, or issues of distributive justice. *See id.*; *infra* note 395 and sources cited therein.

77. *See* Cooter, *supra* note 6, at 1524-25.

78. *See* Fischel, *supra* note 45.

revolution" of deregulation and free-market theory and the previous decade's vigorous academic and social debate over corporate social responsibility.<sup>79</sup> In the *Vanderbilt Law Review* article, Fischel

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79. During the 1970s, there was a vigorous academic discussion about corporate social responsibility. The discussion began in 1973 as an outgrowth of the Watergate investigation when the Office of the Special Prosecutor charged several prominent corporations and senior executives with violations of the Federal Corrupt Practices Act, 18 U.S.C. § 610 (1976) (repealed 1976), for illegal campaign contributions and improper use of corporate funds to influence government officials, both in the United States and abroad. See *SEC v. Dresser Indus., Inc.*, 628 F.2d 1368, 1371 (D.C. Cir. 1979) (en banc); George S. Branch & James A. Rubright, *Integrity of Management Disclosures Under the Federal Securities Laws*, 37 BUS. LAW. 1447, 1462 (1982). At the same time, the Securities and Exchange Commission began extensive investigations of bribes to foreign officials, referred to as "sensitive payments," and the corresponding falsification of corporate books and records. See Branch & Rubright, *supra*, at 1462; see also Marc I. Steinberg, *The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies—Their Influence on Corporate Internal Affairs*, 58 NOTRE DAME L. REV. 173, 221 & n.223 (1982) (discussing the SEC's program to encourage voluntary disclosure of bribes and false books and records). The number of companies that were involved is staggering. In 1977, the Senate Committee on Banking, Housing, and Urban Affairs reported that "[r]ecent investigations by the SEC have revealed corrupt foreign payments by over 300 U.S. companies involving hundreds of millions of dollars." S. REP. NO. 95-114, at 3 (1977), reprinted in 1977 U.S.C.A.N. 4098, 4101. By 1981, in response to a SEC amnesty program, "close to 400 firms voluntarily admitted having bribed foreign or American political or commercial officials or making illegal American campaign contributions." Seligman, *supra* note 64, at 335. At the same time, the environmental and consumer-safety movements fueled discussions about how to reconcile corporate profit-maximizing with social welfare more generally. See RALPH NADER ET AL., *TAMING THE GIANT CORPORATION* (1976); CHRISTOPHER STONE, *WHERE THE LAW ENDS* (1975). These post-Watergate events, and concomitant concerns about corporate accountability and/or corruption, gave rise to the ALI Corporate Governance Project and to a vigorous discussion of corporate social responsibility, both within the academy and among the public at large. See Fischel, *supra* note 45, at 1259 n.1 (listing corporate social responsibility literature of the late 1970s and early 1980s). This debate was, in turn, part of the episodic discussion of corporate social responsibility and the corporate purpose that has reverberated among legal thinkers and writers since at least the 1930s when E. Merrick Dodd and Adolf A. Berle began discussing the scope of corporations' public responsibilities. See E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1162 (1932) ("Business—which is the economic organization of society—is private property only in a qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers even if the proprietary rights of its owners are thereby curtailed."); Adolf A. Berle, Jr., *For Whom Are Corporate Managers Trustees: A Note*, 45 HARV. L. REV. 1365, 1368 (1932) ("Nothing is accomplished, either as a matter of law or of economics, merely by saying that the claim of [shareholders] ought not to be 'emphasized.' Either you have a system based on individual ownership of property or you do not."). Today's corporate social responsibility debate occurs in the context of globalization of the economy and the increasing mobility of both labor and capital in that global, information-based economy. The current debate focuses on the question of whether corporations should be managed solely to maximize shareholder wealth, or whether they should recognize greater obligations to their communities, employees, consumers, and other business partners. See

defended the shareholder wealth-maximizing norm against the claim that "managements' single-minded dedication to profit maximization is inconsistent with social welfare."<sup>80</sup> So, for instance, he pointed out that profitable enterprises provide jobs and produce needed goods and services; that profitable firms are more likely to be able to provide safe working conditions or dispose of waste products properly than are unprofitable firms; and that while firms that relocate plants may cause dislocations in one area, there are presumably greater benefits that will accrue to workers and the community in the new locale.<sup>81</sup>

Fischel recognized, however, that there will be situations involving negative externalities, such as pollution, in which firms "may impose costs on others without providing compensation," or involving types of behavior, such as "sensitive foreign payments," in which some would argue that profit-maximizing was inconsistent with social welfare.<sup>82</sup> According to Fischel, these types of situations were best addressed by changing the laws, rather than by re-evaluating the corporate purpose to de-emphasize profit-maximizing, because when laws restricting pollution or prohibiting foreign payments or anticompetitive behavior are violated, "an argument could be made that a breakdown in accountability has occurred."<sup>83</sup> But, he suggested, "even here the situation is more complicated than may first appear," and he argued that:

Because many laws can be violated inadvertently or by subordinates, the costs of preventing violations may far exceed the gains from avoiding violations. A firm may also find it advantageous to violate a law deliberately and pay the penalty for the same reason that an individual in some

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generally PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995) (compilation of essays that explore various aspects of corporate social responsibility debate).

80. Fischel, *supra* note 45, at 1260, 1265.

81. *See id.* at 1269. Fischel made no attempt to provide evidence for these assertions. While it is undoubtedly true that some profitable firms dispose of waste products better than some unprofitable firms, and likewise treat their employees better, some profitable firms may do neither thing well, and evidence concerning the relative proportion of companies exhibiting various approaches to these and other serious social issues would be illuminating. Similarly, Fischel made no attempt to catalogue, let alone quantify, either the economic or social costs to communities from plant closings, the economic or social benefits to communities to which the plants relocated, or how one compares costs and benefits across communities or countries or generations. In his defense, it is fair to say that providing either type of evidence would be extremely complicated, and that both Easterbrook and Fischel are theoreticians, not empiricists.

82. *See id.* at 1270.

83. *Id.* at 1271.

cases may prefer to breach a contract and pay damages. Because the gains from breach or violation presumably exceed the social costs (as reflected in the penalty), compliance with the statute or contract is undesirable from a personal as well as a social perspective.<sup>84</sup>

Easterbrook and Fischel made a similar argument more recently in their 1991 book on corporate law, *The Economic Structure of Corporate Law*.<sup>85</sup> In the first chapter of the book, Easterbrook and Fischel set out the "nexus of contracts" vision of the corporation,<sup>86</sup> and then developed the implications for questions of corporate social responsibility,<sup>87</sup> ultimately sounding many of the same themes that Fischel had in the *Vanderbilt Law Review* article. Again, Easterbrook and Fischel are explicit in equating penalties assessed for violating the law with prices.<sup>88</sup>

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84. *Id.* (citations omitted). It is clear from this quote that there are two distinct scenarios that Fischel is addressing: the question of how much corporate time, effort, and money needs to be invested in compliance systems generally to ensure that employees obey the law (i.e., "efficient compliance"), versus situations involving more deliberate law violations in which the board, chief executive officers, or high corporate employees make decisions to violate the law or permit employees to violate it in order to boost profits (i.e., "efficient breach"). As noted in the introduction, this Article addresses each scenario separately below. See *infra* notes 294-394 and accompanying text (discussing efficient compliance), and notes 195-293 and accompanying text (discussing efficient breach).

85. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 37-39 (1991).

86. See *id.* at 12 (stating that a corporation has many actors with whom it interacts, including equity investors, bondholders, employees, managers, creditors, and consumers, and is best thought of as a "nexus of contracts," or set of explicit and implicit contracts among these actors, rather than as an artificial or legal entity).

87. Specifically, Easterbrook and Fischel argue that the nexus-of-contracts view "removes from the field of interesting questions one that has plagued many writers: [W]hat is the goal of the corporation?" *Id.* at 35. Their view is that the terms of the contract between the corporation and the equity holders implicitly includes a promise of profit-maximizing. Particular corporations may choose to emphasize different goals (they use the example of the *New York Times*, which may choose to publish a newspaper first and make a profit second) so long as the goals are clearly established when the firm is incorporated and do not change, given the shareholders' legitimate expectations of profit-maximizing. If the goals do change from maximizing profit-making to some greater balancing of other constituents' claims on the corporation, then shareholders would have a claim of breach of contract. See *id.* at 36.

88. See *id.* at 37-38. Thus, they state:

Given wealth as a maximand, society may change corporate conduct by imposing monetary penalties. These reduce the venturers' wealth, so managers will attempt to avoid them. A pollution tax, for example, would induce the firm to emit less. It would behave as if it had the interests of others at heart. Society thus takes advantage of the wealth-maximizing incentives built into the firm in order to alter its behavior at least cost. Nothing in our approach asks whether political society should attempt to make firms behave as if they have the welfare of nonparticipants in mind. We do not address optimal ways to deal with

Another aspect of the law-as-price view of law that is directly derived from rational-choice theory is the tendency to determine whether to obey the law by reference to the likelihood of actually having to pay a penalty for noncompliance, and so discounting penalties by the likelihood of detection and successful enforcement of violations. One articulation of this idea is found in David Engel's article *An Approach to Corporate Social Responsibility*.<sup>89</sup> In that article, Engel defines "corporate voluntarism" or "corporate altruism" (and with it "corporate social responsibility") as instances when corporations "pursue social ends where this pursuit conflicts with the presumptive shareholder desire to maximize profit."<sup>90</sup> Engel's premise is that public corporations should pursue only those goals supported by a broad and clearly signaled social consensus, and that while pursuing profit-maximizing is supported by such a consensus,<sup>91</sup> pursuing other social goals is not.<sup>92</sup> Among the social

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pollution, bribery, plant closings, and other decisions that have effects on people who may not participate in the corporate contract. Society must choose whether to conscript the firm's strength (its tendency to maximize wealth) by *changing the prices it confronts* or by changing its structure so that it is less apt to maximize wealth. The latter choice will yield less of both good ends than the former.

*Id.* (emphasis added).

In 1990, in amendments to the Clean Air Act, Congress created a limited market-like mechanism establishing trading rights for one pollutant, sulphur dioxide, and establishing a permit system for the right to emit specified levels of sulphur dioxide. See 42 U.S.C. §§ 7651b, 7651g (1994). That those amendments explicitly establish a price for sulphur dioxide emissions strengthens the argument that the Easterbrook and Fischel interpretation of most regulatory law as a pricing system is incorrect as a matter of statutory construction. That is, when Congress wants to create a pricing system, it does so explicitly, at the same time creating routinized mechanisms for entities to pay the price.

89. Engel, *supra* note 4.

90. *Id.* at 3.

91. See *id.* at 34. This point may be less true now than in 1979 when Engel wrote it, though. In a 1996 study of public attitudes towards corporate America by Ethel Klein and Peter Hart, there was a broad consensus (between 70% and 80% of the public, across racial, income, and political lines) that there are "serious problems" in the way corporations put the interests of their executives and shareholders ahead of their employees and society." THE PREAMBLE CENTER FOR PUBLIC POLICY, CORPORATE IRRESPONSIBILITY: THERE OUGHT TO BE SOME LAWS: A STUDY OF THE POLITICAL AND POLICY IMPLICATIONS OF PUBLIC ATTITUDES TOWARD CORPORATE AMERICA 1 (1996) (on file with the *North Carolina Law Review*) (providing results based on a public opinion survey of 800 randomly selected registered voters nationwide, and discussions in six "focus-groups"; the margin of error for the poll is 3.5%, and all percentage differences analyzed in the report were statistically significant at the 95% confidence interval). While it is undoubtedly true that profit-making is supported as an important object of management decision-making, there is far less consensus about *how* profits ought to be sought and what ethical constraints management ought to exercise in the pursuit of profits. So, for instance, numerous commentators have disagreed on the use of corporate downsizing as a management technique to bolster quarterly profits. See, e.g., ALAN



goals that Engel considers for which corporations might forego profit-making is "altruistic" corporate obedience to the law, or complying with the substantive standards of the law even when the corporation can escape a liability rule because of non-detection or non-prosecution.<sup>93</sup> The way Engel poses the question is to ask whether a corporation, having determined that it is profitable to violate a given law (given the potential penalty, as discounted by the risks of detection and successful prosecution), should nonetheless act to forbear violating that law based on a cost/benefit calculation using the non-discounted penalty, which Engel assumes equals the full social costs that the corporation's behavior would impose.<sup>94</sup>

Note, however, the narrowness of Engel's position: What is defined as altruism is not even "voluntary" obedience to the substantive standards of the law, but rather the corporation's use of a non-discounted penalty in its cost/benefit analysis.<sup>95</sup> Even posed this

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Downs, *CORPORATE EXECUTIONS* (1995); *NEW YORK TIMES*, *THE DOWNSIZING OF AMERICA* (1996); Clay Chandler, *U.S. Corporations: Good Citizens or Bad?*, *WASH. POST* (Weekly Edition), May 20-26, 1996, at 16; Robert B. Reich, *How to Avoid These Layoffs*, *N.Y. TIMES*, Jan. 4, 1996, at A13. Indeed, there may be far more consensus that people and corporations ought to obey the law as a general matter (notwithstanding the consequences on profits) than there is consensus on the proper ethical constraints on corporate profit-making. See TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 168 (1990) (noting that social science research has found a strong consensus among Americans about what constitutes a fair procedure, what constitutes a legitimate system of law-giving, and that people and institutions ought to obey the law).

92. See Engel, *supra* note 4, at 4-5. Engel examined three types of "voluntarism" to see if any was supported by a broad and clearly signaled social consensus: (1) voluntary obedience to the law; (2) voluntary sacrifice of operating profits in an emergency situation when the gain to third parties would far exceed the loss of profits to the corporation; and (3) certain kinds of voluntary corporate disclosure or forbearance from interfering with the legislative and governmental processes. See *id.* Engel ultimately concluded that there might be a limited case for arguing that there is a social consensus about the last category of corporate voluntarism, but not for the first two. See *id.*

93. See *id.* at 55. Engel described changes in the substantive standards the law imposes in explicit law-as-price terms. Thus, he contended that:

a public decision through the political process to modify the likely long run consequences to the corporation of some action or inaction that management may be considering—as, for example, by making it illegal, so that management's calculus must include at least the odds and long run detriment of getting caught—cannot be viewed as a political determination that we want 'more' corporate social responsibility. It is merely a decision (whether wise or unwise) to enlist the profit motive in the service of a modified set of social goals.

*Id.* at 9.

94. See *id.* at 38.

95. Engel looked at both the deliberate violation case (the extent to which society wants corporations to meet the substantive standards of the law beyond the point dictated by profit-maximization) and the efficient compliance case (the extent to which society wants corporations to spend money on compliance, beyond the dictates of profit-maximizing, to keep lower-echelon employees from violating the law). See *id.* at 36-58.

narrowly, Engel finds no persuasive evidence that society clearly signals that it wants corporations to act “altruistically” in this manner.<sup>96</sup> So, he concludes, while we may want corporations “at least some times—to obey, for example, substantive criminal laws—or to spend money to keep lower echelon employees within the laws—beyond the point dictated by profit-maximization,” there is no way for society to signal when it wants such “corporate voluntarism.”<sup>97</sup>

Engel’s article also sets out the argument for the “efficient investment in compliance” paradigm. Looking at the particular context of crime, Engel first argues that it is not true that “we criminalize only those acts that we do not want performed in the society at all—regardless of cost.”<sup>98</sup> Rather, “[i]n an emergency, or where the costs of law-obedience are otherwise high enough, we do not view the laws against trespass or larceny or burglary or even homicide as absolutes.”<sup>99</sup> So instead of enumerating all of the justifiable “violations,” the legislature allows discretion with respect to the penalty; the penalty indicates how much society cares about certain categories of violations.<sup>100</sup> Engel then applies this principle to the corporate context and asserts that “the argument that the socially optimal level of crime is zero seems particularly infirm in the corporate context.”<sup>101</sup> This is because reducing corporate crime involves the special costs of corporate law-compliance expenditures, except in the rare instances in which the board actively conducts or condones a pattern of criminal activity.<sup>102</sup> And, with respect to law-compliance expenditures,

[I]t is not plausible to argue that *every* substantive crime represents a legislative judgment that *every* corporation should spend an *infinite* amount on an internal auditing system to ensure that *none* of its employees engages in the

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96. See *id.* at 44. Engel’s argument here is somewhat nihilistic. He argued that there are substantial ambiguities involved in arguing that by setting the penalty at \$X, the legislature “sanctions an altruistic decision by corporate management always to deem \$X a cost of the relevant conduct [in its cost/benefit analysis]—even if the conduct might well escape detection or prosecution.” *Id.* at 41. These ambiguities arise because, using the economic model of criminal law, the legislature has also estimated the probabilities of detection and conviction, and has presumably set \$X above the true social costs to account for those probabilities (of non-detection or non-prosecution). See *id.* Thus, according to Engel, “[m]anagement’s knowledge of the level of X, without also knowing the legislature’s estimate of this probability, tells the corporation nothing.” *Id.*

97. *Id.* at 44.

98. *Id.*

99. *Id.* at 45.

100. See *id.*

101. *Id.*

102. See *id.*

prohibited conduct. And yet as soon as the argument is diluted at all from this proposition, a moralistic approach to the meaning of substantive criminal law gives no guidance as to *how much* a corporation should spend to reduce lower-echelon crime.<sup>103</sup>

The additional guidance on how much a corporation should spend on law compliance, according to Engel, is found in the penalty levels:

This is not in itself to suggest . . . that it is necessarily appropriate or desirable for corporate management to shape its conduct entirely with a calculated view to legislative penalty levels. . . . But it is meant to say that not all violations are socially undesirable; and that if some are undesirable without being clearly signaled to the corporation by the penalty level, then they must be clearly signaled in some other way or the corporation will not know it should avoid them.<sup>104</sup>

In Easterbrook and Fischel's writing, and in Engel's, one thus sees articulated a number of the premises of the law-as-price view of law, including (1) equating breaches of mechanisms of public-law ordering (statutes and regulations) with breaches of mechanisms of private-law ordering (contract); (2) explicit interpretation of the penalties for violation of the law as prices or as taxes on behavior; (3) an assumption that the penalties for violating the law equal the social costs of the harm thereby imposed; (4) development of the concept of efficient investment in law compliance; (5) reduction of the concept of the law as a system of limiting individual freedom and structuring

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103. *Id.* The histrionics of Engel's suggestion that *every* corporation would have to spend an *infinite* amount of money to ensure that *none* of its employees violate the law if one adopts a "moralistic approach to the meaning of substantive law" is reminiscent of the comment of one faculty participant in an informal presentation of this Article, who ended up convinced that by suggesting that corporations guide their compliance efforts by the substantive standards of the law, rather than the penalties, I was suggesting that "corporations should spend a million bucks to keep some guy in the copy room from sexually harassing a co-worker." I submit that there are numerous, more tailored approaches that a corporation can take to law compliance if one posits a "moralistic approach to the meaning of substantive law" that would require spending far less than an *infinite* amount of money or spending \$1 million to reduce sexual harassment in the duplicating department. Moreover, I submit that structuring law-compliance programs to make a good-faith effort to meet the substantive standards of law (recognizing that there will always be rogue employees notwithstanding the most diligent efforts) actually provides a clearer and more definite standard for what the corporation should do than does "efficient investment in compliance" guided by the penalties for violations. *See infra* text accompanying notes 388-94.

104. Engel, *supra* note 4, at 47 n.155.

behavior; and (6) elevation of the values of efficiency and individual self-interest over the values of democratic authority, community, and social cohesion.

### C. *Intermediate Theories*

The ALI law-as-limit position and the Easterbrook/Fischel law-as-price position define the ends of a spectrum of views about the meaning of penalties attached to violations of statutes and administrative regulations, and ultimately about the meaning of law. Between those two extremes is an important intermediate position. The major premise of the intermediate position, and the characteristic I take to be definitive of it, is the view that, as a descriptive matter, some law prices behavior and some law limits it, and that most regulatory law, and laws penalizing behaviors that are “merely” *malum prohibitum*, prices, rather than limits, behavior.<sup>105</sup> For these latter laws, compliance is voluntary for corporations (and individuals) willing to risk paying the price.

Pepper’s article in the *Yale Law Journal*, *Counseling Clients at the Limits of the Law*,<sup>106</sup> provides a cogent illustration of the intermediate approach. The issue he addresses is when a lawyer ought to give information to clients on the likely consequences of violating a law or administrative rule and when a lawyer should not provide such information, given the recognition that this information may lead some clients to conclude that it is worthwhile to violate the law and given the recognition that some law violations may cause serious harm to other people.<sup>107</sup> Pepper assumes that “our democratic constitutional order presumes that persons do have

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105. Coffee’s work includes this same demarcation between prices (civil law) and sanctions (criminal law), but he does not advocate for a right to deliberately violate civil law and “pay the price.” See Coffee, *Litigation and Corporate Governance*, *supra* note 7, at 794 n.11. Another characteristic of the intermediate position is a lack of normative zeal for the law-as-price understanding of law, and indeed, in some cases, misgivings about it. See Pepper, *supra* note 9, at 1553 (“If the law becomes generally perceived as merely indicating a potential cost, a penalty that one is free to incur and to discount by the probability of its enforcement, then structuring our common life together through law becomes vastly more difficult and requires vastly more resources.”).

106. Pepper, *supra* note 9.

107. See *id.* at 1549. Pepper’s article focuses on an attorney’s professional responsibilities in advising clients and giving them access to information about the law and enforcement, rather than focusing on the client’s compliance obligations under the law. Thus Pepper’s article focuses on the obligations of a different agent (the attorney) than does the ALI (which looks at directors), and there may be considerations unique to the attorney/client relationship (such as fostering client autonomy) that affect Pepper’s analysis. Yet what is interesting for this Article is the view of the nature of law inherent in his analysis.

something approaching a 'right' to know 'the law' that purports to govern them,"<sup>108</sup> and considers facts concerning the enforcement of law as part of "the law" to which people have a right of access.<sup>109</sup> Yet he recognizes that advice about enforcement patterns in conjunction with the "modern lawyer's legal realist (and law-and-economics) view of the law may lead the client to respect the law less; to choose to violate the law and chance the consequences."<sup>110</sup>

In addressing this moral and legal dilemma, Pepper explores seven different distinctions in determining when lawyers ought to provide clients with information about enforcement-related aspects of law, including the potential consequences of violating the law.<sup>111</sup> The distinctions he examines are (1) criminal violations ("law as prohibition") versus civil violations ("law as cost"); (2) conduct *malum in se* versus conduct that is *malum prohibitum*; (3) enforced law versus rarely enforced law versus unenforced law; (4) information on enforcement of law versus procedural law versus substantive legal rules; (5) private information versus public information; (6) lawyer-initiated discussions versus client-initiated

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108. *Id.* at 1599.

109. *See id.* at 1547. Pepper's view of the rule of law is derived from Lon Fuller's work and from Pepper's sense that information about enforcement patterns and the way the legal system would work to process a claim is part of the "promulgation" of law. *See id.* (citing FULLER, *supra* note 44, at 49-51). Yet by including facts concerning the enforcement of law in what constitutes "the law" (including the probability of detection of violations, the probability of prosecution, the burdens and delays of civil litigation, and patterns of administrative enforcement), Pepper expands the notion of the rule of law in an extremely ironic way, ultimately ending up undermining the "rule of law" as traditionally understood (the promulgation of rules meant to apply generally to constrain and shape individual behavior). It is not clear that Fuller would have agreed that the norm of promulgation requires advising clients about the likely enforcement consequences of violating the law, when that advice would be an important factor in a decision to violate the law and risk the consequences, even though Fuller was not absolutely consistent on that point. In *The Morality of Law*, Fuller suggests that how the law is applied is considered by lawyers to be an important part of the rule of law. *See* FULLER, *supra* note 44, at 49-51. But in previous writing Fuller had rejected the notion that lawyers should advise clients in courses of action the lawyer found morally problematic or close to the line of illegality. *See* Lon L. Fuller & John D. Randall, *Professional Responsibility: Report of the Joint Conference*, 44 A.B.A. J. 1159, 1161 (1958) (urging that lawyers not "participate as legal advisor in a line of conduct that is immoral, unfair, or of doubtful legality"). This expansion of Fuller's concept of the rule of law is not unique to Pepper, however. *See* Newman, *supra* note 18, at 288. Newman argued that lawyers' ethical codes ought not penalize lawyers for giving clients truthful information that assists them in violating the law, unless the lawyer's assistance could be prosecuted as participating in the substantive law violation. After all, "[d]id not Lon Fuller say that it is a matter of the law's internal morality that it be promulgated in such a way that people know what it is?" *Id.*

110. Pepper, *supra* note 9, at 1554.

111. *See id.* at 1554-84.

discussions; and (7) whether it is likely or unlikely that the information will be used to assist unlawful conduct.<sup>112</sup> His discussion of these distinctions says much about the current, academic concept of law and the intermediate law-as-price view.

Thus, Pepper discusses the distinction between giving advice concerning violations of criminal law and violations of civil law, which he suggests is a distinction between conduct that is traditionally understood as truly prohibited (criminal law) versus conduct "to which the law only attaches a cost or penalty" (civil law).<sup>113</sup> So, using this distinction, a lawyer would not give information to the client when it would facilitate a criminal violation, but would be free to give advice about a civil violation.<sup>114</sup> But this distinction does not ultimately prove satisfying to Pepper because it is both over-inclusive and under-inclusive. It is over-inclusive because the reach of the criminal sanction, "which is supposed to mean that conduct is truly prohibited," has been expanded dramatically, extending to violations of major areas of regulatory law that Pepper believes cannot be worthy of true prohibition.<sup>115</sup> It is under-inclusive because some violations of civil tort law, otherwise an area Pepper regards as law as cost, can cause serious injury to other people.<sup>116</sup> A much more important distinction, in Pepper's view, is the *malum in se/malum prohibitum* distinction.<sup>117</sup>

In discussing that distinction, Pepper uses the example of communicating information from a police bulletin board about the frequency of police patrols in given neighborhoods (information that could be quite useful to someone planning a burglary) versus communicating information on the EPA's frequency of testing rural water effluent for compliance with standards for discharging ammonia into the water (information that could be quite useful to a company seeking to discharge ammonia at levels higher than those permitted in the regulations).<sup>118</sup> Using that example, he suggests that "our intuition" that it is wrong to communicate the former to a client but not the latter is based on the *malum in se/malum prohibitum* distinction:

The discharge may be a technical legal violation, but it may

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112. *See id.*

113. *Id.* at 1559.

114. *See id.*

115. *See id.* at 1561.

116. *See id.* at 1562-63.

117. *See id.*

118. *See id.* at 1576.

not be wrongful in any other significant sense.... The difference between burglary and this instance of regulatory violation seems to be that the former is clearly wrong in its very nature in addition to being unlawful, and the latter is unlawful, but may or may not be otherwise wrongful.

That difference corresponds to the old distinction between crimes *mala in se*, wrong in their very nature, and crimes *mala prohibita*, crimes wrong only because prohibited by positive law. This distinction also helps in understanding our intuitions concerning the criminal/civil dichotomy.... A prohibition on giving the client legal information that might assist in the commission of a crime rings the right chord when the conduct is something we perceive as "really criminal," but strikes quite another note with vast areas of regulatory law. The *malum in se/malum prohibitum* distinction appears, in older garb, to formulate the difference between law as true prohibition (that is, the identification of conduct not to be tolerated) and law as cost (that is, the identification of conduct to be penalized in some legal fashion, but which *the citizen is still free to choose to do*).<sup>119</sup>

Based, then, on the concept of law as distinguishing between law-as-limit and law-as-price (which for Pepper essentially tracks the *malum in se/malum prohibitum* distinction), Pepper proposes the following general standard for guiding lawyers' conduct:

[W]hen it appears more probable than not that the client will use legal information or advice to facilitate conduct that (1) is clearly prohibited by law *and* (2) involves what is by clear societal consensus a serious and substantial moral wrong, the lawyer shall not provide the client with the legal advice or information.<sup>120</sup>

In counseling clients using the above standard, the lawyer would be guided by the distinctions Pepper discussed:

Is the legal provision really "law," or has it been eroded by

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119. *Id.* at 1576-77 (emphasis added). Judge John Noonan and Professor Richard Painter suggest that this approach to law is similar to that of Elihu Root, who is reported to have said in discussing some trust arrangements he advised upon that were "technical legal violations," that "[e]verybody knows that some rules for the conduct of life are matters of right and wrong, substantial, essential, and that other rules for the conduct of life are matters of convenience, of form, of method, desirable but not essential." JOHN T. NOONAN, JR. & RICHARD W. PAINTER, PROFESSIONAL AND PERSONAL RESPONSIBILITIES OF THE LAWYER 515 (1997) (citing PHILIP C. JESSUP, ELIHU ROOT (1937)).

120. Pepper, *supra* note 9, at 1578 (emphasis added).

desuetude or enforcement policy into something society appears not to be very concerned about? Is the conduct really prohibited, or *just freighted with a legal cost or penalty*? Is the conduct really wrongful, or just legally prohibited?<sup>121</sup>

In other words, that a particular behavior (such as dumping ammonia in the water at levels beyond that set by the Environmental Protection Agency) is legally prohibited is relevant in determining how a client should be advised, but not determinative. What is determinative is the lawyer's individual assessment of whether the underlying behavior "is really wrongful,"<sup>122</sup> that is, whether it "involves what is by clear societal consensus a serious and substantial

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121. *Id.* at 1581 (emphasis added). Pepper's concept of desuetude and of unenforced or rarely enforced law is much broader than the ALI concept of desuetude, *see supra* text accompanying notes 58, 60-61, and provides the lawyer with far more latitude to determine that a given law or regulation is not really law. Thus, Pepper is willing to include a disparity between a water pollution law as written and as enforced as a situation of partial desuetude, *see* Pepper, *supra* note 9, at 1558, and if it is a situation that is generally known in the industry (no doubt because lawyers have communicated it to industry participants) Pepper will draw a stronger conclusion:

[I]f the industry knows, then the government must know that the industry knows, and continuation of the .075 [enforcement] gram limit [when the written limit is .05 grams] and infrequent rural inspections then takes on the characteristics of a conscious "legal" decision by the agency, a policy it knows the regulated use as a guide. In other words, if the lawmaker knows its conduct is known by and guiding the regulated, that conduct looks and sounds like "law" to a contemporary lawyer.

*Id.* at 1572. While this may look and sound like "law" to a contemporary lawyer, and certainly does to the dominant legal realist/law and economics influenced lawyer, that the client complied with the law-as-typically-enforced-but-not-as-written is unlikely to be persuasive as a defense in an enforcement action (as Pepper recognizes, *see id.* at 1554). This indicates that the standard as written means something more than the standard as enforced even given our modern concept of law. On one cynical interpretation, then, counseling clients about the gap between typical enforcement and the standards of the regulation is no more than counseling them on how much they can "get away with," rather than being, as Pepper interprets it, a sophisticated exercise in the applied jurisprudence of "what is law." *See id.* at 1554-58. Of more concern, this kind of counsel can produce a vicious cycle that accelerates the inefficacy of law: as more industry participants adjust their behavior to the law-as-enforced rather than as written, the ability of regulators to enforce the written standards will be undermined, given budget and time constraints, leading more attorneys to determine that the agency is not serious about that particular law, and thus giving advice that further undermines it. Ultimately Pepper's analysis of desuetude gives too much play to "under-enforcement" as "desuetude," particularly with respect to modern laws and enforcement decisions that are due in large measure to regulatory agency constraints and reactions to industry resistance. *See* Gordon, *Corporate Law*, *supra* note 18, at 263-64. Moreover, the legal advice Pepper suggests, if routinely and uniformly proffered to industry participants, produces and then exploits that "desuetude."

122. Pepper, *supra* note 9, at 1578.



moral wrong.”<sup>123</sup> Only when a violation involves what is by clear societal consensus a serious and substantial *moral* wrong should the client be denied the information necessary to assess accurately the risks associated with violating the law, even when the lawyer is the one who initiates the discussion about possibly violating the law.<sup>124</sup>

From Pepper's article, one sees a number of the premises of the “intermediate law-as-price” view of law: (1) some laws prohibit actions (predominantly criminal law) and some laws price actions (predominantly civil law); (2) regulatory law is properly understood as a pricing scheme, even when it includes criminal sanctions for violations; (3) the concept of law includes a sophisticated analysis of the likelihood of detection of violations, and of enforcement, and of various barriers to aggrieved parties asserting their rights in determining if obeying the law is worthwhile; (4) enforcement-related facts will (and perhaps should) figure prominently in a rational actor's calculus about complying with the standards the law sets forth; and (5) except where legal violations are also serious moral wrongs (*mala in se*), compliance with the standards of behavior that statutes or administrative regulations set forth is philosophically voluntary: one has the “right” to violate the law by risking paying the penalties (and thus lawyers have the duty to provide information necessary for clients to be able to exercise that right).

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123. *Id.* One problem with this view is that we live in a large, heterogeneous, pluralistic society that values toleration and respect for individual moral differences (at least in theory). The instances in which there is likely to be a “clear societal consensus” that an action involves “a serious and substantial moral wrong” are likely to be few as compared to the instances in which there is either no societal consensus or widely divergent moral views. Thus, Pepper's proposed standard would dramatically shrink the realm of law that is understood to be mandatory. In contrast, the existence of legislation and/or administrative regulations establishing standards of behavior can be taken, at the least, as strong evidence of the existence of a social consensus, albeit perhaps splintered, wavering, or in need of reconsideration, notwithstanding the existence of differing moral views within the population. Professor Jules Coleman makes the point that one reason markets are useful is because large, heterogeneous groups can exchange goods and services without having to agree on underlying social values or on a conception of the good. See JULES COLEMAN, *RISKS AND WRONGS* 62 (1992). Similarly, one importance of law is that it can produce a structure for social behavior under the same conditions, without making agreement necessary on either the underlying moral questions or a conception of “the good.” By interjecting into the definition of law a requirement for a clear societal consensus that something is a serious moral wrong in addition to being legally prohibited, Pepper's theory would rob law of one of its primary advantages in a heterogeneous society.

124. See Pepper, *supra* note 9, at 1578.

### III. EVIDENCE OF LAW-AS-PRICE THEORIES IN THE *ALI PRINCIPLES* AND IN THE REVISED MODEL BUSINESS CORPORATION ACT

These voluntaristic, law-as-price theories of law do not exist only in academic discourse. In both the *ALI Principles*, as they ultimately evolved over fourteen contentious years, and in the ABA's actions revising the Model Business Corporations Act, one sees intimations of similar views.<sup>125</sup> Thus, one sees in these bodies' actions a distinct endorsement of the voluntaristic view that some kinds of intentional law violations are unimportant and non-culpable, and that the penalties for violating some laws can be treated as prices—or simply the cost of doing business.

#### A. *The ALI Principles*

As described above, in section 2.01 of the *ALI Principles*, the ALI adopted a normative concept of law-as-limit and explicitly rejected the idea that compliance with the law is properly subject to a cost-benefit analysis.<sup>126</sup> Yet the ALI stopped short of imposing explicit, proactive law compliance obligations on the board of directors as specific aspects of the board's fiduciary duty of care,<sup>127</sup> and took other actions that are inconsistent with a fully normative view of law.<sup>128</sup> It is to those actions that this discussion now turns.

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125. See *infra* notes 126-94.

126. See *ALI PRINCIPLES*, *supra* note 14, § 2.01 cmt. g; *supra* text accompanying notes 48-67.

127. Corporate directors have a fiduciary duty of care to their shareholders that essentially protects shareholders from gross negligence. See *Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985). Courts very rarely evaluate the substance of corporate directors' decisions in evaluating whether a Board has met its fiduciary duty of care, however. Rather, if the decision was made with reasonable deliberation about the relevant facts, the board is entitled to the presumption of the business judgment rule that the decision was rational, lawful, and well-informed, and the court will not evaluate the underlying wisdom of the decision. See *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982). In this way, the board is protected from judicial second-guessing, freeing it to engage in economically productive, informed risk-taking. See *id.* at 886.

128. These actions by the ALI are more interesting for what they potentially say about the ALI's view of the importance of law compliance than for their practical significance, since there is so little successful enforcement of the duty of care generally (at least not by way of litigation) given the business judgment rule. See *supra* note 127; *infra* note 149. For a comprehensive analysis of the practical effects of the ALI's enforcement provisions on the law compliance obligation of section 2.01 (including the directors' power to dismiss derivative suits), focused not on the underlying view of law inherent in those actions but rather on the likely effects of those provisions (and of section 2.01) on corporate law compliance going forward, see Ryan, *supra* note 50, at 492-99.

## 1. Section 4.01: The Duty of Care

The first draft of the *ALI Principles* contained two specific fiduciary obligations concerning law compliance as part of the Board's duty of care: section 4.01(b), under which a corporate director or officer would be required "to be reasonably concerned with the existence and effectiveness of monitoring programs, including law compliance programs," and section 4.01(c), under which each director and officer was required to "make reasonable efforts to cause [their] corporation to perform its duty under § 2.01 to obey the law."<sup>129</sup> The redundancy of these provisions alone shows the importance given to law compliance in the first draft.

The emphasis on law compliance makes sense given the political context in which the first drafts were written. That four hundred major corporations admitted to making bribes to foreign officials and maintaining false books and records without the outside directors' knowledge was seen as evidence that outside directors were not involved enough or informed enough to be playing a useful monitoring role with respect to corporate activities, including law compliance (and other aspects of a firm's business, such as strategic development, or evaluating top management).<sup>130</sup> The first drafts

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129. Tentative Draft No. 1, *supra* note 14, § 4.01(b), (c). Section 4.01 of Tentative Draft No. 1 included the following proposed black-letter law describing the corporate director's duty of care:

Corporate law should provide that:

- (a) A corporate director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.
- (b) The duty of care set forth in subsection (a) encompasses the obligation of a director or officer to make reasonable inquiry when acting upon corporate transactions or otherwise performing his functions and also encompasses the obligation of a corporate director to be reasonably concerned with the existence and effectiveness of monitoring programs, including law compliance programs.
- (c) The duty of care set forth in subsections (a) and (b) encompasses the obligation of a director or officer to make reasonable efforts to cause his corporation to perform its duty under § 2.01 to obey the law.

*Id.* § 4.01(a)-(c).

130. As noted above, the *ALI Principles* were undertaken in 1978 in light of post-Watergate investigations of hundreds of major corporations for having bribed foreign officers to get business, with corresponding falsification of the accounting records, in a period of general criticism of American corporations. See Carney, *supra* note 14, at 243-48; Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 421-23 (1971); Seligman, *supra* note 64, at 333-43. Advocates of law reform, including those advocating for federal chartering of corporations, had argued that the widespread allegations of foreign bribery were indicative of a breakdown in

sought to change this pattern by enhancing the monitoring role of outside directors as a part of their duty of care in a number of areas, including law compliance.<sup>131</sup>

The political context in which the *ALI Principles* were being written also helps to explain why the first drafts became so controversial. Professor Joel Seligman has described that context as follows:

[W]hen the ALI project began in 1978, it was widely viewed as likely to produce a "rational, dispassionate analysis" of the principles of corporate governance, more moderate in its recommendations than several more far-reaching proposals then before Congress. With the election of Ronald Reagan in 1980, the political backdrop of the ALI project abruptly changed. With no federal corporate legislation likely to be enacted in the foreseeable future, the ALI Principles endured as the sole significant source of any proposed reforms. It was this change in the political backdrop of the project, not the project itself, that inspired most of the brutal criticisms of the early 1980s.<sup>132</sup>

The law compliance obligations of sections 4.01(b) and (c) were controversial, then, partly because they were part of a reform effort, partly because that reform effort proposed an expanded role for the board (the so-called "mandatory monitoring model"), and partly because the law compliance obligations were thought to create the

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corporate accountability and that enhancing the board's role with respect to law compliance was one way of fostering greater accountability. See Seligman, *supra* note 64, at 336-40.

131. See *supra* note 129.

132. Seligman, *supra* note 64, at 327-28; see also Victor Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223, 228 (1983) (describing a 1982 letter from the Chairman of the Business Roundtable Task Force on Corporate Responsibility indicating that the "ALI 'project had its roots in the '70s as part of the effort to meet federal incorporation and similar proposals'"). Seligman's article is a comprehensive account of the political events that ultimately gave rise to the Corporate Governance Project, and in particular contains a history of the foreign "sensitive payments" and accounting records falsification issues and federal legislative proposals to reform corporate governance that grew out of those events. See Seligman, *supra* note 64, at 328-40. The legislative proposals to which Seligman refers in the above quote included proposals to enact federal "minimum standards" for corporate law, growing out of Professor William Cary's theory about a corporate law "race to the bottom," as states sought incorporation fees by enacting laws favorable to corporate management at the expense of shareholders and society; Ralph Nader, Mark Green, and Joel Seligman's proposal for a federal chartering statute, including employee and community "constituency" directors; and Professor Harvey Goldschmid's proposal to restructure boards of directors so that they would be more independent of senior management. See *id.* at 336-40.

potential for expanded board liability and for increased intervention by the courts into corporate affairs.<sup>133</sup> For instance, the Business Roundtable Task Force on Corporate Responsibility ("Business Roundtable")<sup>134</sup> asserted that "[a] free-floating concern with law compliance in the abstract would not be productive, would unnecessarily detract from other more immediate concerns, and would open directors to unfair liability for acts committed by others of which they had neither knowledge nor notice."<sup>135</sup> Nor did the Business Roundtable think that law compliance deserved "special mention in two separate provisions."<sup>136</sup> Moreover, it thought that to impose a general law compliance obligation on the board, absent a particular event giving rise to suspicions of illegality, was an "unfair and radical" departure from existing law.<sup>137</sup>

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133. See Seligman, *supra* note 64, at 361-62. The ALI's proposals about an enhanced role for the board included a number of mandatory aspects for the boards of large, publicly held corporations, including that there be a majority of outside directors, and that such corporations have audit committees and nominating committees with certain core responsibilities. See Tentative Draft No. 1, *supra* note 14, §§ 3.02, 3.03, 3.05, 3.06.

134. For a description of the Business Roundtable, see *supra* note 64.

135. BUSINESS ROUNDTABLE, STATEMENT, *supra* note 64, at 45. This latter argument does not come to terms with the point that the first ALI Tentative Draft only required board members to be concerned with the existence of compliance mechanisms in the corporation, which was a task that could easily be accomplished at a fairly high level of generality. Exercising such concern would also constitute "mak[ing] reasonable efforts to cause his corporation to perform its duty under § 2.01(a) to obey the law." Tentative Draft No. 1, *supra* note 14, § 4.01(c).

136. See BUSINESS ROUNDTABLE, STATEMENT, *supra* note 64, at 46.

137. *Id.* at 45. Whether this departure from the existing case law was "unfair and radical" is debatable, but it was unquestionably a departure. The controlling Delaware decision concerning the board's obligations for law compliance at the time of the initial ALI debates was (and still is) *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), under which directors have no responsibility to take affirmative steps to ensure that the corporation has effective law compliance systems "absent a cause for suspicion." *Id.* at 130. In *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), Chancellor Allen predicted that the Delaware Supreme Court would no longer approve such a passive role for the board, particularly given the increasing social tendency to employ the criminal law to assure corporate compliance with the law and the substantial incentives under the *United States Sentencing Guidelines* for corporations to have well-functioning compliance programs in effect. See *id.* at 969-70; see also *supra* note 51 (discussing the Sentencing Guidelines). Chancellor Allen held that in order to satisfy their duties of care, corporate managers must

assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

*In re Caremark*, 698 A.2d at 970. In substance, then, Chancellor Allen has articulated a standard that is quite similar to the earliest drafts of the *ALI Principles*, requiring an active role for the board in law compliance.

During the 1982 ALI proceedings, one member asserted that there was an overemphasis on law compliance and that "[c]orporations and their officers should not be required to act as though they were public prosecutors."<sup>138</sup> Another member suggested that the excessive breadth of the law compliance obligation could be demonstrated by considering a

hypothetical that is very real in many corporations to officers and their directors, and that is where a corporation is violating the requirements of the Clean Air Act or the Water Pollution Control Act and is unable to cease the noncompliance without shutting down. . . . [T]he discussion suggests that the director may be exposed to liability for countenancing a violation of the law even though the violation of the law meets all of the requirements of reasonable prudence and normal business judgment.<sup>139</sup>

The Reporter at the time, Professor Harvey Goldschmid, strongly defended including law compliance as a separate aspect of the board's fiduciary duty of care and indicated that the fundamental question was "[w]hat kind of guidance [on law compliance] will we give the world when speaking as The American Law Institute?"<sup>140</sup> Aside from the narrow examples of desuetude, breach of contract, or open violation of a law to challenge its validity, he asserted that, according to the draft, "if you violate the law knowingly, we are saying you are liable. There is no business judgment protection for that; . . . that is the trend in the law, and that is wise public policy. At some point, we will have a chance to vote on the issue."<sup>141</sup>

In fact, the members did not have a chance to vote on the issue; no votes were taken in 1982 on Tentative Draft No. 1,<sup>142</sup> and by the time section 4.01 was brought back before the members in 1985, specific reference to law compliance as part of a director's duty of care had been deleted in the black-letter law (although law compliance was discussed in the commentary).<sup>143</sup> Similarly, the final

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138. *Proceedings of the 59th Annual Meeting of the American Law Institute*, 59 A.L.I. PROC. 511, 513 (1982) [hereinafter *59th Proceedings*] (statement of Milton V. Freeman).

139. *Id.* at 522-23 (statement of Thomas W. Houghton). The speaker did not elaborate upon whether, in this hypothetical, the board authorized the expenditure of at least some funds to start to bring the factory into compliance over time, or whether it had essentially adopted an all-or-nothing approach to environmental compliance. *See id.* (statement of Thomas W. Houghton).

140. *Id.* at 512 (statement of Professor Harvey Goldschmid).

141. *Id.* at 523 (statement of Professor Harvey Goldschmid).

142. *See id.* at 408 (comments by the President of the ALI, Roswell B. Perkins).

143. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (Tentative Draft No. 4, 1985) [hereinafter Tentative Draft

version of the director's duty of care, as adopted by the members in 1992, contains no specific articulation of a law compliance obligation (although, again, compliance with the law is discussed in the commentary).<sup>144</sup>

These changes were greeted as important improvements by some participants in the ALI debates. As one writer stated:

Part IV of the *Principles* is a vastly improved work product when compared to Part IV of Tentative Draft No. 1, both in substance and in tone. Gone, for example, are the rules which would have created new duties of law compliance and director inquiry, and established legal requirements for

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No. 4]. The revised language that was discussed by the membership in the 1985 annual meeting was in part as follows:

Section 4.01: Duty of Care of Directors and Officers; the Business Judgment Rule

(a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

(1) This duty includes the obligation to make, or cause to be made, such inquiry as the director or officer reasonably believes to be appropriate under the circumstances.

*Id.* The commentary to section 4.01 in Tentative Draft No. 4 continued to recognize that the obligations of the directors and officers to perform their functions in good faith includes compliance with section 2.01. *See id.* § 4.01 cmt. d.

144. The version of section 4.01 that was actually adopted provides, in relevant part, as follows:

(a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. . . .

(1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.

ALI PRINCIPLES, *supra* note 14, § 4.01. While the language of section 4.01(a)(1) seemingly tracks *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (1963), permitting a quite passive role for the directors unless specific information comes to their attention suggesting violations of law, the ALI commentary suggests it was not fully endorsing *Allis-Chalmers*. *See* ALI PRINCIPLES, *supra* note 14, § 4.01 cmt. c ("The *Allis-Chalmers* case was decided 30 years ago, and a basic theme of the commentary in Part IV has been that the 'obligation' component of duty of care provisions is a flexible and dynamic concept. Today, an ordinarily prudent person serving as the director of a corporation of any significant scale or complexity should recognize the need to be reasonably concerned with the existence and effectiveness of procedures, programs, and other techniques to assist the board in its oversight role.").

compliance programs.<sup>145</sup>

Other analysts believe the ALI did not go far enough in limiting section 4.01's specification of fiduciary duties.<sup>146</sup> And yet if this provision is the ALI's "guidance to the world" on corporate law compliance,<sup>147</sup> it is hardly a beacon on the hill, particularly when construed in conjunction with the provisions on derivative liability and exculpation in the *ALI Principles*.<sup>148</sup>

## 2. Section 7.18: Derivative Liability

The procedural device used to impose liability on corporate directors and officers for breaches of their fiduciary duties is the derivative lawsuit: shareholders acting in the name of the corporation sue the directors and/or executive officers whose wrongdoing has injured the firm. If such a derivative lawsuit is successful (which is extremely rare in duty of care cases, as opposed to duty of loyalty cases), the directors or officers are personally liable for damages to the corporation.<sup>149</sup> The *ALI Principles* treat the question of derivative recovery for violations of section 4.01 (and other sections) in section 7.18.<sup>150</sup> Under section 7.18(c), though, directors and officers may seek an offset for the profits from law

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145. HANSEN, *supra* note 14, at 37.

146. See, e.g., William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 899 (1993) (criticizing the Corporate Governance Project because it "can be characterized as expanding the role of fiduciary duties of various participants in firms and as expanding the number of open terms in the corporate contract that only courts can clarify").

147. See *59th Proceedings*, *supra* note 138, at 512 (statement of Professor Harvey Goldschmid). In contrast to the ALI's reluctance to impose specific law compliance duties on the board, some other countries specify that compliance with the law is an enforceable obligation under the country's corporations law. For instance, in Japan, compliance with the law is the first obligation of the members of the board of directors. See Tasuku Matsuo, *The Commercial Laws of Japan*, in 4 DIGEST OF COMMERCIAL LAWS OF THE WORLD 1, 28 (Lester Nelson ed., 1992). Article 254-3 of the Commercial Code of Japan provides that "[a] director shall comply with the provisions of any law or ordinance and the Articles of Incorporation as well as any resolution of a general meeting, and shall be under an obligation to perform his duties faithfully for the company." BASIC JAPANESE LAWS 280 (Hiroshi Oda ed., 1997) (translating SHOHO art. 254(3)). In Japan, shareholders can bring injunctive actions to require the directors to comply with the law, *see id.* (translating SHOHO art. 272), and the directors are jointly and severally liable for any damage to the corporation from failure to comply with the law, *see id.* (translating SHOHO art. 266). This liability can be released only by the unanimous consent of all the shareholders. *See id.* (translating SHOHO art. 266(5)).

148. See ALI PRINCIPLES, *supra* note 14, §§ 7.18, 7.19.

149. See CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 347 (2d ed. 1996) ("There are relatively few examples of directors' liability founded on lack of substantive due care.").

150. See ALI PRINCIPLES, *supra* note 14, § 7.18.



violations in calculating the damages for which they are liable in a derivative action.<sup>151</sup> In essence, this provision permits the directors or officers to show that "crime did pay."<sup>152</sup> There is a limitation on these potential offsets: recognizing an offset for the profits from law violation must not be "contrary to public policy."<sup>153</sup> Yet it is interesting that the ALI refused to adopt a per se rule that it is contrary to public policy to permit offsets for illegal profits.<sup>154</sup>

That agnosticism about whether law violations are contrary to public policy as a general matter, while flatly inconsistent with the strong rhetoric about law compliance in section 2.01, is carried forward in an illustration to section 7.18(c):

A derivative action is brought to require a corporate official of XYZ Corporation to account to the corporation for \$200,000 in legally questionable overseas political contributions. The defendant admits the payments, but

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151. See *id.* Section 7.18(c) provides that:

A plaintiff bears the burden of proving causation and the amount of damages suffered by, or other recovery due to, the corporation or the shareholders as the result of a defendant's violation of a standard of conduct set forth in Part IV [duty of care], Part V [duty of fair dealing], or Part VI [role of directors and shareholders in transactions in control]. The court may permit a defendant to offset against such liability any gains to the corporation that the defendant can establish arose out of the same transaction and whose recognition in this manner is not contrary to public policy.

*Id.* § 7.18(c).

152. See Ryan, *supra* note 50, at 452-53; see also Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DEPAUL L. REV. 729, 732-33 (1996) (drawing same conclusion). In adopting this approach, the ALI followed the lead of a number of courts that require plaintiffs to show a "net loss" from illegal activity before a derivative action will lie, that is, that there is a loss after the profits from illegality are subtracted. See Ryan, *supra* note 50, at 453-56 (discussing various cases). The premise of such cases is that derivative liability serves a compensatory function, because the corporation itself receives any recovery, less attorneys' fees. Thus, to permit derivative recovery for the director or officer's illegal but profitable activities would be a windfall to the corporation, because it would get both the profits from the illegality and the derivative recovery. See *id.* Ryan argues that this rationale for the net loss rule may have been undermined in *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969), which recognized a deterrence function for derivative actions as well. See Ryan, *supra* note 50, at 456-57 (citing *Diamond*, 248 N.E.2d at 912). The ALI could have adopted other solutions than the one it did to try to address this problem, though, if articulating an unmitigated message concerning the importance of law compliance was thought important. The ALI could have suggested requiring the corporation to put any derivative recovery that constitutes a double recovery into a segregated fund for enhanced law compliance, for instance, or could have suggested adding the derivative recovery to any public fund established for those injured by law violations. Either approach would have communicated a stronger message about the importance of law compliance than the approach the ALI took.

153. See ALI PRINCIPLES, *supra* note 14, § 7.18(c).

154. See *id.*

seeks to defend on the basis that in prior years other such payments had produced profitable contracts. The court should reject this defense, and any offsets the defendant seeks to prove thereunder, because the alleged profits do not arise out of the same transaction. Even if the offsets arise out of the same transaction, the court should decline to permit offsets *that it determines are contrary to an established public policy*.<sup>155</sup>

That the contributions are “legally questionable” is not enough for the ALI to counsel rejecting offsets for profitable illegality in the final draft; a court must determine that recognizing these offsets would be contrary to an established public policy as well.

How the ALI’s views on the importance of law compliance changed over the time the *ALI Principles* were being drafted is also evidenced by comparing the above illustration in the final version with an almost identical one in the first draft, in which the drafters articulated a strong position against offsets for profitable illegality:

A derivative action is brought to require a corporate official of XYZ Corporation to account to the corporation for \$200,000 in illegal domestic political contributions. The defendant admits the payments, but seeks to defend on the basis that in prior years other such payments had produced profitable contracts. The court should reject this defense, and any offsets the defendant seeks to prove thereunder, both because such alleged profits do not arise out of the same transaction and because *in this case of knowing misconduct the allowance of such offsets would frustrate a clear public policy against bribery*.<sup>156</sup>

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155. *Id.* § 7.18(c) cmt. e, illus. 4 (emphasis added).

156. Tentative Draft No. 1, *supra* note 14, § 7.06 cmt. c, illus. 1 (emphasis added). While the language of these illustrations indicates a softening of the law compliance position between Tentative Draft No. 1 and the completed version, the black-letter language of Tentative Draft No. 1 also left to the courts the determination of whether recognizing an offset for profitable illegality “would frustrate an authoritatively established public policy.” *Id.* § 7.06(b). That choice in the first draft was related to a distinction between offsetting if the law violations were knowing versus negligent. Thus, the commentary in the first draft stated that

“knowing” misconduct seems the strongest case for a *per se* rule [not permitting offsets] since the ancient maxim that an individual should not profit from his own wrong has it [sic] clearest applicability here. Negligent conduct which results in a violation of law presents a different issue: was the statutory policy one which clearly sought to impose liability on the individual official because of a concern with the consequences of directorial inattention?

*Id.* § 7.06(b) cmt. c. This distinction between potentially permitting offsets for a negligent violation versus not permitting them for a knowing violation was not included in the final version, as the discussion of illustration two will indicate. See *infra* text accompanying

The trajectory of a second illustration from the first draft to the final draft also shows the ALI's back-pedaling on law compliance and its ultimate refusal to adopt all of the logical implications of Goldschmid's view that "if you violate the law knowingly, we are saying you are liable."<sup>157</sup> The second illustration posits an insurance company making an impermissible loan (based on legal lending limits) to an ineligible borrower.<sup>158</sup> In the first draft the loan is *negligently* made, that is, as the result of board inattention.<sup>159</sup> The loan was made well in excess of the prime rate and required repayment in five installments, but the borrower was unable to make the final payment. The defendants wish to offset the "excess" interest paid on the impermissible loan against their liability.<sup>160</sup> The commentary in the first draft suggests that public policy would not be frustrated by allowing this offset for negligence, "both [because of] the civil character of the prohibition and the absence of an individual focus to the banking regulation," particularly if some individual liability remained.<sup>161</sup> By the final draft, the illegal loan had been made in *knowing* violation of the applicable legal limits, but the commentary suggests that allowing an offset should still be permissible, again because of the civil character of the prohibition and the apparent absence of an intent in the statute "to create a specific standard for directorial performance," particularly if some residual liability remained.<sup>162</sup> Thus, while section 2.01 of the *ALI Principles* imposes a duty on the corporation to comply with the law, in this example the ALI is also willing to allow directors a credit for the profits from knowing illegality in calculating their personal liability, a position that is at best inconsistent with section 2.01.

### 3. Section 7.19: Exculpatory Clauses

Another provision that suggests a significant tempering of the ALI's concern with law compliance is section 7.19, which treats the subject of "exculpatory clauses."<sup>163</sup> Exculpatory clauses are

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notes 157-62.

157. *59th Proceedings*, *supra* note 138, at 523 (statement of Professor Harvey Goldschmid).

158. *See* Tentative Draft No. 1, *supra* note 14, § 7.06 cmt. c, illus. 2.

159. *See id.*

160. *See id.*

161. *Id.*

162. *ALI PRINCIPLES*, *supra* note 14, § 7.18 cmt. e, illus. 5.

163. *See id.* § 7.19. Section 7.19 provides, in relevant part, that:

Except as otherwise provided by statute, if a failure by a director ... or an officer ... to meet the standard of conduct specified in Part IV (Duty of Care

provisions in a corporation's articles of incorporation that limit directors' and officers' personal liability to the corporation for damages arising from certain types of breach of fiduciary duty, including breach of the duty of care, which would include law compliance. The first statute permitting exculpatory clauses was section 102(b)(7) of the Delaware General Corporate Law,<sup>164</sup> which was passed in 1986 in response to *Smith v. Van Gorkom*,<sup>165</sup> one of the very few cases successfully imposing personal liability on board members for violations of the duty of care.<sup>166</sup> Although *Van Gorkom* was based on egregious facts, it set off a maelstrom of controversy and possibly exacerbated a directors' and officers' liability insurance crisis.<sup>167</sup> In response, Delaware passed a law permitting corporations to add "exculpatory clauses" to their articles of incorporation to limit or eliminate directors' liability to the corporation for certain kinds of breach of fiduciary duty.<sup>168</sup> Delaware's statute does not allow exculpation for breaches of a director's duty of loyalty (that is, conflicts of interest) or for transactions in which the director receives an improper personal benefit, but does permit exculpation for certain breaches of the duty of care.<sup>169</sup> Significantly, though, under

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and the Business Judgment Rule) did not either:

(1) Involve a knowing and culpable violation of law by the director or officer;

(2) Show a conscious disregard for the duty of the director or officer to the corporation under circumstances in which the director or officer was aware that the conduct or omission created an unjustified risk of serious injury to the corporation; . . .

. . . ;

and the director or officer, or an associate . . . did not receive a benefit that was improper under Part V (Duty of Fair Dealing), then a provision in a certificate of incorporation that limits damages against an officer or a director for such failure to an amount not less than such person's annual compensation from the corporation should be given effect . . . .

*Id.*

164. DEL. CODE ANN. tit. 8, § 102(b)(7) (1993).

165. 488 A.2d 858 (Del. 1985).

166. *Van Gorkom* imposed personal liability on the board of directors of the Trans Union Corporation for what the court found was gross negligence for selling the entire company on an expedited basis without having made a corporate decision to sell the company, with no exigent circumstances requiring haste, without a valuation study of the worth of the business, and without reading the agreement of sale. *See id.* at 874.

167. *See* O'KELLEY & THOMPSON, *supra* note 149, at 367-70, 393-94. *But see* Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 24 (1989) (arguing that the directors' and officers' liability insurance crisis was not linked to *Van Gorkom*).

168. *See* O'KELLEY & THOMPSON, *supra* note 149, at 395. Approximately 40 states currently have similar laws. *See id.*

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

Delaware's statute a corporation may not exculpate its directors for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."<sup>170</sup>

The *ALI Principles*, by contrast, permit broader exculpation of directors in section 7.19 (so long as the directors are at least required to pay liability up to the amount of their annual compensation).<sup>171</sup> Thus, under the *ALI Principles* a corporation may not exculpate its directors for "a knowing and culpable violation of law by the director or officer."<sup>172</sup> Implicitly, then, the *ALI Principles* permit companies to exculpate their directors for liability above their annual compensation, even for knowing and intentional violations of the law, so long as these are not also "culpable" violations.<sup>173</sup> The commentary goes to some length to define a culpable violation of law, sounding like some law-as-price commentators in the process:

Section 7.19(1) covers cases involving "a knowing and culpable violation of law." Because in theory it might be arguable that even a breach of contract or an ordinary tort could be described as a "violation of law," the key word in § 7.19(1) is "culpable," by which is meant conduct that is morally reprehensible under generally prevailing standards. . . . Although most knowing violations of the penal law will be considered culpable, under § 7.19(1) there are a limited number of circumstances when noncompliance even with the criminal law may be justified. See Comment g to § 2.01 [necessity, desuetude, civil disobedience]. . . . [E]ven a "knowing" violation of law need not necessarily be considered "culpable." For example, noncompliance may

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170. *Id.* § 102(b)(7)(ii).

171. See ALI PRINCIPLES, *supra* note 14, § 7.19.

172. *Id.* (emphasis added). As might be expected given the evolution from the first drafts to the completed work-product, this provision was changed from the first draft, which would have permitted limitations on liability only so long as the conduct "did not involve knowing misconduct, or recklessness, or otherwise surpass the level of ordinary negligence." Tentative Draft No. 1, *supra* note 14, § 7.06(d)(i).

173. Professor James Cox makes a quite thoughtful argument that this structure of exculpation does a reasonable job of alleviating outside directors' legitimate concerns about astronomical liability while not encouraging intentional violations of law by the board: that liability for damages up to a full year's compensation for service on the board or a full year's salary for officers will serve as an adequate deterrent against knowing illegality. See James D. Cox, *The ALI, Institutionalization, and Disclosure: The Quest for the Outside Director's Spine*, 61 GEO. WASH. L. REV. 1233, 1253 (1993). This Article's primary interest, of course, is in evaluating the underlying concept of law animating the ALI, and from that perspective the ALI could have (and should have) gone further in communicating the message that corporate compliance with the law matters. Cox agrees that the ALI did not go far enough in imposing active responsibilities on the board with respect to monitoring the law compliance of subordinates. See *id.* at 1253-54.

be justified when a law's validity or scope is legitimately in question. . . . In other cases, although the violation may have been a "knowing" one in the strict sense of that term, the statute violated *may have been only a regulatory offense that did not carry significant criminal penalties. Such a violation, particularly if the statute or regulation is highly technical or susceptible to various interpretations, could often be characterized as non-culpable.*<sup>174</sup>

Recall the illustration from section 2.01 of a publicly-held trucking company that directs its drivers to exceed the speed limits because the corporate decision-makers conclude that to do so will increase earnings by \$400,000-\$500,000 annually.<sup>175</sup> Recall also the conclusion in section 2.01 that "the trucking company's action involves a departure from the principle stated in section 2.01(b)(1)."<sup>176</sup> Ironically, given section 7.19's definition of culpable violations, the corporate decision-makers would probably not be fully liable to the corporation for that breach of the duty of care (exculpatory clauses would effectively shield them), since traffic violations are generally considered the quintessential "regulatory offenses that [do] not carry significant criminal penalties."<sup>177</sup>

The illustrations accompanying section 7.19 are even more telling of the shift away from section 2.01's law-as-limit view of law. Thus, in language strongly redolent of the equivalence Easterbrook and Fischel draw between "penalties" and "taxes,"<sup>178</sup> an illustration to section 7.19 provides as follows:

State A has a valid statute that imposes a "penalty" on the sale of colored margarine. Although contained in State A's penal law and described as an "offense," the provision is essentially a tax, which favors the dairy industry at the expense of producers of margarine. If Food Products Corp. sells colored margarine in State A as the result of a decision by its board to incur the liability, such conduct would not amount to a "culpable violation of law" as used in § 7.19(1), because the legislation is chiefly intended to raise tax revenues.<sup>179</sup>

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174. ALI PRINCIPLES, *supra* note 14, § 7.19 cmt. f (emphasis added).

175. *See id.* § 2.01 cmt. g, illus. 10; *supra* notes 54-55 and accompanying text.

176. ALI PRINCIPLES, *supra* note 14, § 7.19 cmt. g, illus. 10.

177. *Id.* § 7.19 cmt. f.

178. *See* EASTERBROOK & FISCHEL, *supra* note 85, at 37-38. Judge Douglas Ginsburg has drawn a similar equivalence between penalties and taxes. *See infra* notes 203-07 and accompanying text.

179. ALI PRINCIPLES, *supra* note 14, § 7.19 cmt. f, illus. 1.

While few people would go to the mat to argue for the critical importance of a food additive law, the illustration raises a number of questions: Why are we sure this is a "penalty," or that it is merely "described as an 'offense?'" On whose authority has it been decided that this is "essentially a tax" or that "the legislation is chiefly intended to raise tax revenues?" Whose political analysis counts when determining that the law is one that "favors the dairy industry at the expense of producers of margarine?" Of what jurisprudential relevance is this public choice view of the underlying legislation?<sup>180</sup> And why should the political coalitions underlying different pieces of legislation matter as to whether the law is worthy of a duty of civic and political obligation (and therefore whether shareholders should have full recourse to corporate decision-makers when those decision-makers intentionally violate the law, necessitating payments of penalties-cum-taxes)?<sup>181</sup> At the least, this illustration is indicative of a very different view of law than that described in section 2.01—one that permits board members to violate the law intentionally and not even "pay the full price," particularly when regulatory law and other "highly technical" statutes or regulations are concerned.

Looking, then, at the exhortatory statements of section 2.01 in conjunction with the language of section 4.01 and the enforcement provisions of sections 7.18 and 7.19 suggests a very different picture of the importance of law compliance in the *ALI Principles* than that of section 2.01 viewed in isolation, and suggests a decided retrenchment from the importance of law compliance in the earliest drafts.<sup>182</sup> In particular, as adopted, the *ALI Principles* suggest that some law violations are of little concern and non-culpable, particularly violations of regulatory law, and that some penalties can be understood as no more than taxes or tariffs on regulated behavior.

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180. See MASHAW, *supra* note 73, at 20-21. Mashaw describes public choice theory as a theory of the legislative process that interprets legislation as the outcome of self-interested competition among interest groups for the best deal for their particular interest group: As such, it is a theory that discounts the view that legislation generally will be public-regarding or based on a fully-developed view of the public interest.

181. The ALI recognized that most exculpatory statutes apply only to directors, not officers, but it was willing to extend exculpation to officers as well, given that the officers could still potentially be liable for a year's salary. The ALI commentary indicated that the potential liability for a year's salary would be a significant enough deterrent to enforce the duty of care, while the potential for astronomical damages might make corporate officers excessively risk-averse. See ALI PRINCIPLES, *supra* note 14, § 7.19 cmt. c.

182. See Ryan, *supra* note 50, at 487 ("Section 2.01(a)'s clear obligation to comply with general legal provisions is not carried through as an absolutely enforceable component of fiduciary duty.").

*B. The Revised Model Business Corporation Act*

During the same period of time that the *ALI Principles* were being drafted, the ABA Committee on Corporate Laws promulgated the Revised Model Business Corporation Act (the "RMBCA").<sup>183</sup> The Committee's actions with respect to exculpation provisions are directly relevant to the issue of the corporate bar's view of the importance of corporate law compliance.<sup>184</sup> Here, too, we see evidence of a view of law much closer to the law-as-price view of Judges Easterbrook and Ginsburg and Professor Fischel than to the law-as-limit view of section 2.01 of the *ALI Principles*.

In February of 1990, the Committee on Corporate Laws proposed new exculpation provisions to permit corporations to eliminate the liability of directors to the corporation or its shareholders for violations of certain fiduciary duties.<sup>185</sup> The impetus for these revisions was the same as that which led to Delaware's exculpation statute: the directors' and officers' liability insurance crisis of the mid-1980s, which included both increased costs and decreased availability, and the decision by the Delaware Supreme Court in *Smith v. Van Gorkom*.<sup>186</sup> Yet the Committee on Corporate Laws went further than either Delaware or the *ALI Principles* in permitting corporations to exculpate their board members from personal liability for violations of the law. Thus, under the standard of the RMBCA, a corporation can exculpate its directors for all intentional violations of civil law, even those that would be defined as "culpable" under the *ALI Principles*, and it can provide full exculpation, rather than exculpation limited by the amount of the director's salary, as in the *ALI Principles*.<sup>187</sup>

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183. MODEL BUS. CORP. ACT (1984). See generally Branson, *supra* note 14, at 281-84 (discussing ABA revisions and the interaction between the ALI project and the ABA project). The draft revisions for the RMBCA were published for comment in 1983. They were formally promulgated for adoption in 1984. Further revisions to the duty of care, including exculpation provisions, were promulgated in 1990. See *id.* at 260.

184. The Committee on Corporate Laws of the ABA is dominated by corporate attorneys from large law firms. According to Branson, it is composed of 25 members who are specifically invited to become members, and it is unique within the ABA in having the authority to make final decisions without prior approval of either the Section of which it is a part (the Section on Corporation, Banking, and Business Law) or the ABA's Board of Governors. See Branson, *supra* note 14, at 260 n.5. As such, it is also good evidence of the thinking of the corporate bar.

185. See ABA Committee on Corporate Laws, *Changes in the Revised Model Business Corporation Act—Amendment Pertaining to the Liability of Directors*, 45 BUS. LAW. 695, 699-701 (1990) [hereinafter *ABA Revisions*].

186. See *id.* at 695 (citing *Smith v. Van Gorkom*, 148 A.2d 858 (Del. 1985)).

187. The exculpation provision of the RMBCA (section 2.02(b)(4)), as adopted, provides as follows:



The Committee on Corporate Laws never explained why directors should be permitted to be exculpated for intentional violations of civil law. Yet their explanation of why directors should *not* be permitted to be exculpated for intentional violations of criminal law is suggestive of the rationale behind permitting exculpation for intentional civil law violations. The general theory the Committee relied upon in developing the exculpation provisions was that shareholders should be able to "allocate the economic risk of the directors' conduct between the corporation and the directors," except when "important societal values are at stake."<sup>188</sup> And yet the Committee recognized that there needed to be some limits on the corporation's exculpatory power, and defined that limit as improper conduct that is "clearly without any societal benefit."<sup>189</sup>

The question arises, then, why intentional violations of civil law are not within the category of conduct that is "so clearly without any societal benefit that the law should not appear to endorse such conduct."<sup>190</sup> The specific rationale for not permitting exculpation of intentional violations of the criminal law sheds some light on this question:

Historically, the criminal law has represented society's statement of the conduct that it most emphatically rejects. Accordingly, even though a director committing a crime may intend to benefit the corporation, the shareholders should not be permitted to exculpate him for any harm caused by his crime, including, for example, fines and legal expenses of the corporation in defending a criminal prosecution.<sup>191</sup>

The distinction the ABA drew, then, between intentional

## § 2.02. Articles of Incorporation

....

(b) The articles of incorporation may set forth:

....;

(4) a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) [approving an improper dividend]; or (D) *an intentional violation of criminal law*; . . .

....

MODEL BUS. CORP. ACT ANN. § 2.02(b) (1996) (emphasis added).

188. *ABA Revisions*, *supra* note 185, at 700.

189. *Id.* at 701.

190. *Id.*

191. *Id.* at 703.

violations of civil law and intentional violations of criminal law is suggestive of portions of the law-as-price view of law, and in particular the notion that only criminal law truly prohibits actions, while civil law generally prices actions.<sup>192</sup> It is also suggestive of the notion that sometimes violating the law and accepting the known consequences of doing so is permissible as a normative concept of law, and may even be of social benefit, particularly when a regulatory rather than criminal norm is concerned.<sup>193</sup> At the least, the Committee was unwilling to conclude that intentional violations of civil law "are so clearly without social benefit that the law should not be willing to endorse such conduct."<sup>194</sup>

#### IV. A DEVELOPING JURISPRUDENCE I: EFFICIENT BREACH IN THE LAW

It is an important conceptual development that writers and corporate law thinkers have begun to adopt a view of law that suggests that intentional violations of some categories of law, particularly civil, regulatory law, are relatively unimportant—in fact, so unimportant that they may be characterized as non-culpable—and that some types of penalties for violating the law can be treated as prices or as an alternative system of taxation. Yet, it is far more important that these and related ideas have begun to have an effect on decided cases, suggesting either a right to break the law so long as one is willing to risk the penalties ("efficient breach") or that the amount of money a corporation should invest in compliance with a particular law is a function of the penalty, which also determines the importance of the law and whether the corporation should take it seriously ("efficient compliance"). This Article describes and criticizes both views below, turning first to efficient breach.

##### A. *Discussions in the Case Law*

One of the first opinions explicitly incorporating the efficient breach theory of law was *Branton v. Federal Communications Commission*,<sup>195</sup> a 1993 decision authored by Judge Douglas Ginsburg on behalf of a panel that included Judges James Buckley and Stephen Williams.<sup>196</sup> *Branton* involved a petition for review of a letter ruling

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192. See Pepper, *supra* note 9, at 1559.

193. See Smith v. National Transp. Safety Bd., 981 F.2d 1326, 1328 (D.C. Cir. 1993) (advancing that view in a decision by Judge Douglas Ginsburg).

194. ABA Revisions, *supra* note 185, at 701.

195. 993 F.2d 906 (D.C. Cir. 1993).

196. See *id.* at 907. Douglas Ginsburg is commonly recognized as a devotee of law and

by the Federal Communications Commission ("FCC") refusing to impose penalties on National Public Radio ("NPR") pursuant to 18 U.S.C. § 1464 for allegedly broadcasting material that was obscene or indecent.<sup>197</sup> Plaintiff Peter Branton, a citizen, complained to the FCC about an NPR broadcast that included evidence from the trial of John Gotti, an alleged leader of a crime syndicate in New York City. The evidence included a tape recording that was heavily peppered with "the f-word." As the court delicately put it, in the 110-word passage, Gotti used "the f-word" to modify "virtually every noun and in one instance even a verb ('I'll f-ing kill you')."<sup>198</sup> The Mass Media Bureau of the FCC found that the broadcast was "not actionably indecent" and refused to bring charges against NPR; the plaintiff challenged this decision in the United States Court of Appeals for the District of Columbia Circuit. Not surprisingly, the court dismissed the plaintiff's petition for review of the FCC determination for lack of standing.<sup>199</sup>

In dismissing the plaintiff's petition, the court first constructed what it thought his argument for standing would be, since Branton sought neither damages for the past offense to his sensibilities, nor an injunction; rather, he sought the imposition of sanctions against NPR. Thus, Judge Ginsburg suggested that "[i]f the petitioner suffers any continuing injury, we suppose it is in the nature of the increased probability that, should the NPR broadcast go unsanctioned, he will be exposed in the future to similar indecencies over the airwaves."<sup>200</sup> But this argument foundered for lack of the immediacy of harm necessary to establish standing, and from lack of causation and redressability. The court was particularly loathe to find redressability, since any impact the plaintiff would view as favorable from the sanctions (reducing programming of "indecent" material) would depend entirely on the reactions of third parties—NPR and other radio stations—to the FCC's imposing sanctions. The court thought the reactions of NPR and other radio stations were not predictable and, in particular, that it was not inevitable that the

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economics, while Stephen Williams is one of a number of judges who has recently been described by Professor Tom Ulen as particularly influenced by law and economics. See Ulen, *supra* note 23, at 434 n.3.

197. See 18 U.S.C. § 1464 (1984). At that time, § 1464 authorized fines of \$10,000, or imprisonment for two years, for radio broadcasts deemed obscene, indecent or containing profane language. See *id.* The statute has since been amended, and no longer set out specific monetary penalties. See 18 U.S.C. § 1464 (1994).

198. *Branton*, 993 F.2d at 908.

199. See *id.*

200. *Id.* at 909.

possibility of being fined would reduce the amount of “indecent” programming. Judge Ginsburg wrote:

For example, radio stations might well decide that the benefits of broadcasting indecent language of the sort petitioner here challenges outweigh the costs of making certain payments to the Government (here in the form of fines rather than of taxes). Predicting the reaction of “public” radio stations to a monetary fine is particularly difficult because such stations are non-profit entities. . . . As a result, the court can have no confidence that the FCC’s failure to impose a sanction upon NPR will lead it or any other broadcaster to injure the petitioner in the future.<sup>201</sup>

But the court was troubled by the apparent contradiction between its rationale and the rational-choice view of law compliance. Thus the court went on to reconcile the contradiction:

This holding . . . may at first seem inconsistent with the fundamental principle that increasing the price of an activity (*i.e.*, broadcasting indecency) will decrease the quantity of that activity demanded in the market, or in the language of economics, that demand curves are downward sloping. We would hardly undertake to doubt this basic principle, however. Rather, our concern is with the magnitude of its effect in this particular case (*i.e.*, with the elasticity of demand for broadcast indecency).

Without some reason to believe that the level of broadcast indecency is significantly affected by the possibility of incurring an FCC sanction, we lack a sufficient basis for the exercise of the federal judicial power.<sup>202</sup>

There are a number of interesting aspects about the *Branton* opinion. First, Judge Ginsburg was apparently unconcerned about radio stations intentionally deciding that the benefits of violating 18 U.S.C. § 1464 outweigh the costs of paying penalties to the government. Thus, he suggested that “radio stations *might well decide*” to make that trade-off, without interjecting any pejorative comment on that decision.<sup>203</sup> Second, note also the apparent

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201. *Id.* at 911-12 (citations omitted).

202. *Id.* at 912 (citations omitted).

203. *Id.* at 911 (emphasis added). One important qualification here is that in the real world it may not always be obvious to a radio station when it is broadcasting material that is “obscene or indecent,” as those terms are defined in the statute. The statute sets out standards of behavior (“do not broadcast obscene material”), rather than rules indicating what behavior is or is not required (“do not include the following words in a broadcast or descriptions of the following activities in a broadcast”). Clearly, reasonable people could

equivalence Judge Ginsburg drew between fines for violating the law and taxes: he described paying fines to the government as making "certain payments to the Government (here in the form of fines rather than of taxes)," <sup>204</sup> as if any distinction between fines and taxes is only one of form and not of substance. Third, note the underlying rational-choice assumption, which Judge Ginsburg "hardly under[took] to doubt," <sup>205</sup> that the level of demand for illegal activity will generally respond just like the level of demand for consumer goods such as potatoes or jeans or computers, <sup>206</sup> so that when the price goes up, the demand for that good goes down (although Judge Ginsburg did indicate that he was not certain about the elasticity of demand for this particular illegal activity in the context of a non-profit entity). <sup>207</sup> That there might be fundamental differences between deciding to violate the law and deciding to purchase consumer goods was not apparently credible to Judge Ginsburg.

Indeed, Judge Ginsburg could "hardly undertake to doubt" the rational-choice view of law compliance, since he had just six months earlier authored another opinion, *Smith v. National Transportation Safety Board*, <sup>208</sup> that had even more explicitly relied on it and developed its normative claims. *Smith* involved a challenge by Don Smith, a small-plane pilot, to an order of the National Transportation Safety Board (the "NTSB") affirming a decision of the Federal Aviation Authority (the "FAA"). The FAA had suspended Smith's commercial pilot's license for sixty days for entering the Dallas-Fort Worth terminal control area (the "TCA") in a small plane without

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differ about whether a broadcast met the standard for obscene or indecent material. (For a general discussion of the import of the distinction between standards and rules, although using different terms for the same distinction, see Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980).) The premise of Judge Ginsburg's discussion, though, is that of a radio station *deciding* to broadcast indecent language on the theory that the benefits outweigh the costs of legal sanctions, which implies that the radio station knows or at least thinks that the material is indecent.

204. *Branton*, 993 F.2d at 911.

205. *Id.* at 912.

206. See Jeffrey L. Harrison, *Egoism, Altruism and Market Illusions: The Limits of Law and Economics*, 33 UCLA L. REV. 1309, 1313 (1986) ("Economics may explain why a trip to the supermarket results in the purchase of one quantity of potatoes instead of another, or why the price of wheat is higher this year than last. But, when the supermarket shelves present choices labeled 'contract breach,' 'theft,' or 'rescue,' we have no reason to believe that the same assumption is appropriate. These decisions are extraordinarily complex. They are heavily influenced by social norms and notions of right, duty, and fairness.").

207. See *Branton*, 993 F.2d at 912.

208. 981 F.2d 1326 (D.C. Cir. 1993).

authorization from the terminal's air traffic controllers.<sup>209</sup> After Smith's TCA incursion, and prior to the FAA hearing on Smith's violation, the FAA had issued a bulletin reevaluating its sanctions policy for TCA violations (a policy the court described as somewhat ad hoc), and specifying that in future cases suspensions should be for not less than sixty days. Smith's license was suspended for sixty days pursuant to that policy.<sup>210</sup> In his petition to the District of Columbia Circuit, Smith successfully argued that the FAA could not rely on its bulletin in suspending his license because the bulletin was not publicly available at the time of his underlying TCA violation.<sup>211</sup>

The argument in the court of appeals turned on whether the bulletin needed to be made available to the public under the Administrative Procedure Act (the "APA")<sup>212</sup> prior to someone being charged based on the revised sanctions policy. While the substantive requirement to contact air traffic control prior to entering a TCA was unchanged by the bulletin, the bulletin did indicate a tougher, more mandatory, approach to sanctions for TCA violations.<sup>213</sup> The APA requires that each agency make public "administrative staff manuals and instructions to staff that affect a member of the public,"<sup>214</sup> and further provides that an agency may not rely on such a manual in an enforcement proceeding if it had not been made publicly available. Thus, the first part of the argument in the court of appeals turned on whether the level of sanctions for violations was something that could "affect a member of the public," as that phrase of the APA had been interpreted, and thus whether the manual needed to have been publicly available before sanctions could be levied in reliance upon it.<sup>215</sup>

The NTSB argued that its sanctions policy should not be deemed to affect members of the public, because "the severity of a sanction ... is not a proper basis for deciding whether to commit unlawful

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209. *See id.* at 1327. A terminal control area is "airspace within which all aircraft must be under air traffic control." RALPH NADER & WESLEY SMITH, COLLISION COURSE: THE TRUTH ABOUT AIRLINE SAFETY 245 (1994).

210. *See Smith*, 981 F.2d at 1327. While Smith's initial suspension was for 60 days, imposed by the FAA in reliance upon the new sanctions policy, an administrative law judge reduced the suspension to 45 days given Mr. Smith's prior record, which was exemplary, his "candor and demeanor," and his lack of notice of the new sanctions policy. On review, the NTSB reinstated the 60-day suspension. *See id.*

211. *See id.* at 1329.

212. 5 U.S.C. § 552(a)(2)(C) (1994).

213. *See Smith*, 981 F.2d at 1329.

214. 5 U.S.C. § 552(a)(2)(C), *cited in Smith*, 981 F.2d at 1327.

215. *See Smith*, 981 F.2d at 1327-28.

conduct.’ ”<sup>216</sup> In making this argument, the NTSB relied on *Capuano v. National Transportation Safety Board*,<sup>217</sup> a First Circuit opinion written by then-Judge, now-Justice, Steven Breyer. *Capuano* also involved an FAA enforcement proceeding and whether the enforcement manual on which it was based needed to be published in the *Federal Register*<sup>218</sup> (versus merely being available for public inspection and copying, as was at issue in *Smith*).<sup>219</sup> In an explicit rejection of law-as-price jurisprudence, Judge Breyer held that the FAA enforcement manual need not be published in the *Federal Register* (but would need to be available for public inspection and copying) because the manual was

not intended to affect the rights, duties, obligations, or conduct of pilots or any other member of the public. A pilot’s obligation, under the law, is to refrain from those activities that call for a sanction, whether that sanction is strict or lenient, and whether the agency devotes many, or few, staff resources to the business of catching violators.<sup>220</sup>

In *Smith*, though, Judge Ginsburg, writing for the court, rejected the NTSB’s argument that its sanctions policy for TCA violations ought not to be deemed to affect the public on a similar rationale. Initially Judge Ginsburg indicated that the court “need not decide today the normative question whether one ‘should’ consider the severity of the sanction when deciding whether to engage in conduct prohibited by regulation.”<sup>221</sup> And yet ultimately Judge Ginsburg could not resist the temptation to proclaim his views on precisely that question, and respond to what he characterized as Judge Breyer’s “dictum” in *Capuano*. He wrote:

The purpose of the APA availability requirement is obviously to give the public notice of what the law is so that each individual can act accordingly. Usually that means conforming to the law, but sometimes it means violating the law (or coming close and risking a violation) and accepting the known consequences of doing so—*especially where a*

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216. *Id.* at 1328 (quoting *Capuano v. National Transp. Safety Bd.*, 843 F.2d 56, 58 (1st Cir. 1988)).

217. 843 F.2d 56 (1st Cir. 1988).

218. *See id.* at 57.

219. *See Smith*, 981 F.2d at 1327.

220. *Capuano*, 843 F.2d at 58. Judge Breyer based his decision upon a different provision of the APA than was at issue in *Smith*.

221. *Smith*, 981 F.2d at 1328. Judge Ginsburg reasoned that the court need not enter the normative debate because the language of the APA seemed clearly to require making the manual public. *See id.*

*regulatory rather than a moral or criminal norm is concerned.*<sup>222</sup>

Judge Ginsburg then went on to describe the underlying rational-choice premise of this view that the level of sanctions will affect compliance with the law, relying upon Justice Holmes's "Bad Man" and Judge Posner's theory that an increase in the severity or likelihood of imposition of a sanction will decrease the incidence of violations.<sup>223</sup>

Again, what is striking about Judge Ginsburg's rationale is the lack of importance he attaches to obeying the law. Thus, while knowing what the law is will usually lead to conforming to law, Judge Ginsburg suggests with total equanimity that it can also lead to violating the law and accepting the known consequences, particularly in the realm of regulatory law. But note that this law seeks to ensure the safety of air travel by permitting air traffic controllers to control the density of air traffic surrounding airports—a far-from-trivial goal.<sup>224</sup> That regulatory goal does not seem to have influenced Judge Ginsburg's views, however, because he seems indifferent between someone complying with the law or violating it and risking the penalty. Again, no pejorative commentary attaches to the latter choice, and the language he uses for the law-violating choice

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222. *Id.* (emphasis added).

223. See *id.* (citing POSNER, *supra* note 3, at 5 ("[A]n increase in either the severity of the punishment or the likelihood of its being imposed will raise the price of crime and therefore reduce its incidence."); Becker, *supra* note 74; Holmes, *supra* note 22, at 459 ("A man who cares nothing for an ethical rule which is believed and practiced by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money, and will want to keep out of jail if he can.")). Each of the sources Judge Ginsburg cites is a classic work in the pantheon of rational-choice writing on law compliance; indeed, Gary Becker first set out the theory in the *Journal of Political Economics* article cited by Judge Ginsburg. Justice Holmes's "bad man" who cares nothing for an ethical rule, but who does care about expected punishments, is, of course, the central character in the rational-choice theory of law compliance. Arguably, though, Justice Holmes's point has been over-extended by rational-choice theorists whose "baseline account assumes that actors are sanction optimizers," defined as "Holmesian 'bad [men].'" Bundy & Elhauge, *supra* note 17, at 274. Justice Holmes was offering an argument for the legal positivist project of separating law from morality since at least some (but not all) people are bad men who cannot be relied upon to be swayed by ethical rules or moral argument, but who will be swayed by the expected penalties for violating the law. Nothing in Holmes suggests that the "bad man" is everyman, but that is precisely the interpretation of Holmes that informs many rational-choice theories of law compliance.

224. Within the past 15 years, there have been two mid-air collisions between commercial airliners and small planes that have occurred within TCA airspace. In one, the pilot of the small plane had not complied with TCA rules. See NADER & SMITH, *supra* note 209, at 245-47, 251-52.



("accepting the known consequences"<sup>225</sup>) connotes accepting responsibility for one's actions, an approach that is normally laudatory. For a judge to suggest that this approach to the law is appropriate as a normative matter—that one can either choose to comply with the law or risk penalties, that either choice fulfills a citizen's political obligations, and that it is therefore a matter of social indifference which choice is made<sup>226</sup>—misunderstands the normative import of even regulatory law, as discussed immediately below.

*B. The Law-as-Price Concept Inherent in Efficient Breach of Public Law Is Fundamentally Ironic*

Recall Pepper's conclusion that facts concerning the enforcement of law should be communicated to clients, even when those facts may help the client violate the law, except when a potential legal violation also constitutes a serious, morally reprehensible action.<sup>227</sup> Recall also Easterbrook and Fischel's view that managers should violate the law when it is profitable, except if the law concerns violence or other acts that are mala in se.<sup>228</sup> Judge Ginsburg recognized a similar line of demarcation, suggesting that the obligations of law are equally met by either conformance with the law or violating it and accepting the known consequences, except when a moral or criminal norm is concerned.<sup>229</sup>

These statements reveal a fundamental irony in the law-as-price position. According to these views, there is a narrow realm of positive law that truly commands obedience: law that prohibits mala in se actions, such as those constituting violence (Easterbrook and Fischel); actions that are deemed morally reprehensible by a clear social consensus (Pepper); and actions that involve criminal or moral norms (Ginsburg). Often these will be the same thing. All other law, and in particular most regulatory law, is law as cost: "[C]onduct to be penalized in some legal fashion, but which the citizen is still free to

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225. *Smith*, 981 F.2d at 1328.

226. Actually, Judge Ginsburg might not be indifferent about which approach a corporation chooses: When it costs more to meet the substantive standards of the law than a firm risks in discounted penalties, he might agree with Easterbrook and Fischel that the firm *should* choose violating the law. See Easterbrook & Fischel, *supra* note 1, at 1177 n.57.

227. See Pepper, *supra* note 9, at 1578; *supra* notes 106-24 and accompanying text.

228. See Easterbrook & Fischel, *supra* note 1, at 1168 n.36; *supra* notes 68-76 and accompanying text.

229. See *Smith*, 981 F.2d at 1328; *supra* notes 208-26 and accompanying text.

choose to do.”<sup>230</sup>

In other words, the only law that is binding operates when law is not actually necessary to set the necessary standards of behavior. If the behaviors that are prohibited are wrongful in their very nature, then we do not need law to establish the standards of behavior. We do not need laws against murder to tell us that murder is wrong, nor, in general, do we need laws against rape or kidnapping or child abuse or arson or burglary to communicate the necessary standards of behavior.<sup>231</sup> These things are obviously wrong whether we have laws to define them as wrong or not because these are actions in which there is a “clear societal consensus” that they involve “a serious and substantial moral wrong.”<sup>232</sup>

Where we need law most, though, given the highly complex, sophisticated, and technological post-industrial nature of society today, is where the law-as-price view of the law would make law impossible: precisely within the broad ambit of regulatory law. There, we definitely need binding law to structure interactions so that there is a level playing field among competitive economic enterprises, so that persons are treated fairly and with respect, and so that industrial practices include considerations of human and environmental health and safety. It is precisely because the issues addressed by regulatory law are so technically complex—composed of interrelated webs of harm, causation, and subtle externalities—and not amenable to determination by reference to obvious moral precepts, that regulatory law is critical.<sup>233</sup> Should airlines maintain

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230. Pepper, *supra* note 9, at 1577.

231. I am not at all suggesting that these laws concerning actions *mala in se* can be done away with; I merely seek to emphasize the point that these are not the critical laws for establishing appropriate and inappropriate behavior since there often is an underlying moral consensus that will arrive at the same, or a similar, result as the law, as contrasted with civil, regulatory law. Of course, even in the realm of laws concerning actions that are *mala in se* there will be situations at the margin where laws are necessary to establish what behaviors are and are not wrongful: kidnapping one's own child in a custody dispute could be subject to significant moral disagreement within society, for instance.

232. This view is particularly ironic given the underlying Holmesian legal positivism of the law-as-price view. That is, positing a sharp separation between law and morality generally, and seeking to reduce law to a system of simple material detriments and consequences for given behaviors, the argument ultimately concludes that the only *real* law is that which has a moral basis.

233. Indeed, many of the actions that are typically understood to be *mala in se* can be argued to derive from a simpler understanding of the concepts of harm and causation. We know that murder is harmful, for instance, as is assault and battery, or burglary, and our legal system has recognized these as harms since the late Middle Ages; the causal connection between the action and the harmful reaction is easily observed and readily understood. Thus, a moral understanding that this particular action is wrongful in its nature can develop to parallel (or to precede) the legal understanding, based on a much

their aircraft by a thorough operational review every twenty flights or every one hundred flights? Who knows, but in our society we have empowered a technically expert administrative agency, the FAA, with at least a partial mandate to protect passenger safety, to make that decision and to impose its decision on every industry participant. Should industrial plants discharge ammonia at a level of .050 grams per liter of effluent or at a level of .060 grams per liter?<sup>234</sup> Who knows, but we have empowered the EPA to study the issue, to consider the economic and health effects of permitting discharges of various levels of ammonia, and to make a binding decision. It is precisely because "most of us would not have an immediate answer" about "whether or not it is wrong to discharge .060 grams of ammonia per liter of water effluent"<sup>235</sup> that we need a rule developed by experts who are not self-interested, and we need that rule to be recognized as binding by all industry participants.<sup>236</sup> Therefore, by

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simpler causal paradigm and the much more obvious nature of harm. We now live in an era when we know the kinds of actions that can cause harm may be invisible, may take many years to be observable, or may be extremely difficult to identify; it is not surprising that no moral consensus has yet developed about these types of actions. Perhaps in 100 years, when (presumably) we will have much more knowledge than we do now, there will be a clear social consensus that dumping ammonia in levels greater than .050 grams per liter is morally reprehensible, for instance, if (hypothetically) it is found to cause leukemia at increased rates. Today we are far from that level of knowledge, so relying upon moral concepts of "right" and "wrong" in distinguishing law-as-limit from law-as-price is certain to be under-protective.

234. As my colleague Professor Betsy Cavendish points out, the primary justification for regulating pollution is that of market failure (i.e., the failure of the market to internalize properly all the negative externalities associated with pollution), rather than technical expertise; but expertise comes into play in setting the actual standards.

235. Pepper, *supra* note 9, at 1576 ("[W]hether or not it is wrong to discharge .060 grams of ammonia per liter of water effluent in a rural area [where the standard is .050 grams per liter] is a question to which most of us would not have an immediate answer. For all we know, such a discharge could be quite harmless; or if kept up for a period of five years, it may be likely to cause several additional cancer deaths in the next forty years. Knowing that the discharge is unlawful adds relevant information, and makes the conduct 'wrongful' in at least one sense, but not on a parallel with burglary. The discharge may be a technical legal violation, but it may not be wrongful in any other significant sense."). So, although Pepper cannot rule out that the advice one gives a client about EPA enforcement could ultimately lead to several deaths (and few lawyers presumably have the technical expertise to evaluate such a question), he still believes that the "autonomous" client, who is potentially the least likely to make the decision in a way that considers the public or is objective, and who has the most (economically) to gain from violating the law, should be the ultimate decision-maker about what the proper standard should be (that is, whether to treat the regulatory standard as binding law or not). *See id.* at 1607.

236. Of course, administrative agencies are subject to political influences, "regulatory capture," and human imperfections that will affect the quality of their decision-making and the trade-offs they are willing to make in balancing safety or health or environmental welfare against the economic burdens of regulation. *See, e.g.,* STEPHEN J. BREYER,

denying the mandatory nature of regulatory law, the law-as-price view denies us law precisely where we need it most: in the regulatory arena, where there is not a social consensus, where there is not an obvious moral component to the standards the law sets, and where humanistic concerns and economic self-interest collide most acutely.

*C. Society Is Not Indifferent Concerning Whether Firms Choose Compliance with the Law Versus Risking Paying the Penalty*

In addition to that fundamental irony at the core of the law-as-price theory, there is another serious problem with the theory: the implicit (and in some cases explicit) premise that society is indifferent concerning whether firms choose compliance with the law rather than risking paying the penalty, or even that society is benefited by this approach to law, is demonstrably false.<sup>237</sup>

The efficient breach concept of statutory and regulatory law, which is based on an understanding of law as a series of prices established for the "right" to violate the law, has evolved as a direct extension of the efficient breach of contract theory.<sup>238</sup> Both Easterbrook and Fischel, separately and writing together, make this derivation explicit.<sup>239</sup> Yet their argument fails to acknowledge the significant differences between breach of contract and breach of

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REGULATION AND ITS REFORM (1982); JOHN M. MENDELOFF, *THE DILEMMA OF TOXIC SUBSTANCE REGULATION* 105-54 (1988); NADER & SMITH, *supra* note 209. Few, if any, regulatory regimes could not be improved if the political will existed to improve them. Yet, as between a standard established by a government regulator concerning the precise requirements for aircraft maintenance, for instance, and the potentially self-interested calculation of an industry participant concerning the same subject, the former has every indication of being more objectively derived and protective of passenger safety (therefore even more rational, in the sense of matching means with ends) than the latter. Moreover, the existence of a regulation does not take away all degrees of freedom for an airline. Any airline would be perfectly free to adopt more rigorous maintenance procedures than those required by law; they are simply not permitted to adopt less onerous procedures.

237. There are other false premises inherent in the "efficient breach" view as well. They include: (1) that the penalties for violations of statutory and regulatory law are an accurate proxy for the social cost of the harm imposed for actions that violate those laws; and (2) if a corporation determines that it is profitable to violate the law, based upon its cost/benefit analysis, the corporation has the political and moral right to engage in willful disobedience of the law. The first premise will be criticized in Part V, *see infra* notes 294-399 and accompanying text, in conjunction with the "efficient investment in compliance" view; the second premise is criticized implicitly throughout this Article.

238. *See supra* note 3.

239. *See* Easterbrook & Fischel, *supra* note 1, at 1157 ("Some antitrust violations are efficient, just as some breaches of contract are efficient."); Fischel, *supra* note 45, at 1271 ("A firm may also find it advantageous to violate a law deliberately and pay the penalty for the same reason that an individual in some cases may prefer to breach a contract and pay damages.").

public law. While Pepper suggests that "Holmes' 'bad man' understanding of contract law has become so descriptively accurate that few would contest the notion of a 'right' to breach a contract,"<sup>240</sup> this insight about private law, even if it were true,<sup>241</sup> says nothing about whether one also has a "right" to breach public, statutory law simply by assuming a similar Holmesian equivalence between performance and paying damages. Admittedly, there is a surface plausibility to the analogy, since a number of influential jurisprudential traditions emphasize a contractarian understanding of social and political relationships.<sup>242</sup> Yet the analogy ultimately

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240. Pepper, *supra* note 9, at 1559. Justice Holmes's theory of contract was that a contract is simply a set of alternative promises either to perform or to pay damages for nonperformance, and so a person is free to break a contract if he chooses. See OLIVER WENDELL HOLMES, *THE COMMON LAW* 301 (1909) ("The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfilment has gone by, and therefore free to break his contract if he chooses."). As consistent with his intellectual project generally, Holmes wanted to drain any moral implications from the fact of having made a promise.

241. There is a well-developed body of work criticizing the notion of efficient breach of contract. For a comprehensive starting point, see Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 23 (1989) ("The efficient breach theory of contract raises issues of both entitlement and efficiency and succeeds on neither, as either a normative or a descriptive matter.") and Ian R. MacNeil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 950 (1982) ("The simple-efficient-breach analysis is fallacious."). For a thought-provoking critique of some of the assumptions underlying law and economics more generally, including efficient breach, see Harrison, *supra* note 206, at 1313.

242. Most notably, of course, is the social contract view of John Locke and Jean Jacques Rousseau, as extended by John Rawls. See JOHN LOCKE, *THE SECOND TREATISE ON CIVIL GOVERNMENT* (1698), reprinted in *SOCIAL AND POLITICAL PHILOSOPHY: READINGS FROM PLATO TO GANDHI* 169 (John Somerville & Ronald E. Santoni eds., 1963) [hereinafter *SOCIAL AND POLITICAL PHILOSOPHY*]; RAWLS, *supra* note 44; JEAN JACQUES ROUSSEAU, *THE SOCIAL CONTRACT OR PRINCIPLES OF POLITICAL RIGHT* (1762), reprinted in *THE SOCIAL CONTRACT AND DISCOURSES* 179 (G.D.H. Cole trans., 1990). Yet the contractarian philosophical tradition emphasizes the notion of an obligation to follow the law that derives from the social contract, and so is inconsistent with Easterbrook and Fischel's argument. Developing this point in any detail is worthy of a separate law review article, but a few general points are in order. Locke, of course, emphasized the contractual nature of social and political organization, and in particular emphasized the obligations of the individual to conform to the will of the majority, given the consent of the individual underlying the establishment of democratic political society. He wrote:

[E]very man, by consenting with others to make one body politic under one government, puts himself under an obligation to every one of that society, to submit to the determination of the majority, and to be concluded by it; or else this original compact, whereby he with others incorporates into one society, would signify nothing, and be no compact, if he be left free and under no other ties than he was in before in the state of nature.

LOCKE, *supra*, at 179. The importance of social obligation to the operation of society

underestimates the differences between breach of contract and breach of statutory law; it also underestimates the extent to which performance of statutory obligations is far superior, from a social viewpoint, to risking paying penalties.<sup>243</sup>

Thus, contract law is a species of private, voluntary law; absent duress, no one is required to enter into most contracts.<sup>244</sup> These are

once created by the original compact can be seen in the fact that Locke concludes the *Second Treatise* by reiterating the point again:

To conclude: The power that every individual gave the society when he entered into it, can never revert to the individuals again as long as the society lasts, but will always remain in the community, because without this there can be no community, no commonwealth, which is contrary to the original agreement.

*Id.* at 204. This idea was relied upon by Rawls in his work as well:

[T]he intuitive idea here is that when a number of persons engage in a mutually advantageous cooperative venture according to certain rules and thus voluntarily restrict their liberty, those who have submitted to these restrictions have a right to a similar acquiescence on the part of those who have benefited from their submission.

RAWLS, *supra* note 44, at 343. Rawls did not completely ground his theory of law compliance on the contractarian idea of voluntary consent to the institutions of the society. Rather, he distinguished between individual obligations, which arise from the voluntary consent of the individual to an institution or position (such as mother or public-office holder), and natural duties (such as natural duties to help other people and not to be cruel), which arise without regard to the individual's voluntary consent. For Rawls, the most important natural duty was the duty of fairness, which

requires us to support and to comply with just institutions that exist and apply to us. . . . Thus if the basic structure of society is just, or as just as it is reasonable to expect in the circumstances, everyone has natural duty to do his part in the existing scheme. Each is bound to these institutions independent of his voluntary acts. . . . Thus even though the principles of natural duty are derived from a contractarian point of view, they do not presuppose an act of consent, express or tacit, or indeed any voluntary act, in order to apply.

*Id.* at 115. In this way, Rawls addresses a point that can be very difficult for contractarian theories: Given that we are born into a society and did not voluntarily agree to the institutional arrangements of that society, why do we have duties to comply with the laws issuing from that society?

243. This paragraph ought not to be interpreted as if I agree with efficient breach of contract, and simply disagree with its extension to efficient breach of public law; rather, one need not reach the efficient breach of contract question to evaluate its extension. In fact, I do not agree with efficient breach of contract, for many of the reasons Friedman and Harrison identify, *see supra* notes 206, 241, and I do not even agree with the Holmesian project of undermining the moral obligations inherent in making a promise. Instead, I agree with Philip Soper's comment on this point, which is that "to admit that the obligation to obey the law is on par with the obligation to keep promises is to solve the problem of political theory." SOPER, *supra* note 43, at 87.

244. This is not to deny that complex problems can arise about the voluntariness of the terms of a contract in a number of important situations, particularly when inequalities in bargaining power may ultimately undermine the concept of "voluntariness." For instance, in the insurance context, in order to become insured one must "voluntarily" agree to certain health tests, or in the securities industry, in order to invest funds or become employed one must "voluntarily" agree to arbitrate claims arising out of the

voluntarily undertaken obligations and usually confined to mechanisms of economic exchange. Even Holmes recognized that the voluntary nature of contract law is important in our view of breach of contract.<sup>245</sup> Public law, on the contrary, is not voluntary in this same sense: one takes on the obligations of citizenship (which include following the law) simply by virtue of enjoying the benefits of society; it is impossible to live in a society without enjoying those benefits, and thereby being required to fulfill the correlative obligations.<sup>246</sup> Indeed, following the law has traditionally been

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relationship. See *Rice v. Brown Bros. Harriman & Co.*, No. 96 Civ. 6326 (MBM), 1997 WL 129396 (S.D.N.Y. Mar. 21, 1997) (involving a plaintiff's claim contesting the voluntariness of arbitration agreement); *Pilanski v. Metropolitan Life Ins. Co.*, No. 95 Civ. 10292 DC, 1996 WL 622024 (S.D.N.Y. Oct. 28, 1996) (holding that involuntariness of agreement to arbitrate must be shown by duress or coercion); *Harris v. Shearson Hayden Stone, Inc.*, 441 N.Y.S.2d 70, 76 (App. Div. 1981) (upholding "voluntary" agreement to arbitrate securities claims), *aff'd*, 435 N.E.2d 1097 (1982). See generally 13 SAMUEL WILLISTON & WALTER H.E. JAEGER, A TREATISE ON THE LAW OF CONTRACTS § 1601 (3d ed. 1970 & Supp. 1996) (describing early cases involving duress).

245. See HOLMES, *supra* note 240, at 237 ("As the relation of contractor and contractee is voluntary, the consequences attaching to the relation must be voluntary."). Of course, one can argue that a moral principle of fidelity should operate more strongly in the contract situation because one did voluntarily choose to bind oneself to enter the contract, and one did choose this particular contract over another and chose the terms of the contract (subject to the caveat concerning voluntariness discussed above).

246. The idea that political obligation may be based on having received the benefits of living in a society is of classical derivation, having been expressed by Socrates in the *Crito*. See Plato, *The Crito*, reprinted in SOCIAL AND POLITICAL PHILOSOPHY, *supra* note 242, at 46, 55-56. More recently, the idea has been developed by John Rawls as an implication of justice as fairness. See RAWLS, *supra* note 44, at 110-12. Rawls explains the point as follows:

[A] person is required to do his part as defined by the rules of an institution when two conditions are met: first, the institution is just (or fair), that is, it satisfies the two principles of justice; and second, one has voluntarily accepted the benefits of the arrangement or taken advantage of the opportunities it offers to further one's interests. The main idea is that when a number of persons engage in a mutually advantageous cooperative venture according to rules, and thus restrict their liberty in ways necessary to yield advantages for all, those who have submitted to these restrictions have a right to a similar acquiescence on the part of those who have benefited from their submission.

*Id.* at 111-12. For this latter insight, Rawls credits H.L.A. Hart, *Are There Any Natural Rights?*, 64 PHIL. REV. 175, 185 (1955). See RAWLS, *supra* note 44, at 112 n.27. Not everyone agrees that having accepted the benefits of a society creates a correlative obligation to that society: Noted Libertarian Robert Nozick has criticized the idea. See ROBERT NOZICK, ANARCHY, STATE AND UTOPIA 90-95 (1974). Nozick would "[a]t the very least . . . want[] to build into the principle of fairness the condition that the benefits to a person from the actions of the others are greater than the costs to him of doing his share," but even "[i]f the principle of fairness were modified so as to contain this very strong condition, it still would be objectionable." *Id.* at 94. Nozick concludes that the fact that we partially are "social products" in that we benefit from current patterns and forms created by the multitudinous actions of a long string of long-

thought of as the absolute *minimum* component of a citizen's duty to her society.<sup>247</sup>

Related to this point is one based on the underlying norms or values of contract law, as opposed to public, statutory law. These norms point in different directions and are effectuated by a different relationship between the individual and her society.<sup>248</sup> Thus, the underlying norms of contract law are autonomy and individualism: "[T]he contract paradigm expresses the basic norm that individuals should be able to agree between and among themselves how to allocate resources."<sup>249</sup> Absent unusual circumstances, society, through the auspices of the courts, will not even enter into the relationship, at least not so far as judging the fairness of the terms of the contract or whether parties should or should not engage in the underlying terms of exchange.<sup>250</sup> In contrast, the underlying norm of regulation is that of social obligation and responsibility, and the

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forgotten people, forms which include institutions, ways of doing things, and language ... does not create in us a general floating debt which the current society can collect and use as it will.

*Id.* at 95. Rather, Nozick would seek to ground political obligation on "persons' consenting to cooperate and limit their own activities." *Id.*

For an interesting third path grounding the duty to comply with law neither on the benefits received, as Rawls did, nor on consent, as Nozick did, but on reason, see SOPER, *supra* note 43, at 76-90. Soper suggests that the following conditions are sufficient to establish political obligation:

(1) the fact that the enterprise of law in general—including the particular system, defective though it may be, that confronts an individual—is better than no law at all; and (2) a good faith effort by those in charge to govern in the interests of the entire community, including the dissenting individual.

*Id.* at 80.

247. For example, see Lon Fuller's discussion of the distinction between the duty of obligation (including following the law) and the duty of aspiration (pursuing excellence and virtue). See FULLER, *supra* note 44, at 5. A similar idea is found in Rawls's discussion of duties and obligations, as distinct from goodness. See RAWLS, *supra* note 44, at 210; see also Stone, *supra* note 38, at 559 (positing that being responsible requires more than just being law-abiding, but involves being morally reflective as well).

248. See *Foley v. Interactive Data Corp.*, 765 P.2d 373, 389 (Cal. 1988) ("The distinction between tort and contract is well grounded in common law, and divergent objectives underlie the remedies created in the two areas. Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate 'social policy.'" (citing WILLIAM L. PROSSER, *THE HANDBOOK OF THE LAW OF TORTS* 613 (4th ed. 1971))).

249. William Powers, Jr., *Border Wars*, 72 TEX. L. REV. 1209, 1211 (1994).

250. Of course there are limits on this statement, such as if one party brings a claim of overreaching, or duress, or claims that the contract was void as against public policy, for instance, but the statement is generally true. See *Rich & Whillock, Inc. v. Ashton Dev., Inc.*, 204 Cal. Rptr. 86, 91 (Ct. App. 1984) (holding a settlement agreement unenforceable when it resulted from duress); *Ekl v. Knecht*, 585 N.E.2d 156, 163 (Ill. App. Ct. 1991) (holding a contract unenforceable when it resulted from duress).



process is one of society, through the legislature and administrative agencies, setting out what constitutes minimally acceptable behavior.<sup>251</sup> There is no obvious reason why conclusions from a paradigm that effectuates individual freedom should apply at all to a paradigm that effectuates the processes of social control—control that is necessary, given the size of the population, in order to maintain any realm of individual freedom.<sup>252</sup>

Yet another distinction is that parties to a contract can be presumed to know their rights, to know when the contract has been breached (or when at least one party thinks it has been breached), and to be able to insist on compensation as defined in the contract. Even the most ardent advocates of the theory of efficient breach of contract recognize that actual compensation is required, or the goal of the theory (efficiency) will not be well-served. Thus, Judge Posner has relied upon this point in ruling on efficient breach, stating that “efficiency is promoted by allowing him to break his promise, *provided he makes good the promisee’s actual losses.*”<sup>253</sup> The same cannot be said about breach of public law: Affected individuals may not know of their rights or that their rights have been infringed upon; or there may be strong disincentives to insisting on one’s rights based on the nature of the relationship (for example, employer/employee or landlord/tenant); or public enforcement agencies may not know of law violations, since violators will have every incentive to hide their conduct; or compensation (paying the penalties) may not occur for many reasons unrelated to the underlying conduct, such as the difficulty and expense of enforcing one’s rights in court, relative to the amount of money at issue. Even when compensation does occur, the costs associated with asserting one’s rights, particularly if attorneys’ fees are not recoverable, may lead to net economic losses. So, taking the parameters of efficient breach of contract as a model, if the goal of “efficient breach of public law” is efficiency, it will not be well-served by behavior that merely risks paying penalties, rather than actually paying them.

But, given the significant differences between “efficient breach of contract” and “efficient breach of public law,” society is still the

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251. See Powers, *supra* note 249, at 1212.

252. See SOPER, *supra* note 43, at 81 (“It is, after all, hard to find a genuine anarchist among contemporary political theorists. Even those most critical of state intrusions on individual liberty remain persuaded of the legitimacy of the state, however ‘ultraminimal.’”).

253. Patton v. Mid-Continent Sys., Inc., 841 F.2d 742, 750 (7th Cir. 1988) (emphasis added).

net loser under the Easterbrook/Fischel view of the law even if there is compensation, given the nature of many of the types of harm caused by failing to comply with one's statutory and regulatory obligations. Since the harm caused by breach of contract is primarily economic, it can often be fully compensated by monetary damages. Significantly, when money damages will not equally compensate a promisee, the courts demand specific performance.<sup>254</sup> In the realm of public law, specific performance of statutory obligations is always far superior to having putative defendants paying penalties when the harm to be avoided is not primarily economic. Even in those instances in which the harm to be avoided by a particular statute is purely economic, statutory compliance will usually be preferable. A number of examples can best illustrate these points.

### 1. Violations of Laws Regulating Economic Harm

The overtime provisions of the Fair Labor Standards Act<sup>255</sup> ("FLSA") establish the general rule that employees must be compensated at not less than one and one-half times their regular rate of pay for all hours worked in excess of forty hours in a single work week.<sup>256</sup> These overtime provisions do not apply to professional, managerial, or administrative employees, as those terms are defined in regulations issued by the Secretary of Labor.<sup>257</sup> Recently, the Employer Policy Foundation, which is an employer-sponsored policy institute in Washington, D.C., issued a report estimating that employees would be paid an additional \$19 billion a year if violations of these overtime rules were not so common.<sup>258</sup>

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254. See *Vincent v. Vits*, 566 N.E.2d 818, 819-20 (Ill. App. Ct. 1991) (holding that specific performance is permitted in real estate, given the unique nature of real estate); cf. *Klein v. PepsiCo, Inc.*, 845 F.2d 76, 80 (4th Cir. 1988) (holding that specific performance was not appropriate when damages would fully compensate injured party for defendant's failure to sell corporate jet as promised); *Van Wagner Adver. Corp. v. S & M Enters.*, 492 N.E.2d 756, 759-60 (1986) (holding that specific performance of contract to lease "unique" billboard space was properly denied when damages were adequate remedy). For an argument that courts should more uniformly award specific performance instead of expectation damages for remedy of contract breach, see Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984).

255. 29 U.S.C. §§ 201-19 (1994).

256. See *id.* § 207(a)(1).

257. See *id.* § 213(a)(1).

258. See G. Pascal Zachary, *Shortchanged: Many Firms Refuse to Pay for Overtime, Employees Complain*, WALL ST. J., June 24, 1996, at A1. Violations occur in a number of ways, as described in the *Wall Street Journal* article:

[M]any employers may deliberately evade federal rules by ... arbitrarily exempting workers from overtime pay. In other cases, workplace changes, due

While the U.S. Department of Labor initiates 20,000 cases a year challenging overtime violations and wins settlements for employees in ninety percent of them,<sup>259</sup> the extent of the problem clearly overwhelms the Department's enforcement capabilities.<sup>260</sup>

A number of points can be made about this example, which is an instance in which the harm to be avoided is purely economic. First, employers are not "efficiently" breaching the law and paying the penalties. They are violating the law and not paying either the penalties or overtime legitimately owed to their employees absent enforcement actions.<sup>261</sup> This should more properly be called stealing or cheating, rather than "efficient breach of law." Moreover, it cannot be argued that this is a law that, through the processes of desuetude, has become "not law." Society has established a labor standard and, through the auspices of the Department of Labor, is attempting to enforce it; in setting that standard the economic interests of employers were no doubt well represented and seriously considered. Certainly the extent of Labor Department enforcement is constrained by the number of investigators. Yet it would be quite a cynical argument to suggest that the low level of investigators is indicative of an underlying lack of seriousness about enforcement of this law that borders on desuetude. Rather, there is a limit to how many resources our society can spend to enforce any of its laws, given all the other competing priorities for the use of funds. To a very

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to corporate downsizing and pushing authority down through the ranks, makes it harder for employers to know which jobs are or aren't exempt.

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Some employers cut through the confusion by ignoring overtime rules. Many small companies, to avoid getting caught, don't keep time records, concoct phony ones or hire the same person under several names, federal inspectors say....

Larger companies are more likely to take a see-no-evil approach. They issue guidelines making overtime pay mandatory, punish employees who work extra hours without permission and yet raise productivity targets. When employees work off the clock to meet those targets, supervisors look the other way....

*Id.*

259. *See id.*

260. In 1996, the Department of Labor had only 800 investigators, and they also investigated and prosecuted violations of minimum wage laws, child labor laws, and other workplace rules. *See id.*

261. As may be expected, certain industries are violating these statutory provisions and administrative regulations more than others: The *Wall Street Journal* analyzed 74,514 cases brought by the Department of Labor from 1991 through 1995, and found that "some industries, such as railroad and tobacco, had almost no violations, while industries such as construction and apparel were cited for illegally denying overtime to one out of every 50 workers during the period." *Id.*

great extent, society needs to rely upon a reservoir of law-abidingness as an "enforcement" tool. To the extent that the efficient breach theory undermines that reservoir and legitimizes violations of law, it is to be condemned.

In their defense, some employers contend that the requirements are uncertain, and, indeed, there are conflicts in the circuits about key provisions in the rules.<sup>262</sup> Doubtless there are numerous instances in which well-meaning employers are unable to determine if a particular employee performs administrative, managerial, or executive functions, as defined in the regulations, and so is exempt from overtime. Yet the fact that ninety percent of cases are settled favorably to employees seems to belie the contention that what is required is uncertain. Rather, in many instances, there is a clear economic incentive for employers to violate the law, since the damages are usually money owed for the prior two years' overtime (or three years for a willful violation) and the delays in getting a judgment can be considerable (which, given the time value of money, operates to the employer's benefit).<sup>263</sup> In most instances, employers can violate these laws with impunity, notwithstanding the social consensus, as expressed in the statute, that non-professional employees ought not to be required to work overtime without appropriate compensation.<sup>264</sup> Since most employers who violate these laws are merely risking paying penalties, not actually paying them, the ultimate effect of this "efficient breach of law" is wrongfully to redistribute \$19 billion per year from workers (who are

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262. For instance, different circuits have adopted different tests to determine whether an employee is a managerial employee, and therefore exempt from receiving overtime. Compare *Hays v. City of Pauls Valley*, 74 F.3d 1002, 1007 (10th Cir. 1996) (holding that in evaluating whether employee's primary duties are managerial, more than 50% of time must be spent on managerial activities), with *Bankston v. Illinois*, 60 F.3d 1249, 1252 (7th Cir. 1995) (holding that in evaluating primary duties, at least 80% of primary duties must be managerial).

263. See MATTHEW W. FINKIN ET AL., *LEGAL PROTECTION FOR THE INDIVIDUAL EMPLOYEE* 238-39 (2d ed. 1996). Double damages are possible, although discretionary: The trial court has the authority to reduce the double-damage aspect if it finds that the employer acted in good faith. See 29 U.S.C. § 260 (1994).

264. There are a number of factors that make these kinds of violations particularly difficult for aggrieved individuals to police. Many people may not know of their legal rights or may be hesitant to insist upon them even if they know about the law. Employers in most instances wield more power than employees, particularly in the current economic environment of downsizing, outsourcing, and relocating production to foreign countries. Employers may fail to keep the records required by FLSA; absent those records, these cases are difficult to prove, particularly since co-workers may be unwilling to testify against their employers.

also consumers) to employers.<sup>265</sup> These kinds of *uncompensated* distributions from employee to employer ought not be dignified under the rubric of increasing efficiency.

## 2. Violations of Laws Regulating Non-Economic Harm

In many (and perhaps most) instances the harm to be prevented by a statute or regulatory enactment is not purely economic; in such cases "specific performance" is even more obviously superior to the risk of paying penalties, or even paying the penalties. Speed limits are one such type of law. Pepper's writing would suggest that speed limits are the essence of a *malum prohibitum* law, firmly located in the realm of law-as-price.<sup>266</sup> In contrast, in commentary to section 2.01 the ALI stated that it would not be permissible for the relevant decision-maker at a trucking firm to instruct its drivers to exceed the speed limit by twenty miles per hour in order to save \$400,000-500,000 per year (although that message of section 2.01 was significantly qualified, as discussed above).<sup>267</sup> In other words, according to the ALI the penalties for violating speed limits are not to be treated as simply another cost of doing business. When the underlying policy goals animating speed limits are examined, it is evident that the unqualified ALI exhortatory position is correct.<sup>268</sup>

Thus, setting speed limits is not simply an economic decision or a revenue-generating device for local taxing authorities, although economics plays a part and speed limits can seem to be a revenue

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265. See Zachary, *supra* note 258, at A1. Similar dynamics operate in other instances in which the harm to be avoided is purely economic. For example, the SEC Discretionary Accounts Rule, 17 C.F.R. § 240.15c1-7 (1997), prohibits "churning," which is defined as excessive trading (either in size of trades or frequency) by a broker who has discretionary authority over a customer's account. The purpose of churning is to generate commissions for the broker. This rule may be violated easily. Here again, people often will not know the law, or will not know that it has been violated, or may be unwilling to bring legal actions to get reimbursement for commissions extracted in violation of anti-churning laws until the amount of money at issue becomes significant. A priori there is no obvious reason why a large distributional effect from shareholders to stockbrokers is a good thing; and even if it would be a good thing for some reason, there is a directive from the SEC to the contrary. Other examples from the labor field are, unfortunately, also prevalent, as Pepper has noted. See Pepper, *supra* note 9, at 1592 (quoted *supra* in note 57).

266. See Pepper, *supra* note 9, at 1561-62; see also Beveridge, *supra* note 152, at 731 n.9 (suggesting that "[t]he recently repealed 1974 federally mandated 55 mph speed limit is a particularly poor choice as an example of a law which should command undeviatingly strict compliance [in § 2.01]," because, according to a *Wall Street Journal* report, "the top speed of 85% of cars on the road is 64.1 mph" (citing Quentin Hardy, *Westerners Rev up to Speed Legally Again*, WALL ST. J., Nov. 13, 1995, at B1)).

267. See ALI PRINCIPLES, *supra* note 14, § 2.01 cmt. f, illus. 10; see also *supra* notes 129-82 and accompanying text (discussing how section 2.01 is qualified by other sections).

268. See *supra* notes 48-67 and accompanying text (discussing the ALI position).

generating device in certain states on certain holiday weekends. In setting speed limits, the primary goal is obviously safety: the higher the speed limit, the higher the fatality rate in serious automobile accidents.<sup>269</sup> A secondary goal is to reduce the environmental impact of driving: driving fifty-five miles per hour instead of sixty-five results in reduced gasoline consumption, which in turn reduces air pollution.<sup>270</sup> Reducing air pollution produces corollary health benefits.<sup>271</sup> And during the 1970s, reducing gasoline consumption was also tied to the policy goal of reducing American dependence on foreign oil.

Moreover, in setting speed limits, the legislature and various administrative agencies balance the economic costs of lower speed limits (including increased transportation time to ship goods) with the social benefits of safety, health, and environmental protection.<sup>272</sup>

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269. Many of these points were made in congressional testimony in 1995 when Congress was considering permitting states to raise their speed limits from 55 mph to 65 mph while still retaining eligibility for federal transportation funds. See generally H.R. REP. NO. 104-246, at 134 (1995), reprinted in 1995 U.S.C.C.A.N. 522, 571 (describing testimony on economic, environmental, and safety effects of higher speed limits); *Advocates for Highway and Auto Safety: Hearings Before the Subcomm. on Transp. of the House Comm. on Appropriations*, 104th Cong. 261 (1995) (statement of Michael F. Dineen, Vice-President of Kemper National Insurance Co.) ("The physical forces in a crash double with every 10 mph increment of speed above 50 mph. At 60 mph, a crash is twice as deadly as at 50 mph, and at 70 mph it is four times as deadly."); *Legislation to Approve the Nat'l Highway Sys. and Ancillary Issues Relating to Highway and Transit Programs: Hearings Before the Subcomm. on Surface Transportation of the House Comm. on Transp. and Infrastructure*, 104th Cong. 705 (1995) (statement of Stephen Hargarten, M.D., Interim Chairman for the Department of Emergency Medicine at the Medical College of Wisconsin) (expressing concern that raising speed limits increases the number of vehicles driving over 70 mph, at which speed crashes are four times as deadly as at 50 mph; in New Mexico, the first state to raise its speed limit to 65 mph, about 40% of all cars were exceeding 70 mph, as were 20% of large trucks).

270. See *Domestic Petroleum Production and Int'l Supply: Hearing Before the Senate Comm. on Energy and Nat. Resources*, 104th Cong. 15 (1995) (statement of William White, Deputy Secretary of Energy) (discussing increased consumption of gasoline at increased speed limits).

271. See, e.g., John J. Fialka, *Clinton Backs Rules Covering Air Pollution*, WALL ST. J., June 26, 1997, at A4; John J. Fialka, *EPA Plan to Tighten Pollution Rules Continues to Divide White House Aides*, WALL ST. J., June 6, 1997, at A16.

272. During the Carter administration, efforts began to centralize review of proposed regulations in the Office of Management and Budget ("OMB"). These efforts were expanded during the Reagan administration, which issued Executive Order No. 12,291, 46 Fed. Reg. 13,193 (1981). President Reagan's executive order stated, *inter alia*, that "[r]egulatory action shall not be undertaken unless the potential benefits to society from the regulation outweigh the potential costs to society"; it developed a specific process for each agency to develop a Regulatory Impact Analysis to identify and quantify, when possible, all of the costs and benefits of a proposed regulation, and who is likely to bear those costs, and it provided for review by OMB. See Executive Order No. 12,291, 46 Fed. Reg. 13,193 (1981); STEPHEN G. BREYER & RICHARD B. STEWART, ADMINISTRATIVE

It is reasonable to assume that the economic interests of corporate entities are well-represented in the legislative and administrative-agency process as a general matter.<sup>273</sup> So, for individual corporations to determine that they will violate the law because the potential costs to them of compliance are outweighed by the potential costs and benefits of violation creates a "double-counting" problem: the legislature has already considered the costs to industry of regulatory compliance in making its determination. In a democracy, if the corporation disagrees with the legislature, there are ways to seek to change that determination short of economic vigilantism.<sup>274</sup> Because general compliance with the law will promote the legislative goals of safety, health, and environmental protection, general compliance is far superior to general non-compliance coupled with some percentage of people paying traffic tickets to various local authorities.<sup>275</sup>

The argument that compliance is socially preferable to paying penalties is even stronger with respect to statutes and regulations that seek to prevent harms that are primarily non-economic, such as health or safety statutes (the Occupational Safety and Health Act<sup>276</sup> being a prime example), environmental statutes (the Clean Air Act<sup>277</sup> or the Clean Water Act,<sup>278</sup> for instance) or civil rights statutes (such as the Americans with Disabilities Act<sup>279</sup> or the Civil Rights Act<sup>280</sup>).

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LAW AND REGULATORY POLICY 108-09 (3d ed. 1992) (citing Exec. Order No. 12,291, 46 Fed. Reg. 13,193 (1981)). President Clinton has continued the approach of having OMB review individual agency proposals, while making clear that non-economic costs and benefits must also be included in the cost/benefit analysis. *See id.*

273. *See, e.g., Legislation to Approve the Nat'l Highway Sys. and Ancillary Issues Relating to Highway and Transit Programs: Hearings Before the Subcomm. on Surface Transportation of the House Comm. on Transp. and Infrastructure*, 104th Cong. 791-94 (1995) (statement of Scott Wexler, on behalf of the National Licensed Beverage Association) (articulating support for the elimination of speed limits and other changes in highway safety laws).

274. This argument does not even address the considerable difficulties with the efficient breach view of law from the perspective of political obligation.

275. One response from the law-as-price advocate could be that it is rhetorical "stacking the deck" to posit such widespread disobedience to speed limits such that the disobedience could have a demonstrable effect on the goals of safety, health, and environmental protection. That response is unpersuasive, since it suggests an approach to law for oneself, or within one's industry, that one recognizes would undermine the substantive goals of a particular law if adopted as a general matter. Certainly a theory about law, and about political obligation, that is possible only so long as a minority of people adopt the theory is suspect.

276. 29 U.S.C. § 651 (1994).

277. 42 U.S.C. § 7401 (1994).

278. 33 U.S.C. § 1251 (1994).

279. 42 U.S.C. § 12101 (1994).

The purposes of these statutes are to promote health, safety, dignity, equality, and environmental protection; they are not simply alternative types of revenue-raising devices. Compensation *ex post* for an arm lost or a daughter killed in an industrial accident or a water table that is lethal or a human spirit that is heavy with being judged as a type and not as an individual is better than no compensation at all, but it is a distinct second-best alternative to being the beneficiary of good faith efforts to comply fully with the protective goals of the law *ex ante*.<sup>281</sup> While the costs of these "intangible" harms can be given an economic value for purposes of compensation *ex post*, to confuse the economic value of after-the-fact compensation with the actual human (and environmental) costs of non-economic harm is like an occupant of Plato's cave confusing the shadows of reality for the real thing.

Even if the analogy between breaching a contract and breaching a public law were a good one—and it is not, for the reasons identified above—"specific performance" of statutory obligations is always superior to risking penalties, even when the underlying statute aims at preventing economic harm (because of distributional effects), but in particular when the underlying statute seeks to prevent various kinds of non-economic harm that are badly compensated, if at all, in money. Taking this "moralistic approach to the meaning of . . . law,"<sup>282</sup> must one then argue that every law is equally important? On one interpretation, what the "law-as-prohibition" versus "law-as-cost" approach seems to be getting at is the obviously correct idea that some laws are more important than other laws. So, are OSHA regulations requiring posting of inspection information, or a Delaware statute requiring corporations to keep a list of their current shareholders available in Delaware for shareholders to inspect and copy, as important as FAA regulations governing commercial airline maintenance and equipment requirements? And are each of these laws as important as laws prohibiting murder? Of course not. It is not a necessary corollary to an argument that the penalties for violations of the law cannot be treated as a price tag for the right to

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280. 42 U.S.C. § 1981 (1994).

281. The point that many harms are badly compensated in money is, of course, well-recognized in law and economics. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 306 (2d ed. 1997) ("Compensatory damages are intended to 'make the victim whole.' In some circumstances, this is impossible. For example, when a child is killed in a tortious accident damages cannot be computed on the formula, 'Find a sum of money such that the parents are indifferent between having the money and a dead child, and not having the money and having their child alive.'").

282. Engel, *supra* note 4, at 45.



violate the law that one assume every law is equally important. The importance of a law is determined by its purposes and the harm it seeks to prevent or ameliorate.<sup>283</sup> A law seeking to prevent an immediate death is obviously of paramount importance because of the irrevocability of the harm. Laws such as airline maintenance requirements seeking to prevent a very small possibility of death or serious injury are somewhat less important (although still extremely important), since some huge proportion of individuals will "beat the odds" no matter how bad airline maintenance becomes.<sup>284</sup> The law on corporate shareholders' lists is less important still (except perhaps to shareholders and institutions ready and willing to engage in proxy contests), and the OSHA posting requirements are less important than each of the others, since failure to post required information is not, in itself, likely to result in an injury or illness.

And yet to recognize that there is a range of importance of law does not mean that there is a range of permissible fidelity to the law that goes to zero, simply because one is willing to risk the imposition of a penalty. Unless a law explicitly and clearly imposes a tax or tariff on behavior, even the most objectively unimportant, purely administrative law with no distributive, health, safety, environmental, or existential implications (hereinafter "unimportant law") establishes a minimum standard of behavior that may not be overcome by a corporate or individual actor's private economic benefit (assuming the underlying political system is worthy of fidelity).<sup>285</sup> That is the ideal.<sup>286</sup> The vagaries and imperfections of

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283. Soper suggests that the importance of a law can affect the weight of the obligation to obey, such that the moral culpability of not fulfilling the obligation to obey is directly proportional to the seriousness with which those who would demand others' compliance with a particular law would view disobedience. See SOPER, *supra* note 43, at 87. The insight that there is a range of *weight* to the prima facie obligation to comply with law is an important one, since it comports with our collective sense that some laws are more important than others and that the moral wrong of a failure to comply will also vary with the importance of law. But Soper does not suggest that at some point the obligation to comply disappears, except in the case of desuetude: "[A] law that nobody cares about anymore simply does not obligate, legally or otherwise." *Id.*

284. In 1991, Eastern Air Lines, Inc., pled guilty to criminal charges arising out of a pattern of falsifying maintenance records by stating that required maintenance procedures had been performed when they had not. See *United States v. Upton*, 856 F. Supp. 727, 733 n.1 (E.D.N.Y. 1994). Those charges arose out of Eastern's falsifying maintenance records beginning in 1985 "to, on or about February 1989," and, according to the FAA, flying aircraft that were "not in an airworthy condition." NADER & SMITH, *supra* note 209, at 325. Fortunately, no Eastern Air Line airplanes crashed during that period of time. See *id.* at 353-54 app.

285. See SOPER, *supra* note 43, at 87. Indeed, where a law is unimportant in the sense this Article has defined (protects neither health, safety, dignity, environmental cleanliness, nor economic rights), the fact of compliance as an act of political faith or

human beings being what they are, the ideal will never be fully realized. And yet we ought not to sully our ideals about law by undermining the meaning of law *ab initio*, turning it into a price tag, available to be risked by anyone who can afford it, and then, further to undermine the ideal, dignify that erosion by calling disobedience "efficient" and suggesting that it is to society's benefit.

The one qualification I would add here is to acknowledge that many theories of law have recognized a right of the individual to refuse to comply with a law that is fundamentally morally abhorrent to that individual—that is, the right of civil disobedience.<sup>287</sup> John Rawls defines the issue as that of conflicting duties: "At what point does the duty to comply with laws enacted by a legislative majority (or with executive acts supported by such a majority) cease to be binding in view of the right to defend one's liberties and the duty to oppose injustice?"<sup>288</sup> But Rawls's definition of civil disobedience—as a public, conscientious political act contrary to law, usually done to bring about a change in the law—shows that there are determinative differences between civil disobedience and the so-called efficient breach of law.<sup>289</sup> Thus, civil disobedience presupposes an open violation of law with the expectation and goal that sanctions will be imposed. And, as traditionally understood, it is motivated by deeply held moral views about the injustice of a particular law or legal structure and is based upon a theory of public benefits from changing the law, with no expectation of personal profit. This motivation is quite different than that of a secret violation of law—hoping to escape sanctions, based upon a calculation of private economic benefits to a particular corporation, the purpose of which is self-

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responsibility or even *maturity* may be more important than any other positive social benefits from compliance.

286. This is not a surprising assertion, although in the context of today's process-dominated, Holmesian, law-and-economics-influenced, positivist view of law, it may sound quite naive, even quaint. Yet arguments against the concept of political obligation to law are a relatively new phenomenon. As Philip Soper has put the point, "Philosophers, after all, have only recently begun to argue against the existence of a [prima facie obligation to comply with the law]; most moral philosophers who have shaped Western consciousness, from Plato to Kant, seem to have assumed or explicitly argued for [such an obligation]." SOPER, *supra* note 43, at 94. Soper points to M.B.E. Smith and Joseph Raz as among the political philosophers who have begun to question the notion of a prima facie obligation to obey the law. See JOSEPH RAZ, *The Obligation to Obey the Law*, in *THE AUTHORITY OF LAW: ESSAYS ON LAW AND MORALITY* 233 (1979); Joseph Raz, *Authority and Consent*, 67 VA. L. REV. 103 (1981); Smith, *supra* note 43.

287. See RAWLS, *supra* note 44, at 363.

288. *Id.*

289. See *id.*

interested profit-making.

One possible rejoinder is to suggest that personal autonomy is being actuated by the law-as-price view, and that vindicating this sort of personal autonomy is the equivalent of vindicating a deeply felt, conscientious moral objection in the theory of civil disobedience.<sup>290</sup> Yet it is an odd sort of autonomy-interest to posit, since a majoritarian moral consensus can override it, as can the moral views of an individual lawyer counseling her clients. Thus, Easterbrook and Fischel recognize that the autonomy interest leading to violations of law can be overridden by "laws concerning violence or other acts *thought to be malum in se*," thus giving substantial play to the dominant moral consensus about what is and is not *malum in se*.<sup>291</sup> And Pepper advocates not giving information to clients that could facilitate violating the law when, *in a particular lawyer's view*, the underlying conduct is "really wrongful" as opposed to being "merely penalized" with the cost of damages.<sup>292</sup> So, in Pepper's theory, the client's autonomy is substantially limited by the lawyer's moral views. Neither concept of autonomy is especially robust, particularly when contrasted with the *sine qua non* of civil disobedience as traditionally understood: assertion of an individual's conscientious moral views against the moral or political views of the majority. The asserted autonomy-interest of law-as-price theories is more properly understood as self-interest, and, "it goes without saying that civil disobedience cannot be grounded solely on group or self-interest."<sup>293</sup>

Taken as a whole, therefore, the case for efficient breach of public law is wholly underwhelming. As will be demonstrated below, the case for efficient investment in compliance is not much stronger.

## V. A DEVELOPING JURISPRUDENCE II: EFFICIENT INVESTMENT IN COMPLIANCE

As defined in this Article, the efficient compliance view of corporate law compliance suggests that the penalty levels for violations of a particular law determine the maximum amount of money that a corporation should spend on compliance efforts (since it would be inefficient to spend more on compliance than one risks in fines), and, significantly, that the penalty levels signal how important

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290. This argument was quite thoughtfully made by Jamie G. Heller. See Heller, *supra* note 18, at 2505.

291. Easterbrook & Fischel, *supra* note 1, at 1168 n.36 (emphasis added).

292. See Pepper, *supra* note 9, at 1579.

293. RAWLS, *supra* note 44, at 365.

a law is and whether it should be taken seriously. Penalty levels are obviously central to rational-choice theories of law compliance as well, since a central premise of the rational-choice theory of law is that in conforming their conduct to law, people and corporations rely upon the severity of potential penalties in deciding whether to obey the law (or how much money to invest in law compliance). Because the expected penalty is the foundation of the cost end of the cost/benefit equation (weighing the potential corporate benefits of non-compliance against the potential corporate costs of liability), embracing this view of the law, one could argue that fairness requires that one have a settled expectation of a given penalty level for a given level of violation. The Supreme Court was recently presented with a case that tests that proposition, and its decision is an indication of the extent to which rational-choice theories of law compliance have affected our thinking about law.

#### A. Landgraf v. USI Film Products

The Supreme Court was cleanly presented with the question of whether one does have such a settled expectation in *Landgraf v. USI Film Products*,<sup>294</sup> when it was asked to consider whether certain amendments to Title VII promulgated in section 102 of the Civil Rights Act of 1991<sup>295</sup> ("the Act" or "the Civil Rights Act") would be applied in cases that were pending when the Act was passed. Section 102 did not change the substantive standards of the law; that is, the conduct necessary to conform to Title VII (which prohibits discrimination in employment) was not changed. Rather, section 102 added compensatory and punitive damages to the pre-existing equitable remedies of reinstatement and two years' back pay for intentional employment discrimination in violation of Title VII (subject to fairly restrictive caps)<sup>296</sup> and also provided for jury trials.<sup>297</sup>

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294. 511 U.S. 244 (1994). This author was associated with the law firm of Cravath, Swaine & Moore ("Cravath"), which, together with the Lawyers' Committee for Civil Rights ("Lawyers' Committee"), represented petitioner Barbara Landgraf before the Supreme Court, and was an author, although not a principal author, of petitioner's briefs. The principal authors were Julie North, Paul Saunders, and Suja Thomas of Cravath, and Richard Seymour of the Lawyers' Committee.

295. Pub. L. No. 102-166, § 102, 105 Stat. 1072 (1991) (codified at 42 U.S.C. § 1981a(a)(1) (1994)). The Civil Rights Act of 1991 made a number of changes in Title VII and 42 U.S.C. § 1981, including "overruling" two Supreme Court cases of the late 1980s that had narrowed civil rights protection: *Patterson v. McLean Credit Union*, 491 U.S. 164 (1989), and *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642 (1989).

296. The nonpecuniary compensatory damages plus punitive damages cannot exceed \$50,000 per claimant for an employer with 15 to 100 employees; \$100,000 per claimant for an employer with 101 to 200 employees; \$200,000 per claimant for an employer with 201

Using the jurisprudential construct of law as price, section 102 simply made violations more expensive.

The lower courts, and ultimately the Supreme Court, interpreted the language of the Act and the intent of Congress to be unclear concerning retroactivity (defined here as permitting plaintiffs to seek the expanded damages in cases that were already in court when the Act was passed).<sup>298</sup> According to the Supreme Court's precedent at the time (at least where a statute is unclear concerning retroactivity), *Bradley v. School Board of Richmond*,<sup>299</sup> whether the expanded damages could be sought in cases already in court therefore turned on whether permitting such expanded damages would work a "manifest injustice" by undermining the parties' "vested rights."<sup>300</sup>

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to 500 employees; and \$300,000 per claimant for an employer with more than 500 employees. See 42 U.S.C. § 1981a(b)(3). One reason Congress added these damages provisions is well-illustrated by the facts of the *Landgraf* case itself. As the Fifth Circuit stated:

It is uncontested that Barbara Landgraf suffered significant sexual harassment at the hands of John Williams during her employment with USI. This harassment was sufficiently severe to support a hostile work environment claim under Title VII. . . . She reported this harassment to her employer through supervisor Bobby Martin on several occasions and no corrective action was timely taken.

*Landgraf v. USI Film Prods.*, 968 F.2d 427, 429 (5th Cir. 1992), *aff'd*, 511 U.S. 244 (1994). After over a year of such treatment, Ms. Landgraf left voluntarily (she was not fired), and the district court found that she was not constructively discharged; that finding was upheld by the Fifth Circuit. See *id.* at 430. Absent constructive discharge, which would have permitted Ms. Landgraf to be compensated with the equitable remedies of reinstatement and two years' back pay, Ms. Landgraf was entitled, under the pre-1991 version of Title VII, to no compensation for the severe, hostile-environment, sexual harassment to which she was subjected. See *id.* at 433. After passage of the Civil Rights Act of 1991, a plaintiff in Ms. Landgraf's position could receive compensation for the effects of such sexual harassment, even if the harassment did not ultimately lead to a constructive discharge. See Civil Rights Act of 1991 § 102(b)(3), 42 U.S.C. 1981a(b)(3) (1994).

297. See 42 U.S.C. § 1981a(c).

298. See, e.g., *Landgraf*, 511 U.S. at 263 (holding that the language of the Act was unclear concerning retroactivity); *Johnson v. Uncle Ben's, Inc.*, 965 F.2d 1363, 1372 (5th Cir. 1992) (same); *Fray v. Omaha World Herald Co.*, 960 F.2d 1370, 1377 (8th Cir. 1992) (same); *Vogel v. City of Cincinnati*, 959 F.2d 594, 597 (6th Cir. 1992) (same). The question of the retroactivity of the Civil Rights Act of 1991 generated an enormous number of published and unpublished opinions in a short amount of time. The Act became law on November 21, 1991, and by October 28, 1992, when the petition for writ of certiorari was filed on behalf of Barbara Landgraf, there had been 263 district and circuit cases addressing the issue. See *Petition for Writ of Certiorari* at 5, 10 n.3, *Landgraf* (No. 92-757). The above discussion does not purport to describe that case law in any detail at all. Rather, it only discusses illustrative cases that explicitly develop the law-as-price theory inherent in the issue.

299. 416 U.S. 696, 711-15 (1974).

300. See *id.* at 711, 720-21. The *Bradley* Court had unanimously held that "a court is to apply the law in effect at the time it renders its decision, unless doing so would result in

Changes in the law can be of many sorts, of course, from changing the standards of behavior necessary to conform to law (which would presumably never be fair to change retroactively), to changes in litigation procedures (lengthening or shortening the statute of limitations or changing jurisdictional provisions) or trial procedures (hearing before a judge or jury), or remedies (adding or subtracting remedies for pre-existing causes of action).<sup>301</sup> In essence, then, the “manifest injustice” exception to *Bradley*’s presumption that a court

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manifest injustice or there is statutory direction or legislative history to the contrary.” *Id.* at 711 (citing *Thorpe v. Housing Auth.*, 393 U.S. 268, 281-82 (1969); *United States v. Schooner Peggy*, 5 U.S. (1 Cranch) 103, 110 (1801)). In explaining the manifest injustice exception, the *Bradley* Court stated that “[t]he concerns . . . relative to the possible working of an injustice center upon (a) the nature and identity of the parties, (b) the nature of their rights, and (c) the nature of the impact of the change in law upon those rights.” *Id.* at 717. According to the *Bradley* Court, the third aspect of this inquiry (upon which the *Landgraf* decision and many of its antecedents turned) “has to do with the nature of the impact of the change in law upon existing rights, or, to state it another way, stems from the possibility that *new and unanticipated obligations may be imposed* upon a party without notice or an opportunity to be heard.” *Id.* at 720 (emphasis added). Thus, in *Bradley* the Court found that imposing attorneys’ fees based on new statutory authorization for attorneys’ fees in school desegregation litigation was fair because it “did not alter the Board’s constitutional responsibility for providing pupils with a nondiscriminatory education. Also, there was no change in the substantive obligation of the parties.” *Id.* at 721. As this Article argues below, *Bradley*, properly understood, was primarily concerned with new substantive obligations—that is, new standards of conduct—not being imposed retroactively.

301. The Supreme Court has struggled for some time to develop the proper analysis for determining the retroactivity of civil statutes, since, unlike in the criminal context, there is no *ex post facto* clause generally prohibiting retroactivity. See Harold J. Krent, *The Puzzling Boundary Between Criminal and Civil Retroactive Lawmaking*, 84 GEO. L.J. 2143, 2145-46 (1996). Yet the results of that struggle have not been an unmitigated success. See Jill E. Fisch, *Retroactivity and Legal Change: An Equilibrium Approach*, 110 HARV. L. REV. 1056, 1058 (1997) (“The Court has addressed retroactivity questions on at least seven occasions in the past five years, but its decisions, rife with separate opinions, reflect a variety of conflicting and confusing approaches.”). In contrast to *Bradley*’s presumption that a court is to apply the law in effect at the time it renders a decision, absent a statutory directive requiring prospectivity or manifest injustice, in *Bowen v. Georgetown University Hospital*, 488 U.S. 204 (1988), the Court, in dicta, articulated an opposite presumption, stating that “congressional enactments and administrative rules will not be construed to have retroactive effect unless their language requires this result.” *Id.* at 208. Thus, stated as abstract propositions, *Bradley* and *Bowen* seemingly pointed in different directions when Congress was silent about when a statute would go into effect. Yet, when applied to specific facts, those cases yield similar results. For instance, the “manifest injustice” principle of *Bradley* would preclude retroactive application of the statute at issue in *Bowen*, a statute that altered federal reimbursement rates for medical care that had already been provided. See *id.* at 208-09. The decision in *Landgraf* was not only important for its holding that section 102 of the Civil Rights Act of 1991 would not be applied retroactively, but also for the opportunity it gave the Court (albeit unrealized) to clarify its analysis of the proper framework for deciding issues involving potentially retroactive legislation more generally. See Fisch, *supra*, at 1071 & n.103.

will apply the law in effect at the time of a decision<sup>302</sup> is an inquiry into the fundamental fairness of applying a change in the law to the particular case, based on an analysis of the type of change wrought by the law, and the type of effect that change would have upon vested rights or settled expectations, if any, of the parties.

In undertaking the manifest injustice analysis with respect to section 102 of the Civil Rights Act—which provides for expanded damages—the lower courts had sharply disagreed on the Holmesian “bad man” view of the law implicit in a finding that one could have a vested right to a civil penalty level, given that the underlying conduct necessary to conform to the law was unchanged by section 102.<sup>303</sup> In both the lower courts addressing the retroactivity of section 102 and the Supreme Court in *Landgraf*, the issue turned on whether it would be fundamentally unfair to “up the ante” after the violation had occurred, either because employers should be held to have a right to rely on the limited damages provisions of the pre-existing law, and a settled expectation of the amount of money risked for violating the law, or because the amount of money an employer put into compliance efforts would be geared toward the penalties for violations, and if the penalties were increased the employer should have an opportunity to increase the vigor with which they sought compliance. In essence, then, *Landgraf* tests what we think of as important about law: Is it the substantive standards of conduct that the law sets forth that demand our attention, or is it the penalties assessed for behavior that fails to meet those standards of conduct, or is it some combination of the two? While every court recognized that it would be fundamentally unfair to permit retroactivity if what was once lawful became unlawful,<sup>304</sup> there was less unanimity that fundamental fairness would be undermined when what was already unlawful merely became more expensive.<sup>305</sup>

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302. See *Bradley*, 416 U.S. at 717.

303. See *infra* text accompanying notes 306-26 (discussing the split among the lower courts).

304. See, e.g., *Gersman v. Group Health Ass'n*, 975 F.2d 886, 898-99 (D.C. Cir. 1992) (holding that changes in law that define standards of behavior may not be applied retroactively); *Mozee v. American Commercial Marine Serv. Co.*, 963 F.2d 929, 939 (7th Cir. 1992) (“[C]ourts should not retroactively apply statutory provisions that define the scope of a party’s substantive rights and obligations at any stage of the proceedings. The rationale behind this conclusion is that it is unfair to make persons accountable for acts that did not violate statutory laws when they were performed.”); *Lockley v. Chao*, 1993 WL 33381 (D.D.C. 1993) (following *Gersman*).

305. See *infra* notes 306-26 and accompanying text.

### 1. Section 102 in the Lower Courts

The leading proponent of the view that an employer should have a settled expectation of the amount of money risked by unlawful behavior was the Seventh Circuit in *Luddington v. Indiana Bell Telephone Co.*,<sup>306</sup> in an opinion written by Judge Richard Posner. Judge Posner first sketched out a presumption of legislative prospectivity based on the "rule of law" and institutional considerations derived from the enormous power of legislatures "to redistribute wealth and otherwise disturb settled expectations . . . uncabined by a professional tradition of modesty" as found in the judiciary.<sup>307</sup> His description of the "rule of law" is quite interesting, for it is founded on the traditional, pre-law-as-price view that what is important to a just system of law is that one be given notice of the substantive conduct necessary to conform to law, not that one be able precisely to calibrate the cost of liability should one choose not to so conform.<sup>308</sup>

Given the emphasis on conduct-regulating aspects of law in this concept of the "rule of law," retroactive application of section 102 should have been perfectly acceptable, because Judge Posner recognized that section 102 had not changed the conduct necessary to

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306. 966 F.2d 225 (7th Cir. 1992). The potential for increased damages in *Luddington* did not come about by an application of section 102 of the Civil Rights Act of 1991, which added compensatory and punitive damages. *Luddington* involved claims of racial discrimination under Title VII and under 42 U.S.C. § 1981 by the plaintiff, an African-American male employee of Indiana Bell Telephone Company, who was denied numerous promotions for which he had applied. A violation of section 1981 can give rise to compensatory and punitive damages of the sort added to claims under Title VII in the Civil Rights Act of 1991, although not limited by caps on damages as are similar damages under the Civil Rights Act. The Civil Rights Act of 1991 had "overruled" *Patterson v. McLean Credit Union*, 491 U.S. 164 (1989), which had interpreted § 1981 to be inapplicable to claims based on a refusal to promote an employee, unless the promotion could be said to create a new employment relation. See *id.* at 185-89. So, in *Luddington*, if the Civil Rights Act were held not to be retroactive, then *Patterson* would apply, Mr. Luddington would not have a claim under § 1981, and he would be limited to pre-Act Title VII equitable remedies (here two years' back pay). Retroactive application of the Civil Rights Act would render *Patterson* nugatory, and would mean that the promotion decisions Mr. Luddington challenged could give rise to potential liability under § 1981, and so the employer potentially could be liable for increased damages (common-law compensatory and punitive damages).

307. *Luddington*, 966 F.2d at 228.

308. See *id.* at 227-28 ("The idea that the law should confine its prohibitions and regulations to future conduct, so that the persons subject to the law can conform their conduct to it and thus avoid being punished, whether criminally or civilly, for conduct that they had no reason to think unlawful, is a component of the traditional conception of the 'rule of law.'").



conform to law.<sup>309</sup> Yet, Judge Posner went beyond the “traditional conception of the rule of law,” even as he had defined it, and articulated a post-traditional, rational-choice influenced conception of the rule of law.<sup>310</sup> Thus, he asked if there was any reason that the presumption of prospectivity should be overcome in the case of the Civil Rights Act:

If the Civil Rights Act of 1991 made merely technical changes to the statute the presumption of prospective application would be rebutted. It does more. True, it does not prohibit any conduct not already prohibited by Title VII . . . . It makes changes in remedies, procedures, and evidence. But such changes can have as profound an impact on behavior outside the courtroom as avowedly substantive changes. . . . The new statute brings [ordinary promotion decisions] under section 1981 and thus subjects employers to greater liabilities.

It could be argued that since the underlying norm of nondiscrimination was not new, employers should not be heard to complain that the norm has now been given teeth. But many of us would squawk very loudly indeed if people with unpaid parking tickets were made retroactively liable to life imprisonment; and in fact such a change although purely remedial would violate the *ex post facto* clause. . . . The amount of care that individuals and firms take to avoid subjecting themselves to liability whether civil or criminal is a function of the severity of the sanction, and when the severity is increased they are entitled to an opportunity to readjust their level of care in light of the new environment created by the change.<sup>311</sup>

Given this rationale, the court held that the Civil Rights Act was applicable only to “conduct engaged in after the effective dates (plural because several sections carry different effective dates) in the

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309. *See id.* at 229.

310. *See id.*

311. *Id.* at 228-29 (citations omitted). Without undertaking a criticism of its central rational-choice premise here, *see infra* text accompanying notes 378-99, a number of quick observations are in order. First, the language that Judge Posner uses quite understates the source of the employer's obligation: although the underlying *norm* of nondiscrimination is in play, so is an actual *law* prohibiting discrimination. Second, it betrays a rather casual attitude about racial and/or sexual equality to analogize liability for discrimination to an unpaid parking ticket. On one interpretation this is quite a telling analogy, though: liability for two years' back pay, given many employees' wages, is not a lot of money, and the possibility of such liability may have had the same effect upon many corporate employers, if using a law-as-price view of the law, as an unpaid parking ticket would have had upon an individual.

act.”<sup>312</sup> As will be seen below, Judge Posner’s rationale defined the central point of dispute in many other courts’ manifest injustice inquiry, and ultimately in the Supreme Court: is it true with respect to statutes (or regulations) that

[t]he amount of care that individuals and firms take to avoid subjecting themselves to liability whether civil or criminal is a function of the severity of the sanction, and when the severity is increased they are entitled to an opportunity to readjust their level of care in light of the new environment created by the change[?]”<sup>313</sup>

The Fifth Circuit answered that question in the affirmative in *Landgraf* itself,<sup>314</sup> in an opinion written by Judge Patrick Higginbotham. As set out above, plaintiff Barbara Landgraf had been found to have been subjected to severe hostile-environment sexual harassment, but was left without compensation because she was also found not to have been constructively discharged.<sup>315</sup> Prior to her appeal, Congress passed the Civil Rights Act of 1991,<sup>316</sup> and so one issue in the Fifth Circuit was whether the expanded damages provisions of section 102 should apply to her case on appeal.<sup>317</sup> Like

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312. *Luddington*, 960 F.2d at 229. Judge Posner recognized that the employer in *Luddington* actually had no reliance interest in limited damages because *Patterson* was decided three years after the last act for which Luddington sought to hold Indiana Bell liable, and thus, “the change brought about by the new statute is a change back to the legal regime that existed when the defendant committed the acts for which it is being sued.” *Id.* In other words, at the time of the conduct at issue in *Luddington*, § 1981 was interpreted to apply to promotion decisions, and so an employer was potentially subject to compensatory and punitive damages under § 1981. Thus, by Judge Posner’s own rationale, Indiana Bell should have taken the possibility of compensatory and punitive damages into account in determining the amount of care it would take to ensure that its employees did not make racially discriminatory employment decisions. Notwithstanding this non-existent reliance interest in the actual case before the court, Judge Posner was willing to allow a windfall to the employer (continuing *Patterson*’s vitality by refusing to apply the Civil Rights Act) for two reasons: First, he held that the pre-*Patterson* legal regime interpreting § 1981 was “merely a set of lower-court decisions, constituting a stab in the dark concerning issues on which the Supreme Court had not yet ruled,” a “tentative regime, which *Patterson* swept away,” *id.*; and second, Judge Posner found the administrative difficulties of separating cases with a true reliance interest from those without to be insuperable, *see id.* at 229-30. In other words, he was content to vindicate the rational-choice theory of decision-making about law compliance notwithstanding facts indicating that theory was clearly inapplicable in the case before him.

313. *Id.* at 229.

314. *See Landgraf v. USI Film Prods.*, 968 F.2d 427, 433 (5th Cir. 1992), *aff’d*, 511 U.S. 244 (1994).

315. *See supra* note 296 (discussing facts of *Landgraf*).

316. Pub. L. No. 102-66, 105 Stat. 1072 (1991) (codified at 42 U.S.C. § 1981a(a)(1) (1994)).

317. *See Landgraf*, 968 F.2d at 433.

the Supreme Court's ultimate decision in *Landgraf*, the Fifth Circuit's analysis turned on the "manifest injustice" exception to *Bradley*'s presumption that a court should apply the law in effect at the time it renders a decision. Judge Higginbotham found such a manifest injustice, however, by virtue of the effect of the expanded damages provisions of section 102 on employers' "settled expectations":

The addition of compensatory and punitive damages to the remedies available to a prevailing Title VII plaintiff does not change the scope of the statute's coverage. That does not mean, however, that these are inconsequential changes in the Act. As Judge Posner notes in *Luddington*, "such changes can have as profound an impact on behavior outside the courtroom as avowedly substantive changes." ... [T]he amended damage provisions of the Act are a seachange in employer liability for Title VII violations. For large employers, the total of compensatory and punitive damage which they are potentially liable can reach \$300,000 per claim.

... It would be an injustice within the meaning of *Bradley* to charge individual employers with anticipating this change in damages available under Title VII.<sup>318</sup>

It is interesting to focus on how the Fifth Circuit defined the manifest injustice of permitting expanded damages: that it would be an injustice within the meaning of *Bradley* "to charge individual employers with anticipating this change in damages available under Title VII."<sup>319</sup> So, if employers, acting as "rational actors," calculated the amount of money they risked with respect to sexual harassment liability, and determined the seriousness of their compliance activities based upon those calculations, according to the Fifth Circuit it would be unfair for courts to "charge" employers with thinking about the fact that their calculation might be upset by a change in the statutory basis for damages. It is only by permitting employers to orient their actions according to the severity of the penalty (and, in fact, according to their valuation of the severity of the penalty in the context of their firm's economic activities, since that valuation will change from employer to employer), and not according to the substantive standards of the law, that there can be any claim of unfair

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318. *Id.* (quoting *Luddington v. Indiana Bell Tel. Co.*, 966 F.2d 225, 229 (7th Cir. 1992)).

319. *Id.*

surprise—a claim the Fifth Circuit wholly embraces.<sup>320</sup>

In contrast, a number of courts took issue with the view that employers could have a legitimate reliance interest in the amount of liability for intentional misconduct, that compliance with the law should be subject to a cost-benefit analysis, or that the amount of a penalty risked by non-compliance with the law should be interpreted as a substantive aspect of the law. So, for instance, Judge Sporkin of the United States District Court for the District of Columbia identified the underlying rational-choice premise of the issue and then rejected it, holding that “[t]he law has never countenanced that an employer may weigh the legal consequences of his discrimination and choose to continue his unlawful conduct.”<sup>321</sup> That rationale is echoed in an opinion by Judge Fuste of the United States District Court for the District of Puerto Rico:

While an individual may predicate his decision to park illegally upon a cost/benefit analysis, this does not make that behavior any less illegal. If the fine were to suddenly increase ten-fold, he would have to accept that the illegal behavior was going to cost more than he had planned.<sup>322</sup>

One quite thoughtful analysis was undertaken by Judge Thomas Ellis of the United States District Court for the Eastern District of Virginia. As in many of the decisions concerning section 102, the outcome ultimately turned on the manifest injustice inquiry. Judge Ellis found no such injustice because section 102 did “not implicate substantive rights and liabilities.”<sup>323</sup> Applying the three-factor “manifest injustice” test of *Bradley*,<sup>324</sup> the court found that the most

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320. See *id.* Other courts that interpreted the possibility of substantially increased damages as a manifest injustice if retroactively applied include the United States District Courts for the Districts of Delaware and New Jersey. See *Crumley v. Delaware State College*, 797 F. Supp. 341, 351-52 (D. Del. 1992) (“[While] it is difficult to accept the proposition that a defendant who knew its actions were illegal at the time it acted can successfully claim ‘manifest injustice’ . . . [b]ecause of the potential for lawsuits, decisions to downsize or to terminate employees often include a calculus of exposure to damages from civil suits” and “it can be persuasively argued that it is unreasonable to expect defendants to pay damages that were not calculated into their decisions.”); *Thomas v. Frank*, 791 F. Supp. 470, 476 (D.N.J. 1992) (holding that, while not creating a new cause of action, the damages provision of the 1991 Act created a new source of liability for substantial monetary damages, and, as such, was substantive rather than procedural in nature).

321. *Robinson v. Davis Mem'l Goodwill Indus.*, 790 F. Supp. 325, 332 (D.D.C. 1992), *rev'd mem.*, 36 F.3d 127 (D.C. Cir. 1994) (unpublished disposition available at 1994 WL 499164 (July 1, 1994)) (reversal based on Supreme Court's opinion in *Landgraf*).

322. *Bonilla v. Liquilux Gas Corp.*, 812 F. Supp. 286, 291-92 (D.P.R. 1993).

323. *Jaekel v. Equifax Mktg. Decision Sys., Inc.*, 797 F. Supp. 486, 492 (E.D. Va. 1992).

324. See *supra* notes 300-03 (discussing the three-factor test).

significant factor was that there were no "new and unanticipated obligations" being imposed on the defendant, as the phrase "new and unanticipated obligations" was defined in *Bradley*. Judge Ellis wrote:

Nothing in § 102 of the 1991 Act, providing for jury trials and expanded remedies, changes the definition or nature of the conduct proscribed by the Act. Intentional discrimination was unlawful at the time of the alleged harassing conduct, and defendant had an absolute obligation at that time to refrain from perpetrating, or permitting its employees to perpetrate, such conduct. What is indisputably affected is the potential amount defendants may have to pay if found liable for intentional discrimination. The ante has been, in the vernacular, "upped." But this increased economic risk does not mean that the actual harm resulting from unlawful intentional discrimination has changed. Rather, an "artificial ceiling" has been lifted. As a result, defendant, if liable for intentional discrimination, is required to bear more accurately the full cost of the injury inflicted, or, in other words, to make plaintiffs more nearly whole.<sup>325</sup>

In adopting this rationale, Judge Ellis directly responded to Judge Posner's analysis in *Luddington*, stating that the difficulty with Judge Posner's argument that the severity of a penalty affects how much care an individual or corporation takes to avoid subjecting themselves to liability is that

Title VII . . . propounds an intentional discrimination standard of liability, not a negligence standard. Judge Posner's view seems valid in the context of negligent conduct, but not in the context of intentional conduct. Congress surely did not intend for employers to perform a cost-benefit analysis to decide whether to engage in or permit illegal discriminatory conduct. Rather, Congress plainly meant that no cost-benefit ratio could justify unlawful discrimination.<sup>326</sup>

## 2. The Supreme Court Litigation

Like the lower courts, the litigants before the Supreme Court in *Landgraf* framed the question of the retroactivity of section 102 in part as an argument over the law-as-price view of law (particularly since that had been the basis for the Fifth Circuit's decision being

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325. *Jaekel*, 797 F. Supp. at 492-93 (citations omitted).

326. *Id.* at 493 n.14.

appealed).<sup>327</sup> Petitioner argued that applying the damages provisions of section 102 would neither alter vested rights nor upset reasonable expectations, since section 102 did not change the substantive conduct necessary for employers to conform their conduct to the law.<sup>328</sup> Indeed, petitioner asserted that it would be deeply problematic for the Supreme Court to uphold the Fifth Circuit's reasoning that section 102 imposes "additional or unforeseeable obligations," because it would result in adopting "a particularly extreme version of the 'bad man' theory of the law—that because there was no damages remedy, respondents had a legitimate or settled expectation that they could violate Title VII with impunity and without adverse consequences."<sup>329</sup> Moreover, petitioner took direct issue with the view of law that Judge Posner had articulated in *Luddington*:

This argument[, that the amount of care one takes to avoid liability is a function of the severity of the sanction,] proceeds upon two premises: (1) in deciding whether to follow the law, people weigh the potential costs of liability against the benefits to be gained from not following the law; and (2) when a person decides not to follow the law, that person's expectations about the potential liability he or she risks are "settled expectations" that the law should recognize as valid, and protect.

The first premise may be correct as a descriptive matter—certainly one reason for increasing the costs of non-compliance with a law is precisely to encourage greater compliance with that law. The second premise is incorrect as a normative matter. Only a person's settled expectations about *compliance* with the law are entitled to recognition; indeed, that is one basis for the manifest injustice exception of *Bradley*. If one's substantive behavior conforms to the law in effect at the time of the behavior, that gives rise to an expectation of non-liability that the law must recognize as

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327. Petitioner Barbara Landgraf had primarily argued to the Supreme Court that the plain language of the Civil Rights Act of 1991 required that section 102 be applied to pending cases, but that if the Court disagreed, there would be no manifest injustice inherent in following the *Bradley* presumption that a court is to apply the law in effect at the time it renders a decision. See Brief for Petitioner at 6-7, *Landgraf v. USI Film Prods.*, 511 U.S. 244 (1994) (No. 92-757).

328. See *id.* at 29-31.

329. *Id.* at 31 (citing Holmes, *supra* note 22, at 461-62). This point by petitioner echoes the point developed *supra* in footnote 223: that Holmes's "bad man" analysis should be understood as a descriptive statement of the approach to law of some people, but that it should not be understood as a description of the proper understanding of the normativity of law.

valid. The converse is not true. We assert that this Court should not protect as "settled" a person's expectations about the consequences of deliberate non-compliance with the law.<sup>330</sup>

Not surprisingly, the respondents, USI Film Products, Bonar Packaging, Inc., and Quantum Chemical Corporation, took issue with these arguments, asserting that the new damages provisions of section 102 increased respondents' substantive liabilities and that retroactive imposition of these expanded damages would therefore be manifest injustice under the *Bradley* standard.<sup>331</sup> Relying upon Judge Posner's opinion in *Luddington* and Judge Higgenbotham's opinion for the Fifth Circuit in *Landgraf*, respondents made a number of "efficient compliance" arguments, including the following:

[Posner's argument about the level of care an individual or corporation takes to comply with the law being a function of the sanction] is especially true where the human conduct being regulated occurs at many levels of the respondent employer's operation. . . . The theory of substantive liability for the harassment that Petitioner espouses against Respondents is thus derivative and based on respondeat superior.

Such a claim of vicarious liability makes all the more important that employers have the opportunity to train and counsel their supervision and plant management in how to respond. That effort, and the resources committed to it, is affected by the source and degree of liability involved. For Respondents to be subjected retroactively to materially increased exposure for human conduct it did not commit patently increases its substantive liabilities.<sup>332</sup>

Respondents also relied upon Holmes's "bad man" to argue that people ought to be able to predict the precise economic consequences of different courses of action, and without that predictive capacity the possibility of liability cannot play its proper deterrent function:

Deterrence of human conduct by avoidance of risk and liability is Holmes' method of the law, "to advise people in such a way as to keep them out of court." He is four-square with the principle against retroactive application of laws regulating human conduct: What has already occurred

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330. Brief for Petitioner at 31-32, *Landgraf* (No. 92-757).

331. See Brief for Respondents at 25, 28, *Landgraf* (No. 92-757).

332. *Id.* at 27 (citations omitted).

cannot be deterred, and liability inflicted beyond that forewarned by law when the conduct occurs is not only unjust but inhibits people's acceptance and use of the law as a deterring prophecy.<sup>333</sup>

The deterrent function of law also figured prominently in respondents' argument that retroactive application of section 102 would be manifestly unjust as defined in *Bradley*:

[T]he employers involved would have had no opportunity to measure the risk of their conduct. A potential \$300,000 swing in exposure will have a deterrent effect. . . .

The corollary of deterrence is an opportunity to avoid the penalty imposed for the violation. For employers such as Respondents here to be subjected to the penalty without the opportunity to avoid it would be manifestly unjust.<sup>334</sup>

In reply, the petitioner responded at length to this law-as-price understanding of law, directly challenging the Supreme Court to hold that this is an incorrect understanding of law and of citizens' obligations under law:

The sections of the Act that affect petitioner, those regarding damages and jury trial, do not "regulate human conduct" nor do they create a new cause of action or create "substantive liabilities." They simply increase the remedy for conduct that has been unlawful for almost thirty years and they also require a new decision-making mechanism. . . . Respondents have no "settled right" to disobey the law nor do they have a right to decide whether to obey the law if the cost of compliance would be greater than the cost of violation. The notion, which finds mistaken support in *Luddington v. Indiana Bell Tel. Co.*, that citizens should have the right to make an economic cost-benefit analysis before deciding whether to obey a given law is not only destructive of the civil rights laws, but is also ultimately destructive of all law . . . .<sup>335</sup>

In one sense, the arguments of petitioner and respondents do not fully meet each other, although they come close. Petitioner's arguments primarily criticize the notion of deliberate violations of law when the costs of compliance are higher than the potential penalties and do not as fully and explicitly address the arguments of

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333. *Id.* at 27 n.12 (citations omitted) (quoting Holmes, *supra* note 22, at 460-61).

334. *Id.* at 34.

335. Reply Brief for Petitioner at 10-11, *Landgraf* (No. 92-757) (quoting Brief for Respondents at 21, 25-36, *Landgraf* (No. 92-757)) (citations omitted).



efficient compliance made by respondents and by Judge Posner in *Luddington*.<sup>336</sup> In contrast, many of respondents' arguments relied upon the counterfactual premise that section 102 of the Civil Rights Act changed the conduct necessary to conform to law,<sup>337</sup> and do not directly address the seemingly more difficult point that since the conduct required to conform to law was *not* changed, the "rule of law" is not offended by applying the new damages remedies. In any case, the litigants did pose the more general question to the Court, albeit imperfectly: What aspects of law should guide corporations' behavior, the standards of conduct set by the law, or the level of the penalties?<sup>338</sup>

### 3. The Court's Decision

In response, the Supreme Court agreed with respondents that the level of the penalties for violations of law would have a determinative effect on a corporation's compliance efforts, so that increasing the amount of liability for prior conduct, by permitting section 102 to be applied retroactively, would be manifestly unjust. The Court recognized that section 102 "does not make unlawful conduct that was lawful when it occurred" and "only reaches discriminatory conduct already prohibited by Title VII."<sup>339</sup> Yet, in an opinion authored by Justice Stevens, the Court held that the possibility of expanded damages was "the type of legal change that would have an impact on private parties' planning"<sup>340</sup> and would "give managers an added incentive to take preventive measures to ward off discriminatory conduct by subordinates *before* it occurs."<sup>341</sup> Because section 102 attaches "an important new legal burden" to

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336. Even though the actions giving rise to the sexual harassment were intentional, which is the point petitioner emphasized, they were intentional actions of company employees, so the important questions were the ones posed by Judge Posner: whether the time and money the company puts into efforts to encourage compliance with the civil rights laws (among others) would be limited given the limited penalties for violations, and whether fundamental fairness requires the company to be given an opportunity to increase the seriousness of its compliance efforts if the penalties increased. The line between intentional actions and efficient investment can blur, however, since the decision to put "X" amount into compliance is obviously an intentional decision.

337. Brief for Respondents at 25-31, *Landgraf* (No. 92-757).

338. Brief for Respondents at 34, *Landgraf* (No. 92-757); Reply Brief for Petitioners at 9-11, *Landgraf* (No. 92-757).

339. *Landgraf*, 511 U.S. at 281-82.

340. *Id.* at 282. Justice Stevens authored the majority opinion for Chief Justice Rehnquist, Justices O'Connor, Souter, and Ginsburg. Justice Scalia wrote an opinion concurring in the judgment in which Justices Kennedy and Thomas joined. Justice Blackmun dissented. *See id.* at 245.

341. *Id.* at 282 n.35.

conduct occurring before the statute was enacted, the Court held that it is the kind of provision that “does not apply to events antedating its enactment in the absence of clear congressional intent.”<sup>342</sup> In so holding, the *Landgraf* Court squarely agreed with respondents and with Judge Posner in *Luddington*, in essence validating the “efficient investment in compliance” view of law that suggests that the amount of money a firm should invest in law compliance will be determined by the maximum penalties for violations, rather than the substantive standards for conduct that the law sets forth. What determines the importance of law, then, is the price of a violation: it is the expected penalties of Kohlberg’s pre-conventional child that motivates the *Landgraf* Court’s corporation.<sup>343</sup>

Like *Luddington*, the *Landgraf* Court premised its decision on a theory about the “rule of law” that would, in fact, be utterly undisturbed by retroactive application of section 102. The Court stated that “[e]lementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly; settled expectations should not be lightly disrupted.”<sup>344</sup> Yet there was nothing in section 102 that changed what conduct was required to conform to law (which had been required for thirty years), and so any individual or corporation was in a position to “know what the law is and to conform their conduct accordingly.”<sup>345</sup> The Court recognized this point.<sup>346</sup> Moreover, any individual or corporation would have been able to have “confidence about the legal consequences of their actions,” notwithstanding section 102, and would have been able to predict whether their actions could potentially lead to liability or not.<sup>347</sup> So it was only by adding a rational-choice gloss on the rule of law, even as the Court itself articulated it, that there could be any claim of unfairness.

Given the Supreme Court’s rationale, it is not enough that one know what conduct is required by law; surely employers knew that sexual discrimination was prohibited by Title VII. And it is not enough that one know generally whether one risks liability or not;

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342. *Id.* at 283.

343. See KOHLBERG, *supra* note 76, at 17 (positing that the pre-conventional child is primarily concerned with expected punishments when deciding how to act).

344. *Landgraf*, 511 U.S. at 265.

345. *Id.*

346. See *id.* at 281-82 (stating that section 102 “does not make unlawful conduct that was lawful when it occurred” and “only reaches discriminatory conduct already prohibited by Title VII”).

347. See *id.* at 266.

surely employers knew that they risked liability for violations. Rather, one needs to be able to predict the precise amount of liability, if one's conduct risks putting one in the "realm of liability." Indeed, the Court explicitly recognized that it is not enough to know whether one's conduct risks liability or not, but one must also know "[t]he extent of . . . liability."<sup>348</sup> This is because the amount of potential liability will "have an impact on private parties' planning" and "give managers an added incentive to take preventive measures to ward off discriminatory conduct."<sup>349</sup> What the Court has told us, then, is that we cannot expect corporations (or even individuals, presumably) to follow the law simply because it is the law. Rather, this Court agreed that the law has to carry a big enough stick before corporations can be expected to take it seriously.

The Court did seek to blur the law-as-price underpinnings of its decision, though, since a decision for USI Film Products on fairness grounds suggests a rather problematic view of the normativity of law, particularly given the way the litigants had framed the issue. The Court suggested that, in reality, section 102 "can be seen as creating a new cause of action," because it "confers a new right to monetary relief on persons like petitioner who were victims of a hostile work environment but were not constructively discharged, and the novel prospect of damages liability for their employers."<sup>350</sup> This is such a cynical argument—that employers could have previously permitted sexual harassment to go on unabated so long as it did not rise to the level of a constructive discharge, and so would have had a settled expectation of non-liability—that the Court immediately reframed its position: "Because Title VII previously authorized recovery of backpay in some cases, and because compensatory damages under § 102(a) are in addition to any backpay recoverable, the new provision also resembles a statute increasing the amount of damages available under a preestablished cause of action."<sup>351</sup> Permitting such an increase retroactively would be unfair, according to the Court, because "[t]he extent of . . . liability" is an "important legal consequence that cannot be ignored."<sup>352</sup> So, rather rapidly, the Court was right back to the law-as-price view of law.

The Court's other attempt to soften the implications of its decision rested on a misstatement of facts (and shared the above

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348. *Id.* at 283.

349. *Id.* at 282 & n.35.

350. *Id.*

351. *Id.* at 281.

352. *Id.* at 283-84.

cynical argument). Thus, in a footnote, the Court stated that:

As petitioner and *amici* suggest, concerns of unfair surprise and upsetting expectations are attenuated in the case of intentional employment discrimination, which has been unlawful for more than a generation. However, fairness concerns would not be entirely absent if the damages provisions of § 102 were to apply to events preceding its enactment, as the facts of this case illustrate. Respondent USI's management, when apprised of the wrongful conduct of petitioner's coworker, took timely action to remedy the problem. The law then in effect imposed no liability on an employer who corrected discriminatory work conditions before the conditions became so severe as to result in the victim's constructive discharge. Assessing damages against respondents on a theory of *respondeat superior* would thus entail an element of surprise.<sup>353</sup>

Yet, the facts established in the record showed that the actions taken were neither timely nor fully remedial. Barbara Landgraf's supervisor had done nothing about her complaints, and she ultimately had to go above her supervisor—action that is usually not well-received in corporate environments—to file a complaint with a human resources officer, who did take successful remedial action.<sup>354</sup> USI Film Products also conceded that her supervisor's actions were unsuccessful in keeping the harassing individual away from Barbara Landgraf.<sup>355</sup> So, given the actual facts of the case, *Landgraf* did not present a situation of unfair surprise being visited upon a company that had fully complied with the law. Rather, the core of the Court's decision vindicates the law-as-price view of law: A company that may have ignored the law or treated it as relatively unimportant, because the penalties were unimpressive, or may have "risked close passage," should not have to pay higher penalties than it anticipated.

Justice Blackmun stood alone in dissent. He would have applied the statute retroactively, both because he found that its language compelled that result and because he rejected the penalty-driven view of law compliance relied upon by the majority. He wrote:

Section 102 of the Act expands the remedies available for acts of intentional discrimination, but does not alter the scope of the employee's basic right to be free from discrimination or the employer's corresponding legal duty.

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353. *Id.* at 282 n.35.

354. *See Landgraf v. USI Film Prods.*, 968 F.2d 427, 429 (5th Cir. 1992), *aff'd*, 511 U.S. 244 (1994).

355. *See id.*

There is nothing unjust about holding an employer responsible for injuries caused by conduct that has been illegal for almost 30 years.<sup>356</sup>

The majority and dissent articulate very different views of law. To the majority, the amount of money risked for violations of law (the precise *extent* of liability, not just the possibility of liability) is an important factor in a corporation's planning with respect to law compliance, at least as important as the substantive standards the law sets forth. To the dissent, the law commands conformity notwithstanding penalties that are low. As developed below, the dissent's argument provides a much surer basis on which to ground political obligation and by which to structure social, political, and economic interactions. But prior to turning to that point, it is important to appreciate the break with the past that *Landgraf* represents.

#### 4. *Landgraf* Compared to Prior Cases

In *Landgraf*, the Court determined that new compensatory damages provisions in the Civil Rights Act of 1991 would not be available in a case that was in court when the Act became law, because to permit the plaintiff to seek those damages retroactively would be "manifestly unjust," as that term was understood in *Bradley v. School Board of Richmond*.<sup>357</sup> *Bradley* sought to protect parties from changes in the law that undermined their "vested rights"; permitting such changes retroactively would be manifest injustice, and consequently impermissible.<sup>358</sup> The expansion of the "manifest injustice" limitation from *Bradley* to *Landgraf* is therefore central to understanding why, on one interpretation, *Landgraf* is evidence of an important change in our way of thinking about the law.<sup>359</sup>

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356. *Landgraf*, 511 U.S. at 297 (Blackmun, J., dissenting).

357. 416 U.S. 696 (1974).

358. *See id.* at 711-12.

359. The actual *Landgraf* holding was that in the absence of congressional direction about the temporal reach of a statute, a court must determine "whether the new statute would have retroactive effect, *i.e.*, whether it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed," *Landgraf*, 511 U.S. at 280, in which case the statute would only apply prospectively, *see id.* With one important exception, *Landgraf* is nothing more than an application—or misapplication—of *Bradley*, because the instances the Court describes as having "retroactive effect" are essentially those in which the *Bradley* "manifest injustice" principle would preclude applying a change in the law retroactively. The one part of the test that is not derived from *Bradley*, though, is the Court's statement that increased liabilities for past conduct can give rise to a problematic "retroactive effect." *See id.* at 281. Here, the Court relies on precedents from criminal

In *Bradley*, the Court was concerned with the unfairness of applying new standards of conduct to judge prior behavior—to impose “new and unanticipated obligations,” or “additional or unforeseeable obligation[s],” after the fact.<sup>360</sup> While the notion of expanded damages fits comfortably within the language of “unforeseeable obligations” or “unanticipated obligations,” because a finding of liability would give rise to an obligation to pay money, the Supreme Court in *Bradley* was referring to an entirely different concept: new behavioral obligations. Thus, the *Bradley* Court cited *Thorpe v. Housing Authority of Durham*,<sup>361</sup> pointing out that retroactivity was proper in *Thorpe* (with respect to a statute that promulgated notice and hearing regulations prior to eviction of public housing tenants) because the statute did not change the conduct required by landlords or tenants to conform with the terms of their lease agreements.<sup>362</sup> In *Bradley* itself, the Court found that imposing attorneys’ fees in school desegregation litigation, based on new statutory provisions permitting such fees, “did not alter the Board’s constitutional responsibility for providing pupils with a nondiscriminatory education. Also, there was no change in the substantive obligation of the parties.”<sup>363</sup> What the *Bradley* Court was concerned with, then, would be the obvious unfairness of retroactively altering the substantive rules by which conduct would be judged to have conformed to law.

This interpretation of *Bradley* is consistent with the other modern Supreme Court cases in which the Court examined legislative retroactivity. Thus, in *Bennett v. New Jersey*,<sup>364</sup> the Court held that a federal statute redefining eligibility standards for state education expenditures would not be used to determine if prior expenditures

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law for the proposition that a statute that increases a party’s liability for past conduct must be applied prospectively only, yet in the criminal context the Ex Post Facto Clause specifically requires that result. *See id.* at 269 n.23 (citing *Miller v. Florida*, 482 U.S. 423, 429 (1987)). While at some point the Due Process Clause may operate to preclude liability-enhancement in the civil context, *see* *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976), no one, including the respondents in *Landgraf*, had argued that this point had been reached here. The actual effect of the *Landgraf* holding is opaque at best. *See* Fisch, *supra* note 301, at 1110 (“Although the *Landgraf* default rule has initial appeal because of its apparent clarity, it does not withstand scrutiny. . . . [T]he *Landgraf* rule requires an initial judgment by the courts as to whether a new rule is sufficiently retroactive to trigger the presumption of non-retroactivity. The circularity in this process is apparent.”).

360. *Bradley*, 416 U.S. at 720-21; *see also supra* note 300 (discussing *Bradley*).

361. 393 U.S. 268 (1969).

362. *See Bradley*, 416 U.S. at 720-21.

363. *Id.* at 721.

364. 470 U.S. 632 (1985).

had been proper because "statutes affecting substantive rights and liabilities are presumed to have only prospective effect."<sup>365</sup> The *Bennett* Court stated that its rationale was in accord with *Bradley*, so that if new legislation would undermine the substantive standards and obligations upon which parties had relied under an old law, the presumption against retroactivity, rather than the *Bradley* rule, would apply.<sup>366</sup> Similarly, in *Bowen v. Georgetown University Hospital*,<sup>367</sup> the Court refused to permit the Secretary of Health and Human Services to promulgate retroactive rules concerning how hospitals could calculate reimbursable Medicare costs when health care providers had already been reimbursed in reliance on the prior standards and would be required to return funds in excess of the retroactive limits.<sup>368</sup>

Thus, in prior cases in which the Supreme Court refused to apply a law retroactively (when Congress had not clearly indicated the temporal reach of a statute), it was because the law would retroactively change the conduct necessary to conform to law, or change the substantive standards by which prior actions would be judged.<sup>369</sup> These instances of non-retroactivity are readily distinguishable from *Landgraf*, in which section 102 did not affect the conduct necessary to conform to law, but merely increased the cost of liability when the possibility of liability existed under prior law,<sup>370</sup> and may even have been risked by the employer.

Indeed, the extent to which *Landgraf* represents a shift toward rational-choice theories of law compliance can be seen by contrasting it with another Supreme Court opinion of twenty years earlier, *Usery v. Turner Elkhorn Mining Co.*,<sup>371</sup> decided in 1976, before law and economics took hold of American legal theory. In *Usery*, the Court upheld the constitutionality of federal legislation that required coal mine operators to compensate certain miners, former miners, and their survivors for death or total disability due to black lung disease.<sup>372</sup> The coal mine operators had argued that "to impose

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365. *Id.* at 639.

366. *See id.* at 639-40.

367. 488 U.S. 204 (1988).

368. *See id.* at 208-09.

369. In *Kaiser Aluminum & Chemical Corp. v. Bonjorno*, 494 U.S. 827 (1990), the Court declined to apply amended post-judgment interest rates retroactively because it concluded that there was clear direction from Congress that the amendments be prospective only. *See id.* at 837-38.

370. *See supra* notes 339-56 and accompanying text (discussing *Landgraf*).

371. 428 U.S. 1 (1976).

372. *See id.* at 5-6.

liability upon them for former employees' disabilities is impermissibly to charge them with an unexpected liability for past, completed acts that were legally proper and, at least in part, unknown to be dangerous at the time."<sup>373</sup> The Court rejected this argument, holding that the imposition of liability for the effects of disabilities bred in the past was "justified as a rational measure to spread the costs of the employees' disabilities to those who have profited from the fruits of their labor—the operators and the coal consumers."<sup>374</sup> In so holding, the Court stated:

To be sure, insofar as the Act requires compensation for disabilities bred during employment terminated before the date of enactment, the Act has some retrospective effect . . . . And it may be that the liability imposed by the Act for disabilities suffered by former employees was not anticipated at the time of actual employment. But our cases are clear that legislation readjusting rights and burdens is not unlawful solely because it upsets otherwise settled expectations. This is true even though the effect of the legislation is to impose a new duty or liability based on past acts.<sup>375</sup>

In *Usery*, then, the Court permitted the legislature to increase the cost of *legal* activities (mining coal) retroactively on the basis of a compensatory rationale; in *Landgraf* the Court refused to increase the costs of *illegal* activities (employment discrimination) retroactively on a similar compensatory rationale.<sup>376</sup> This contrast is best explained as an indication of the extent to which our concept of law, and underlying intuitions about fairness, have incorporated a

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373. *Id.* at 15.

374. *Id.* at 18.

375. *Id.* at 15-16 (citations and footnote omitted).

376. The Court in *Usery* stated that:

While the Operators have clearly been aware of the danger of pneumoconiosis for at least 20 years, and while they have not specifically pressed the contention that they would have taken steps to reduce or eliminate the incidence of pneumoconiosis had the law imposed liability upon them, we would nevertheless hesitate to approve the retrospective imposition of liability on any theory of deterrence or blameworthiness.

*Id.* at 17 (citations and footnote omitted). The Court then went on to develop its rationale, upholding the legislation based on a compensatory theory of liability. *See id.* at 17-20. Similarly, in *Landgraf* the Court rejected the idea that the punitive damages provisions of section 102(b)(1) could be applied retroactively. *See Landgraf v. USI Film Prods.*, 511 U.S. 244, 281 ("Retroactive imposition of punitive damages would raise a serious constitutional question." (citing *Usery*, 428 U.S. at 17)). The *Landgraf* analysis discussed above was with respect to the new compensatory damages provisions of section 102(a)(1).



rational-choice, penalty-driven view of motivation towards law. Why else would it be important that the penalty was increased, given that the behavior required by law was not changed and the employer had thirty years' notice of that required behavior? The Court also agreed that the amount of money invested in law compliance activities will be a function of the level of the penalties, since it reasoned that increasing the penalties will give corporations added incentives to "take preventive measures to ward off discriminatory conduct by subordinates *before* it occurs."<sup>377</sup> So if the penalties are low, the employer will take less care than in situations in which the penalties are high and will invest less in compliance. While both of these aspects of the Court's rationale follow logically from rational-choice thinking about law, there are practical and conceptual difficulties with this theory of "efficient compliance."

*B. Practical Difficulties with the Landgraf Theory of Efficient Compliance*

First, there are numerous instances one can think of in which full compliance with a law would be far more expensive than the penalties risked for non-compliance: Was the Court really saying that a corporation can choose one or the other, or that the corporation's efforts towards compliance should be "capped" at the levels of the potential penalties? While the Court has not stated that a corporation has the right to choose to violate the law, the Court did hold that it will recognize and protect a reliance interest in the amount of damages risked for violations of law and recognizes that a corporation will be guided in its compliance efforts by the amount of potential penalties.<sup>378</sup> Recall the labor law examples earlier in this Article of overtime violations under the FLSA or of deliberate violations of employees' federally-protected organizing rights.<sup>379</sup> In both instances, it is potentially far more expensive for an employer to obey the law today than to risk the discounted value of potential penalties for violations tomorrow, given the time value of money. Is the Court suggesting that it is sensible, then, for the corporation to make only minimal efforts to encourage compliance with these laws because the penalties are low? Presumably under a *Landgraf* analysis, if the penalties were raised, the Court would not permit

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377. *Landgraf*, 511 U.S. at 282 n.35.

378. See *supra* notes 339-56 and accompanying text.

379. See *supra* notes 56-57 and accompanying text (discussing violations of organizing rights); *supra* notes 255-65 and accompanying text (discussing overtime violations).

them to be applied retroactively, because the corporation should have the opportunity to increase its compliance efforts to match the increased penalties. So why, under the Court's analysis, should a corporation take seriously the standards of the law today when penalties are low, if its only concern is the low amount of money risked in penalties under current law?

Or consider a corporation's environmental compliance obligations to meet air quality standards or water quality standards, in a situation where it would require investment in new technology that is far more expensive than the corporation risks in penalties to comply with the law. If one cares about the environment, one wants the corporation to make the necessary technological investment even though it is more expensive than the potential penalties. But what incentive does the Court's opinion create towards that end? The Court's rationale instead suggests that law violators should have a settled expectation of penalties, and need not worry about future enhancements, and that it is reasonable for corporations to orient their compliance efforts by the penalties for non-compliance rather than the substantive standards of behavior. If corporate officers share the diminished sense of civic obligation inherent in the Court's view, there will be large realms of positive law that can be all but ignored.

Second, in many instances penalties will be low precisely because of the involvement of corporate lobbyists in the legislative process, and because of the involvement of corporate contributions in the campaign finance process.<sup>380</sup> If corporate compliance efforts are

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380. See generally ELIZABETH DREW, *POLITICS AND MONEY: THE NEW ROAD TO CORRUPTION* (1983) (describing the effects of campaign contributions on policy); RALPH NADER & WESLEY J. SMITH, *NO CONTEST: CORPORATE LAWYERS AND THE PERVERSION OF JUSTICE IN AMERICA* 256-319 (1996) (describing the involvement of attorneys representing private corporations in the legislative drafting process). Part of those efforts would be to lobby to reduce penalties for violations and to reduce funds for enforcement of existing law, so one cannot assume ab initio that the levels of penalties are a good indication of either social costs or an "objective" social consensus about how important a law is. See, e.g., Christopher Drew, *In the Productivity Push, How Much Is Too Much?*, N.Y. TIMES, Dec. 17, 1995, at C1 ("One of the goals of U.P.S. is to slash OSHA's budget and shift some of its focus from fining companies for safety problems to merely advising them. U.P.S. is also a key player in a 300-company coalition that seems on the verge of killing a proposed Federal rule meant to limit injuries from heavy lifting and repetitive job motions."). Indeed, corporations may be required by the wealth-maximization norm to try to shape laws and regulations in their favor. Jim Shultz makes this point in *The Initiative Cookbook*, when he discusses a 1990 initiative in California that would have raised taxes on the alcohol industry (including the economically important wine sector); estimates suggested that the tax would have raised \$760 million in the first year alone. Alcohol producers successfully spent \$27 million for advertising to defeat the

"capped" by the maximum penalties that are risked by violations, and if the penalties are too low, there may well be insufficient corporate resources spent to comply with the standards of the law, leading both to increased numbers of violations, some proportion of which will never be redressed,<sup>381</sup> and excess social costs imposed by the corporation on society. While one response to this problem may be simply to raise the penalties so that compliance efforts will be similarly augmented, there are well-documented limits to the effectiveness of increasing deterrence of corporate malefaction by increasing penalties, and limits beyond which penalties cannot be raised because of due process and other fairness concerns.<sup>382</sup>

Third, penalties may bear an indirect relationship, at best, to the actual social costs of the harms imposed by violating laws subject to penalty provisions. For instance, the maximum penalty plus compensatory award per violation of Title VII for a large employer is \$300,000.<sup>383</sup> Yet a 1988 study of the costs of sexual harassment (which is one type of discrimination reached by Title VII) to large Fortune 500 firms (averaging 23,750 employees) found that the average annual costs were \$6.7 million per company, including increased absenteeism, increased incidence of stress-related disease, higher employee turnover, and decreased productivity, but not including the costs of litigation.<sup>384</sup> So in that instance, the penalty for one violation is less than five percent of the total actual costs of sexual harassment (although the firm itself bears many of the

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initiative. Shultz points out that this 28:1 return on investment was a much higher return on investment than other business uses of the funds, such as building new breweries or changing production techniques. JIM SHULTZ, *THE INITIATIVE COOKBOOK* 8 (1996).

381. This assumes that money spent on compliance efforts is usually successful in reducing the number of violations.

382. See, e.g., Bundy & Elhauge, *supra* note 17, at 273 ("[T]he legal regime cannot always set penalties high enough to eliminate underdeterrence. If the frequency of detection and punishment is low, it may be impossible to raise sanctions sufficiently to deter all undesirable conduct. Or the level of sanctions required to eliminate underdeterrence may be disproportionate, unfair, cruel, beyond individual actors' wealth (so that increasing sanctions yields no additional deterrent benefit), or, in the case of extensive incarceration, too costly to administer."); John C. Coffee, Jr., "No Soul to Damn: No Body to Kick": *An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 390 (1981) (positing that "the maximum meaningful fine that can be levied against any corporate offender is necessarily bounded by its wealth," so, using a pure rational actor model, "our ability to deter the corporation may be confounded by our inability to set an adequate punishment cost which does not exceed the corporation's resources").

383. See 42 U.S.C. § 1981a(b)(3) (1994).

384. See Susan Crawford, *A Wink Here, A Leer There: It's Costly*, N.Y. TIMES, Mar. 28, 1993, at F17, cited in Beverley H. Earle & Gerald A. Madek, *An International Perspective on Sexual Harassment Law*, 12 LAW & INEQ. J. 43, 44 (1993).

quantifiable costs of the harassment). It is a foundational premise of "efficient sanctioning" that penalties ought to equal and/or do equal the social costs of law violations so that corporations properly internalize the costs of such harm in their decision-making—by making the correct investment in compliance.<sup>385</sup> Yet, there is little evidence that legislatures write penalty provisions utilizing the assumptions of efficient sanctioning. Do we really think that sexual harassment in a small corporation, which can engender compensatory and punitive damages of up to \$50,000 per claim, harms the target individual one-sixth as much as the target of sexual harassment in a large company, where the same damages are capped at \$300,000 per claim? Do we really think that when Congress set those penalties it had a study quantifying the social costs of harassment indicating that harassment in large companies imposed per claim social costs that were six times that of harassment in small companies? This scenario seems highly improbable, at best.<sup>386</sup> Indeed, even some of the most ardent proponents of "efficient sanctioning" and rational-actor modeling have come to recognize that statutory penalty provisions may have little relationship, if any, to the social costs of harm imposed by violations of those same statutes.<sup>387</sup> So, again, use of the penalty levels as an indication of how much money to invest in law compliance, when the penalties bear no real relationship to the social costs of harm (particularly if there are no estimates of how many violations per company per year to expect), will often lead to the wrong amount of money being invested in law compliance.

Fourth, while the amount of "the penalty" sounds like an objective standard by which to determine the proper amount of corporate investment in law compliance, on further examination "the penalty" provides a wholly illusory benchmark. In most cases, the same conduct can give rise to differing penalties of different amounts under parallel federal and state statutes or common-law precedent.<sup>388</sup>

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385. See Engel, *supra* note 4, at 37-38; Fischel, *supra* note 45, at 1271.

386. The far more likely explanation for this range of penalties is that it represents a political compromise protecting small business and was driven by Congress's view of the ability of violators to pay, not its view of the social costs of harm from harassment.

387. See Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 322-23 (1996) ("[T]he criminal justice system rarely makes any attempt to set the penalty equal to the social harm caused by the crime, a policy that *may* make sense in setting the level of sanctions against individual criminals. But sanctions uncalibrated to the level of harm can have quite a pernicious effect when the target of a sanction is a corporation.").

388. See, e.g., *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238, 256 (1983) (holding that states may require firms engaged in the nuclear power industry to pay punitive damages for violating state law that is duplicative of federal law, even when federal law sets a cap on monetary damages); *NAACP v. American Family Mut. Ins. Co.*, 978 F.2d 287, 295 (7th

If punitive damages are permitted, the "amount of the penalty" is an inherently indeterminate construct.<sup>389</sup> Moreover, an increasing number of civil violations can give rise to potential criminal liability as well, particularly in the regulatory arena.<sup>390</sup> The follow-on effects of criminal liability can be profound, as Drexel Burnham Lambert, Kidder Peabody, Archers Daniels Midland, Caremark, and E.F. Hutton, among others, have found. In the securities or other highly regulated industries, a criminal indictment may cause a firm to go out of business, as did Drexel and E.F. Hutton. Or, if they stay in business, the firm may lose key employees and customers, see its bond ratings downgraded, and see its cost of credit rise, among other effects; it may be subject to onerous injunctions or be precluded from contracting with the U.S. government or state or municipal governments; and institutional investors may disinvest.<sup>391</sup> None of

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Cir. 1992) (holding that parallel and duplicative remedies of the Federal Fair Housing Act and the Wisconsin fair housing law were permissible so long as state law provisions do not conflict with federal because "duplication is not conflict").

389. See, e.g., *TXO Prod. Corp. v. Alliance Resources Corp.*, 509 U.S. 443, 462 (1993) (upholding as constitutional a \$10 million punitive award when compensatory damages were \$19,000). Indeed, the argument has been made that it is important to allow significant leeway to juries in awarding punitive damages precisely to prevent corporations from being able to predict potential penalties in order to treat them as a cost of doing business. This argument was rejected by Justice O'Connor in dissent in *Pacific Mutual Life Insurance Co. v. Haslip*, 499 U.S. 1, 58-59 (1991) (O'Connor, J., dissenting).

390. See Coffee, *Paradigms Lost*, *supra* note 7, at 1880-81 ("It has become the common statutory pattern in the United States for a statute establishing an administrative agency to provide that any willful violation of the rules adopted by the agency constitutes a federal felony. As a direct result, one estimate places the number of federal regulations currently punishable by criminal penalties at over 300,000.").

391. Each of these problems was demonstrated in the highly publicized Salomon Brothers scandal in 1991, for which one trader, Paul M. Mozer, was primarily responsible. (Mozer falsely used customers' names to bid in seven Treasury auctions to obtain government securities in excess of applicable Treasury Department regulations.) The scandal broke in early August of 1991. By late September major corporate and government customers suspended or reduced their business with Salomon pending resolution of the matter, including: the World Bank; the state pension funds of Texas, Wisconsin, Massachusetts, California, Connecticut, New Jersey, and Colorado; and AT&T, Cigna, U.S. Steel, and J.P. Morgan. See Randall Smith & Michael Siconolfi, *Salomon Is Scolded by AT&T Chairman, Who Calls Bid Scandal 'Unforgivable'*, WALL ST. J., Sept. 24, 1991, at C23. (Rule 2a-7 promulgated under the Investment Company Act of 1940 limits the ability of money market funds to invest in commercial paper rated below A-1 or P-1, so adverse actions by Moody's or Standard & Poor's commercial paper rating services in light of well-publicized wrongdoing by even one or two rogue employees, as in the Salomon example, can have serious consequences.) The Federal Reserve suspended Salomon's right to submit bids in Treasury auctions on behalf of customers. Salomon's underwriting business plummeted because one important role of the underwriter is as reputational intermediary. See Michael Siconolfi & William Power, *Underwriting Fees Heated for a Record*, WALL ST. J., Mar. 24, 1992, at C1 (reporting record profits from underwritings for investment banks other than Salomon). *Business*

these effects are subject to accurate specification, let alone quantification, ex ante, although they represent very real costs ex post. Moreover, the serious reputational harm that can be done to a firm by criminal liability or well-publicized civil liability (as in the recent discrimination settlement at Texaco<sup>392</sup>) likewise imposes real costs on a firm that are virtually impossible to quantify ex ante, or, if quantified, are likely to be underestimated due to widely shared cognitive biases.<sup>393</sup> Finally, in any of the above scenarios, to truly figure out the potential penalties from corporate wrongdoing, one would need to include the costs of litigation, including the opportunity costs of having the firm's executives spending their time working with litigators rather than working against competitors. Again, these are virtually impossible to quantify ex ante. These difficulties in prediction suggest that determining how much money to invest in law compliance by determining the amounts of potential "penalties" is likely to be impossible in all but the most schematic sense.

A much clearer standard is simply to invest the amount of money necessary to try, in good faith, fully to meet the standards of the law. In some instances, such as in the environmental area, that amount may end up being more money than the potential penalties because it may require investment in new technologies. In other instances, it may require far less money than the potential penalties. Consider sexual harassment for a moment (as in *Landgraf*): Although the parties and some courts were concerned that the

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*Week* reported that Salomon's market share of equity underwritings went from over 8% in the period August 1, 1990 to July 31, 1991, to under 3% in the period August 1, 1991 to January 31, 1992, and its market share of debt underwritings went from over 10% to approximately 7% for the same periods. See Leah Nathans Spiro & Richard A. Belcher, *Rescuing Salomon Was One Thing, but Running It . . .*, BUS. WK., Feb. 17, 1992, at 120, 121. After the scandal, Salomon's employee turnover surged, particularly among highly compensated employees. See Douglas Feiden et al., *A Hiring Frenzy*, CRAIN'S N.Y. BUS., Jan. 20-26, 1992, 6, 6 ("[T]hough they don't like to admit it on the record, headhunters are benefiting from the troubles of Salomon Brothers Inc. They report a surge of business from U.S. and foreign investment and commercial banks and other financial service companies seeking to lure away the best and the brightest at Salomon."); Philip Maher & Jessica Sommar, *Salomon Exodus Continues As Rival Banks Swoop in*, INV. DEALERS' DIG., Jan. 20, 1992, at 6.

392. See Anne Reifenberg, *Texaco Settlement in Racial-Bias Case Endorsed by Judge*, WALL ST. J., Mar. 26, 1997, at B15 (describing \$176 settlement of race discrimination class action lawsuit against Texaco, Inc.).

393. See Donald C. Langevoort, *Beliefs, Biases and Organizational Behavior: The Epistemological Dilemma of the Corporate-Securities Lawyer*, 50 STAN. L. REV. (forthcoming 1998) (noting that among typical cognitive biases seen in an organizational setting is optimism, which will cause employees within the organization to underestimate the importance of negative information).

amount of the penalty would affect the efforts put into compliance, how expensive can those efforts really be? A company needs to develop a sexual harassment policy, which will require managerial time, effort, and consideration; fully publicize that policy within the firm with the proper degree of seriousness and educate employees about sexual harassment; and create a grievance mechanism that is also well-publicized. There will need to be occasional reminders of the policy, when problems are brought to a supervisor's attention; and grievance committees will need to meet. In some cases, adverse personnel actions will need to be taken. The costs of these actions are minuscule, though, compared to either the penalties for sexual harassment or the costs of sexual harassment to the firm.<sup>394</sup> In any case, the standards of statutes and regulations are likely to provide a far clearer account of what efforts are necessary than is "the penalty."

C. *Conceptual Difficulties with the Landgraf Theory of Efficient Compliance*

Those practical difficulties in determining the amount of "the penalty," buttressed by social science research questioning the rational-choice view of law,<sup>395</sup> as well as by casual empiricism,<sup>396</sup>

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394. See *supra* note 384 and accompanying text (discussing study of costs of sexual harassment to large firms).

395. One descriptive assumption underlying rational-choice accounts of law compliance is that obeying the law is based on a "rational actor's" comparison of the potential costs of compliance with the benefits of non-compliance. See Ulen, *supra* note 23, at 442. In fact, that descriptive assumption has not been fully borne out in empirical research. Rather, obeying the law is responsive to and dependent on a much richer calculus, including that of a general sense of moral and civic obligation and of fairness. See TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 178 (1990). In empirical studies of law compliance, the author found that reasons why people obey the law include an individual's social relationships and the potential influence of others' judgments, as well as that person's sense of internal obligation to obey the law because of a felt obligation to behave morally, or because of a view of legal authorities as having a legitimate right to dictate their behavior. See *id.*; see also CHARLES R. TITTLE, *SANCTIONS AND SOCIAL DEVIANCE: THE QUESTION OF DETERRENCE* 170-78 (1980) (finding that, in addition to the fear of sanctions, people comply with laws based upon their degree of moral commitment to norms, the degree they feel integrated into the community, and whether the social system has deprived them of opportunity or alienated them); John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 L. & SOC'Y REV. 7, 7, 24-36 (1991) (studying 410 chief executives of nursing homes and their compliance with regulatory standards, and finding partial support for the theory that the certainty of detection affects compliance with law but no support for the theory that either certainty or severity of penalties had a bearing on compliance with law); Irving Piliavin et al., *Crime, Deterrence, and Rational Choice*, 51 AM. SOC. REV. 101, 101-19 (1986) (studying serious and high risk criminal offenders, and finding no evidence that the expected severity of sanctions has a bearing on the decision to violate the law); Sunstein,

suggest a more fundamental problem with the Court's analysis in *Landgraf*: it may be based on a theory about how decisions about law compliance are made that is wrong. Judges Posner and Higginbotham, as well as the *Landgraf* respondents' counsel, seized upon the notion that it would be unfair to "up the ante" since a corporation would have "relied upon" the amount of the potential penalty in determining how much care to take to avoid liability. In so doing, they deployed the rational-choice model of law compliance. But what if corporate decision-makers do not actually think this way? What if many attorneys advising many corporations are conservative, that is, they want to keep their employer or client out of trouble, and think that the substantive standards the law sets forth are important simply because they are law (although they may certainly disagree with a legislature's policy choices with respect to any individual law)? These attitudes would suggest that in giving advice about investing in compliance programs, attorneys are more likely to be concerned with balancing the cost of the program against the probability of violation—a completely different focus, and one that ultimately seeks compliance with the law.

On one level, then, the Court has simply made a mistake: it relied upon a theory of decision-making that is incomplete at best. But it is the particular nature of the mistake that is important. While rational-choice theory was originally proposed as a theoretical (and necessarily simplified) model of how to think about decisionmaking generally, and was then applied to thinking about law and deterrence,<sup>397</sup> the Court's analysis treats the model as if it were a true description of the underlying reality of decision-making about law

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*supra* note 23, at 903 (positing an interaction between laws and norms as shaping behavior, so that changes in social norms can alter the reputational incentives and consequences of complying with the law).

396. My observations as a practicing attorney, as well as conversations I have had with other attorneys both before and after I began working on this Article, lead me to believe that many corporations make serious efforts to comply with the requirements of law irrespective of the levels of penalties, particularly since many firms recognize that the reputational effects of law violations can be seriously damaging and are of far more serious concern to the firms than are the statutory penalties. In determining the level of investment in law compliance programs, companies are more likely to weigh the cost of a compliance program against the probability of a violation than they are to weigh the benefits of deliberate breach of a statutory obligation against the potential costs of breach. Factors affecting the probability of violations include the nature of the industry and types of statutes and regulations applicable to it, the compensation structure of the firm and its organization, including its supervisory and accounting structure, and its relationships with suppliers, producers, and customers. (I particularly appreciate the insights of my colleague Professor Phil McConaughay on this point.)

397. See Becker, *supra* note 74, at 170; Ulen, *supra* note 23, at 436.



compliance. In so doing, the Court's analysis has potentially affected that underlying reality. By endorsing the view that compliance with the law is properly shaped by whether the penalties are financially significant (or at least *understandably* shaped by that factor), and by holding that it is unfair to impose expanded penalties when managers had "relied upon" lower penalties and had thus developed an expectation that the Court treats as settled, the Court seemingly endorses the rational-choice theory of law compliance, both as a descriptive matter *and* as a normative matter. In so doing, the Court serves to undermine the normative significance of law, particularly when penalties are insignificant (as to a large corporation), which may ultimately have an impact on law compliance such that future corporate decision-makers *will* consider the size of penalties as determinative in orienting their law-compliance activities, even if they would not have done so previously.

But even if the efficient investment paradigm does accurately describe how corporate managers, prior to *Landgraf*, typically think about developing a law-compliance program, we are then back to the more fundamental question: Why should the penalty level have mattered at all? If the law made clear what substantive behavior was required to conform to law, why should it matter that a civil violation became more expensive? What has the Supreme Court told us about its concept of law in *Landgraf*?

Unfortunately, what it has told us is that its concept of law is penalty-driven and thin. The Court could have articulated a view of law much closer to that of Judge (now Justice) Breyer in *Capuano*: An entity's "obligation, under the law, is to refrain from those activities that call for a sanction, whether that sanction is strict or lenient, and whether the agency [charged with enforcement] devotes many, or few, staff resources to the business of catching violators."<sup>398</sup> It could have upheld the view of law of those courts that rejected *Luddington*'s law-as-price view and that instead focused on whether the substantive standards of behavior necessary to conform to the law had been changed by the Civil Rights Act of 1991.<sup>399</sup> Instead, the Supreme Court focused on the level of the penalty as a determinative factor affecting corporate compliance with the law.

In adopting this penalty-driven approach to law, the Court gives credence to a view that makes it impossible to structure social and legal interactions with any degree of confidence. Each corporation or

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398. *Capuano v. National Transp. Safety Bd.*, 843 F.2d 56, 58 (1st Cir. 1988).

399. See *supra* text accompanying notes 321-26 (discussing these decisions).

individual will value penalties, and therefore laws, differently, depending on their profit levels, their tolerance for financial risk, the structure of their industry, and their competitive position in that industry. These different values will affect the efforts put into law compliance, on the Court's view, and thus will affect the extent to which the law is implemented in that firm. While this patchwork quality is undoubtedly a true description of the way law is implemented across firms, it is unfortunate to accept this description as a perfectly plausible account of the most we can expect from firms, as the Court did in *Landgraf*. And having accepted that account, the Court's logic can produce a self-fulfilling prophecy, as described above.

Ultimately, the most problematic aspect of the *Landgraf* decision is what it says about the Court's view of political obligation. Perhaps enhanced penalties will have an impact on private parties' planning, and perhaps enhanced penalties will give added incentives to corporate managers to invest more in law compliance programs. But why should we not assume that there is a *prima facie* obligation to comply with the law even without those added incentives? Was the "price" of potential violations so low that the Court thinks it reasonable that USI Film Products would just not be very concerned with compliance? Why should we adopt that as a perfectly plausible theory of political obligation? For the reasons discussed above, we should not.

## VI. THE CORPORATE SOCIAL RESPONSIBILITY DEBATE

To this point, this Article has argued that the law-as-price theory of law is an incorrect understanding of the meaning of law in a democracy. As applied to the corporation, moreover, it is also premised upon an incorrect understanding of the corporation and its obligations as a citizen and social actor. This Article will conclude by briefly sketching out this argument, while recognizing that its full development could entail a separate article.

Recently, in both academic publications<sup>400</sup> and the popular

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400. See, e.g., PROGRESSIVE CORPORATE LAW, *supra* note 79; MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993) [hereinafter Bainbridge, *In Defense*]; Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971 (1992) [hereinafter Bainbridge, *Interpreting*]; William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989); George Djurasovic, *The Regulation of Socially Responsible Mutual Funds*, 22 J. CORP. L.

press,<sup>401</sup> the question of the proper relationship of the corporation to society has again begun to surface as a matter of some concern. This question was posed in modern times by Merrick Dodd and Adolf Berle in the 1930s as follows: To whom do corporate managers have fiduciary obligations—shareholders only, or other constituents as well—and what is the nature of those obligations—to maximize shareholder wealth, or to maximize social welfare, or some combination of the two?<sup>402</sup> This “corporate purpose” debate between Dodd and Berle has remained largely unresolved in the modern shareholder/stakeholder debate between progressive corporate law

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257 (1997); Barbara A. Frey, *The Legal and Ethical Responsibilities of Transnational Corporations in the Protection of Human Rights*, 6 MINN. J. GLOBAL TRADE 153 (1997); Elizabeth Glass Geltman & Andrew E. Skroback, *Environmental Law and the Ethical Investor*, 22 J. CORP. L. 465 (1997); Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409 (1993); Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021 (1996); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997); Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1 (1994); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477 (1995); Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 901 (1993).

401. See, e.g., Wendy Bounds, *Critics Confront a CEO Dedicated to Human Rights*, WALL ST. J., Feb. 24, 1997, at B1; James Cramer, *Let Them Eat Stocks*, NEW REPUBLIC, Apr. 29, 1996, at 24; Richard B. Freeman, *Toward an Apartheid Economy?*, HARV. BUS. REV., Sept.-Oct. 1996, at 114; Carey Goldberg, *A Promise Is Kept, Mill Reopens*, N.Y. TIMES, Sept. 16, 1997, at A14; Steven Greenhouse, *Accord to Combat Sweatshop Labor Faces Obstacles*, N.Y. TIMES, Apr. 13, 1997, at A1; Bob Herbert, *Separation Anxiety*, N.Y. TIMES, Jan. 19, 1996, at A29; Michael Lerner, *Social Responsibility Amendment and Initiative*, TIKKUN, July 1997, at 33, 33-34; Alison Mitchell, *Republicans and Democrats Jumping on Issue of Corporate Responsibility*, N.Y. TIMES, Feb. 15, 1996, at B15; Steven Pearlstein, *No More Mr. Nice Guy*, WASH. POST (Weekly Ed.), Dec. 18-24, 1995, at 10; Robert B. Reich, *How to Avoid These Layoffs?*, N.Y. TIMES, Jan. 4, 1996, at A21; Hanna Rosin, *The Evil Empire: The Scoop on Ben & Jerry's Crunchy Capitalism*, NEW REPUBLIC, Sept. 11, 1995, at 22; *Shareholder Values*, ECONOMIST, Feb. 10, 1996, at 15; *Stakeholder Capitalism*, ECONOMIST, Feb. 10, 1996, at 23; Michael Winerip, *Where the Loss of Jobs Means Growing Anger*, N.Y. TIMES, Feb. 27, 1996, at A16; see also President Clinton's Conference on Corporate Citizenship (May 16, 1996) (transcript available from the Office of the Press Secretary of the White House) (on file with the *North Carolina Law Review*) (discussing corporate responsibility and highlighting actions of corporations that have been financially successful and also concerned with employee and community needs).

402. See Berle, *supra* note 79, at 1368; Dodd, *supra* note 79, at 1162. As Professor Steve Bainbridge has pointed out, the corporate responsibility debate predates the 1930s, so it is more accurate to suggest that the *modern* corporate social responsibility debate began with Dodd and Berle's exchange. See Bainbridge, *Interpreting*, *supra* note 400, at 971.

scholars and contractarians.<sup>403</sup> But Dodd and Berle also disagreed upon a more fundamental, underlying question: whether the corporation should be understood as purely private property, as Berle argued, or as quasi-public property, as Dodd asserted.<sup>404</sup> Following that line of argument may ultimately be more fruitful.<sup>405</sup>

In the work of both the ALI Corporate Governance Project and of the ABA Committee on Corporate Law Revisions to the Model Business Corporations Act, we can see evidence of the views of leading academics and practitioners on the obligations of the corporation as a citizen and social actor, as exemplified by the seriousness with which those bodies treat the obligation of corporate boards and officers to ensure obedience with the law. One of the striking aspects of the ALI and ABA views on the importance of law compliance is that certain types of law violations are treated as relatively unimportant and of limited concern in structuring corporate governance systems—civil law violations, even if intentional, according to the ABA, or non-culpable law violations, either civil or criminal, according to the *ALI Principles*.<sup>406</sup> Both the *ALI Principles*, particularly in later years, and the ABA Committee on Corporate Laws have been shaped by the perceived interests of large corporate clients, as communicated by large law firm lawyers, and by the law and economics approach to corporate law.<sup>407</sup> The former, for obvious reasons, perceive their interests to be furthered by provisions limiting potential board liability to shareholders and to the corporation, because that will reduce the potential for expensive derivative litigation and will increase the certainty of boards' and officers' predictions of the liability consequences of corporate decision-making.<sup>408</sup> The latter have conceptualized the firm as a

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403. One reason this debate may still be largely unresolved is that it is ultimately a political debate, but is rarely recognized as such. If so, then Steve Bainbridge's recent critique of *Progressive Corporate Law* in the *Cornell Law Review* at least serves the admirable purpose of bringing the underlying political disagreements to the fore. See Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 858 (1997) (reviewing PROGRESSIVE CORPORATE LAW, *supra* note 59) ("Although most corporate law scholars, including most in the law and economics camp, purport to embrace an apolitical objectivity, my disagreement with progressive corporate law scholars is explicitly political. This Essay continues and refines our on-going dialogue by candidly articulating a conservative version of the law and economics account of corporate law.").

404. See *infra* text accompanying notes 416-20.

405. Larry Mitchell has taken this approach to the corporate purpose debate recently. See Mitchell, *supra* note 14, at 877.

406. See *supra* text accompanying notes 149-94.

407. See Branson, *supra* note 14, at 281-84; Seligman, *supra* note 64, at 342-44.

408. These concerns, along with a concern for creating conditions that allow the

"nexus of contracts," both implicit and explicit, among equity investors, bondholders, employees, managers, creditors, and consumers, and have elaborated upon the relationships among these entities as a sub-species of contract law.<sup>409</sup> There may well be a tension between these "camps" on some issues, such as management's duties when presented with a hostile takeover attempt,<sup>410</sup> but under both views corporate law is predominantly a type of private law, and the relationship of the board to the shareholders, among other relationships, is of private concern, for the most part, and is subject to "voluntary" agreement in the certificate of incorporation.<sup>411</sup> Thus, if the shareholders "agree" that the board ought not be liable to the corporation for intentional violations of civil law, or for "non-culpable" violations of any law, because that structure of exculpation is thought to advance the corporation's interests, then that private agreement suffices to take the issue of law compliance off the table as a subject for corporate governance concern under both views.<sup>412</sup>

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maximum flexibility for economic risk-taking in corporate decision-making, are dominant themes in the Business Roundtable's criticisms of the First Draft of the *ALI Principles*. See generally BUSINESS ROUNDTABLE, STATEMENT, *supra* note 64 (arguing that the ALI's proposed *Principles of Corporate Governance and Structure* would impede corporate flexibility by over-emphasizing litigation).

409. See EASTERBROOK & FISCHEL, *supra* note 85, at 12. Easterbrook and Fischel argue that a contractual approach does not draw a sharp distinction between suppliers of financial capital (shareholders, bondholders, and creditors) and suppliers of human capital (employees), yet for employees and constituents other than shareholders (such as community members), enforcement of the corporate contract means enforcing the "explicit, negotiated contract," *id.* at 37, while shareholders as "residual claimants" get the benefit of favorable implicit contract terms, such as shareholder profit-maximizing as the sole legitimate object of corporate endeavor, *see id.* at 38. In contrast, other writers have suggested that there could be favorable implicit contracts between a corporation and its employees. See, e.g., Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189, 1203-07, 1252-53 (1991) (stating that employees develop long-term attachments to companies under implicit contracts in which employees accept lower wages in return for a degree of job security; based on these implicit contracts, directors should have fiduciary duties to mitigate the effects of layoffs and plant closings upon displaced workers). So while a private-law vision of corporate law has been the usual implication drawn from the nexus-of-contracts view of the corporation, that implication is not inevitable.

410. On this issue, corporate lawyers tend to be more sympathetic to the concerns of management, particularly if they have represented takeover targets, while academics of the law and economics school are concerned with maximizing shareholder wealth (which, for target shareholders, usually involves being acquired) and effectuating the discipline of the market for corporate control to dislodge entrenched management.

411. Neither the ALI nor the ABA think that these questions are purely of private concern, though, as is evidenced by the limitations both groups placed on the corporation's ability to exculpate its board. See *supra* text accompanying notes 163-82.

412. One should be cautious in interpreting shareholders' "voluntary agreement" for a

The *ALI Principles* and the ABA revisions on exculpation, then, are an indication of the ascendancy of a private-law vision of corporate law within the corporate bar, and with it a constrained theory of corporate social responsibility.<sup>413</sup> The nexus-of-contracts view of the corporation that so influenced the *ALI Principles* and ABA revisions not only explicitly relies on a metaphor of private ordering (that of contract law) to describe the corporation, but suggests that any argument of public responsibilities for such private entities is just wrong. As Fischel has put the point:

Those who argue that corporations have a social responsibility and, therefore, that managers have the right, and perhaps the duty, to consider the impact of their decisions on the public interest assume that corporations are capable of having social or moral obligations. This is a fundamental error. A corporation . . . is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit. Since it is a legal fiction, a corporation is incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations.<sup>414</sup>

Moreover, an extreme variant of a private-law vision is inherent in the efficient breach view of public law, since it posits that the private wealth-maximizing behavior of individual corporations can

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number of reasons. First, some shareholders will have purchased shares after exculpatory amendments to the articles of incorporation limiting board liability were enacted (although the price of the shares may have been discounted somewhat to reflect the increased risks to shareholders from the liability limitations, and so by purchasing at a discount those shareholders could be argued to have consented to and have been compensated for increased risks of directors' misconduct). See Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 64 (1989) (reporting that firms electing to adopt exculpation provisions experienced a statistically significant drop in share price). Second, management typically owns or controls a majority of shares, and so is in a position to cause "the shareholders" to consent to limitations on management's liability.

413. See Branson, *supra* note 14, at 281-84; Seligman, *supra* note 64, at 342-44.

414. Fischel, *supra* note 45, at 1273. On this view, rather than being more than the sum of its asserted parts, for instance by organizing, coordinating, and prioritizing this web of explicit and implicit contracts, the corporation is somehow only the sum of its parts. Even so, if we are not to ascribe moral responsibility for the effects of corporate action to the corporation as the organizing and coordinating collective entity, then the moral responsibility must remain with the individuals who comprise the corporation, who make the decisions, and who participate in the contracts. Moreover, one of the most important implicit contracts is with society, through the auspices of the state, and so it is entirely consistent with a nexus-of-contracts view to examine what the terms of this particular implicit contract are.

overcome the substantive standards set by laws of otherwise general applicability.<sup>415</sup> Easterbrook and Fischel's theory of a private right to violate public law when it is profitable presumes, one must conclude, that if each corporation maximizes its profits by non-morally repugnant violations of law when the potential profits outweigh the potential penalties, that is, pursues its self-interest more or less untrammelled, then social wealth will be advanced. If the *ALI Principles* and the ABA Committee's views on exculpation represent a partial ascendancy of a private-law vision of the corporation, Easterbrook and Fischel's theory represents the total ascendancy of such a private-law vision.

And yet that vision of the corporation and the corporate social relationship is neither uncontested nor incontestable. Merrick Dodd initiated the modern corporate social responsibility debate in 1932 precisely by arguing that modern corporations ought not to be considered purely private entities because they form the backbone of the economic organization of society, and that concomitant with this position and concentration of economic power are certain public responsibilities.<sup>416</sup> Dodd argued that "business is permitted and encouraged by the law primarily because it is of service to the community rather than because it is a source of profit to its owners."<sup>417</sup> Indeed, he argued that the corporation is an institution that is greater than a simple aggregation of shareholders (contrary to how it is now understood by nexus-of-contracts devotees) and one that is central to the economic and now political organization of society.<sup>418</sup> Moreover, he asserted, managers of large corporations must be understood to be fiduciaries for the institution, and not for its constituent shareholders.<sup>419</sup> This reconceptualization is

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415. Private wealth-maximizing operates in two ways in the Easterbrook/Fischel theory to mediate the relationship between the corporation and society. First, society sends price signals to firms in the penalties it sets, and firms respond by efficient investment in compliance or by varying their demand for law violations in order to maximize profits. See Easterbrook & Fischel, *supra* note 1, at 1157. Second, the dictates of private wealth-maximizing operate as a trump to overcome the substantive standards set by the law. See *id.* at 1177 n.57.

416. See Dodd, *supra* note 79, at 1149. Dodd pointed to the regulation of certain industries that are imbued with important "public" responsibilities, such as railroads, gas, electric service, and telephones, as evidence of limitations on the extent to which businesses can be considered purely private property, and also pointed to the then-newly developing regulations promoting employee health and safety and economic security as further evidence of that point. See *id.* at 1149-51.

417. *Id.* at 1149.

418. See *id.* at 1162-63.

419. See *id.*

unimportant if the purpose of the institution is simply profit-maximizing, but Dodd was unwilling to agree to that narrow definition of the corporate purpose, because he lived during the Depression (given the obvious defects in the social results the private wealth-maximizing view had seemingly produced in that era) and because of his view that with increasing corporate power came increasing social responsibility.<sup>420</sup>

This more public-law vision of corporate power and responsibility continues to compete with the private-law vision in the work of some corporate law scholars today, and possibly in the *ALI Principles* themselves, given the inconsistent signals on the importance of public-law ordering in corporate regulation contained therein.<sup>421</sup> Most of the essays contributed to *Progressive Corporate Law* are written by corporate-law scholars who reject a purely private-law understanding of the corporation.<sup>422</sup> Another recent

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420. See *id.* at 1157 ("Modern large-scale industry has given to the managers of our principal corporations enormous power over the welfare of wage earners and consumers, particularly the former. Power over the lives of others tends to create on the part of those most worthy to exercise it a sense of responsibility."). Dodd's claims were disputed, in part, by Adolph Berle in the same issue of the *Harvard Law Review*, which gave rise to the modern corporate-purpose debate. See Berle, *supra* note 79. Berle did not disagree with Dodd's analysis of the growing power of corporations; in fact, he was more explicit about the fact that, given the degree of financial concentration and coordination exercised by corporations, private corporate enterprises were undertaking essentially quasi-governmental roles of industrial planning and development. See *id.* at 1366. Yet Berle was ultimately concerned with the problem that still vexes corporate thinkers who see the social problems caused by unmitigated shareholder profit-maximizing: Once you abandon the shareholder as the central focus of fiduciary concern, asserted responsibilities to other constituents—employees, consumers, or the community—can often mask management self-interest or entrenchment. See *id.* at 1367-68.

421. Professor Larry Mitchell has argued that during the time the *ALI Principles* were being developed, "the corporate law debate, paralleling similar debates in political and moral philosophy, sociology, and economics, began to revolve around the fundamental issue of whether the social institution that has become the publicly held corporation was the private domain of the stockholders or the subject of broader public concern." Mitchell, *supra* note 14, at 872. Mitchell's thesis is that the drafters of the *ALI Principles* failed "to address and resolve the great unanswered question in corporate law: What is the nature and purpose of the corporation," and whether "the modern corporation is essentially a matter of public or of private concern." *Id.* at 875-76. From that failure, he suggests, derives the ironic fact that the *ALI Principles* fails to satisfy either the "free market" camp of corporate law scholars or the "regulatory" camp. See *id.*

422. See *PROGRESSIVE CORPORATE LAW*, *supra* note 79. *Progressive Corporate Law*, as the name suggests, is a collection of essays that sets out a self-described progressive, and in many cases communitarian, understanding of the corporation. It includes contributions by Professors Douglas Branson, William Bratton, Lynne Dallas, Theresa Gabaldon, Gregory Mark, David Millon, Lawrence Mitchell, Marleen O'Connor, Eric Orts, Joel Seligman, and Lewis Solomon. Communitarian corporate law, as described by David Millon, focuses "on the sociological and moral phenomenon of the corporation as community, in contrast to the individualistic, self-reliant, contractarian stance that



collection of essays on the corporate social relationship, *Corporations and Society: Power and Responsibility*, includes the work of additional scholars who challenge a purely private-law understanding of the corporation.<sup>423</sup> Even some scholars typically not associated with the progressive "camp" of corporate law scholars have developed a much more nuanced understanding of the corporation as involving public responsibilities, or at the least as being a proper subject for public concern and regulation, than the views of the most ardent nexus-of-contracts private-law devotees.<sup>424</sup> While it is too ambitious at this stage of this Article to set out a full justification for a richer concept of the corporation as a public actor, with fully developed public responsibilities, a few points on the subject are in order.

First, the purely private-law vision invariably puts central emphasis on shareholder wealth-maximizing as the important focus of the corporate manager's activities, and often imbues shareholder wealth-maximizing with strong moral overtones.<sup>425</sup> And yet the actions permitted *or required* by shareholder wealth-maximizing are

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dominates current academic discourse in corporate law." David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in PROGRESSIVE CORPORATE LAW, *supra* note 79, at 1, 1. The importance (or uniqueness) of this book is such that it inspired not one, but two, book reviews in the *Cornell Law Review* alone (reaching diametrically different conclusions). Compare Bainbridge, *supra* note 403, at 858 (criticizing communitarian corporate law, finding it an unpersuasive critique of contractarianism), with Deborah A. DeMott, *Trust and Tension Within Corporations*, 81 CORNELL L. REV. 1308, 1310, 1315 (1996) (stating that the introduction of communitarian and international perspectives into corporate law debates has "invigorated discussion and deepened analysis").

423. See CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY (Warren J. Samuels & Arthur S. Miller eds., 1987) (including contributions by Professors Walter Adams and James Brock, Michael Barzelay and Rogers Smith, Martin Benjamin and Daniel Bronstein, John Flynn, Morton Horwitz, Samuel Loescher, David Dale Martin, Arthur Miller, Warren Samuels, Martin Sklar, Aviam Soifer, and William Lovett).

424. See, e.g., Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1971-73 (1991) (proposing a socio-historical account of *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), that stresses a legitimate role for state power to curb the excesses of "market driven, self-seeking, laissez-faire individualism"); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1555 (1989) [hereinafter Gordon, *Mandatory Structure*] (arguing for an important role for mandatory fiduciary duty provisions of state corporate law as against the contractarian claim that since all corporate law is really a species of contract law, the corporation should be presented with few mandatory fiduciary duties under state law, and should be able to contract around laws that primarily set out default positions).

425. See, e.g., Bainbridge, *In Defense*, *supra* note 400, at 1427-28 ("In economic life, as in religious life, no one can serve two masters at the same time. Directors thus cannot be loyal to both shareholders and nonshareholder constituencies. Rather, their role as stewards requires them to prefer the interests of their shareholder masters.").

actions that many people (and perhaps most people) find ethically problematic at best, or simply wrong at worst. So, for instance, cigarette companies are required by wealth-maximizing aggressively to market cigarettes to teenagers to maintain their market, since eighty-two percent of long-term smokers make the decision to start smoking before age eighteen.<sup>426</sup> In fact, "among smokers aged 12-17 years, 70 percent already regret their decision to smoke and 66 percent state that they want to quit."<sup>427</sup> As might be expected, the companies' marketing campaigns use themes of particular relevance to adolescents: establishing independence, rejecting parental authority, and being adult.<sup>428</sup> So, in order to maximize profits, cigarette companies study the particular vulnerabilities of non-adults and use those vulnerabilities in marketing a lethal product, with the result of initiating the process of addiction in thousands of teenagers a week. "If an adolescent's tobacco use continues for a lifetime, there is a fifty-percent chance that the person will die prematurely as a direct result of smoking."<sup>429</sup> Private wealth-maximizing is the reason for this conduct, and in fact *requires* this conduct, but it surely offers an inadequate ethical justification for it.<sup>430</sup>

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426. See Regulations Restricting the Sale and Distribution of Cigarette and Smokeless Tobacco Products to Protect Children and Adolescents, 60 Fed. Reg. 41,314, 41,314 (1995) (reporting findings of fact of the FDA upon issuing regulations to restrict advertising, promotional activities, and sales of cigarettes to minors).

427. *Id.*

428. See *id.* at 41,329 (reporting findings of fact of the FDA). The report states that [o]ne Canadian tobacco company described its "masculine" targeting in these words: "since 1971, [the company's] marketing strategy has been to position [a cigarette brand] as a 'masculine trademark for young males.' It has been our belief that lifestyle imagery conveying a feeling of independence/freedom should be used to trigger the desire for individuality usually felt by maturing young males." Advertising for cigarette brands targeted to women have proven successful in attracting young female smokers.... Some of these campaigns utilized themes thought to be appealing to women (e.g. liberation and feminism, images of slimmness and sophistication). The advertising campaigns preceded a rapid increase in smoking initiation rates among girls under 18....

*Id.* (quoting an Imperial Tobacco Company marketing report).

429. *Id.* at 41,318 (quoting PETO, ET AL., MORTALITY FROM SMOKING IN DEVELOPING COUNTRIES 1950-2000, at A10 (1994)).

430. The moral dilemma is particularly acute if one tends towards either deontological or consent-based moral justifications for human action. Both approaches emphasize the importance of human rationality, broadly construed, and thus the importance of engaging another person's well-informed rationality, their consent, to action. Cigarette companies are encouraging teenagers and children to make these decisions before their rationality is fully developed, and indeed before the teenagers are permitted to offer legal consent, an arguably less onerous standard than that either Kant or Rawls might impose on the concept of consent.

The justification of private wealth-maximizing also *permits* many actions that are ethically or politically problematic. Corporate involvement in the democratic political process in this country is pervasive, from funding candidates to lobbying legislators and regulators to actually writing legislation.<sup>431</sup> This involvement has changed the relationship of the individual to her government, and has arguably undermined Americans' confidence in the institutions of government. And yet this involvement is permitted by wealth-maximizing (and may even be required).<sup>432</sup> Other types of corporate action, from investing in infrastructure with repressive or corrupt foreign governments,<sup>433</sup> to employing people in other countries at prevailing wages under forty cents per hour without basic labor, health, or safety protections required in this country are, again, perfectly permissible using the wealth-maximizing standard.<sup>434</sup>

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431. See DREW, *supra* note 380 (analyzing corporate campaign contributions); NADER & SMITH, *supra* note 380, at 256-319 (analyzing corporate involvement in lobbying and writing legislation).

432. See *supra* note 380 (discussing return on investment from corporate lobbying efforts).

433. A key economic development project in Burma (Myanmar) involves an offshore gas deposit being mined in part by Unocal (28% ownership interest), and in part by the Burmese government, which is a military government. In order to extract this natural resource, a new \$1 billion electricity plant was required, as was a 32-mile on-shore section of pipeline. The U.S. State Department has claimed that these infrastructure projects have relied upon "[c]itizens, including women and children ... forced to labor under harsh working conditions," and human rights groups claim that the projects also forcibly resettled villages during the construction. See U.S. Department of State, *Burma Report on Human Rights Practices for 1996*, (visited Feb. 5, 1998) <<http://www.usis.usemb.se/human/burma.html>>.

434. See, e.g., Rebecca Blumstein & Dianna Solis, *GM's Mexican Houses on Shaky Ground: Workers' Program Leads to Criticism for Low Wage Rate*, WALL ST. J., June 20, 1997, at A15 (describing how a GM program to help its Mexican workers buy a house came under attack by activist shareholders who contend that while GM wages of \$.90 per hour are in line with the local wage structure, they are still too low to provide a decent living, including decent housing, for the majority of GM workers); Raymond Bonner & Christopher Drew, *Cigarette Makers Are Seen as Aiding Rise in Smuggling*, N.Y. TIMES, Aug. 25, 1997, at A1 (reporting that law enforcement officials think tobacco companies are selling billions of dollars of cigarettes to black market dealers who have lucrative businesses in Canada, Italy, and China); Wendy Bounds, *Labor: Critics Confront a CEO Dedicated to Human Rights*, WALL ST. J., Feb. 24, 1997, at B1 (detailing criticism of Phillips-Van Heusen Corp. by international human rights activists for paying wages in Guatemala below poverty levels, hiring contractors that use child labor, and intimidating union organizers); Clare Collins, *A "Family" and Town Battle the Shock of a Plant's Closing*, N.Y. TIMES, Dec. 31, 1989, at CN2 (examining the effect on a neighborhood in Stonington, Connecticut, where a company plant that had been a major employer in the community was finally closed, after two leveraged buy-outs of the company, which was in turn sold by, *inter alia*, Michael Milken and Ivan Boesky); Alix M. Freedman, *Juiced up: How a Tobacco Giant Doctors Snuff Brands to Boost Their 'Kick'*, WALL ST. J., Oct. 26, 1994, at A1 (looking at new assertions by former U.S. Tobacco chemists, who say

In point of fact, while private wealth-maximizing is the explanation for why these actions are taken, it is not a persuasive justification that they should be taken or that they can be called "right." A more public-regarding theory, one that focuses on the underlying ethical quality of corporate action and the effects of that action on other people, or compares the way corporations treat American citizens with the way they treat other countries' citizens, offers a more persuasive ethical lens through which to evaluate corporate action than does private wealth-maximizing. While such a public-regarding theory certainly needs to include the legitimate claims of shareholders, it ought not assume that an ethical analysis of corporate action begins and ends with private shareholder wealth-maximizing.<sup>435</sup>

Second, it is beyond argument that modern, international corporations exercise enormous power in society, including social power, political power, and economic power. Seventy-two percent of all assets of active corporations (worth over \$6165 trillion) are owned

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companies, despite constant denials, have purposely increased the amount of nicotine users absorb); Kelly Green & Rick Brooks, *Winston-Salem Relapses into White-Collar Funk*, WALL ST. J., June 18, 1997, at S2 (spotlighting the troubles of a North Carolina city, which has lost several thousand jobs due to corporate relocation, restructuring, and downsizing); Harry M. Markowitz, *Markets and Morality, or Arbitrators Get No Respect*, WALL ST. J., May 14, 1991, at A22 (reporting an examination by the author, who shared the 1990 Nobel Prize for Economics, of "right and wrong, especially as applied to participants in financial markets"); Betsy Morris & Michael J. McCarthy, *RJR, in Long-Awaited Move, to Dismiss About 12 Percent of Workers at Tobacco Unit*, WALL ST. J., Aug. 11, 1989, at A3 (highlighting some of the first victims of the leveraged buy-out of RJR Nabisco, Inc., by Kohlberg Kravis Roberts & Co.—1640 employees); Peter Schmeisser, *Pushing Cigarettes Overseas*, N.Y. TIMES, July 10, 1988, at F16 (chronicling the moral debate in the United States concerning how, faced with anti-smoking activists and stricter regulations on advertising, cigarette manufacturers are harvesting huge financial gains abroad).

435. This may be a subset of the point that utilitarian theories generally cannot explain the developed moral intuitions of persons steeped in either American constitutionalism (which stresses the rights of the individual) or Kantian or Rawlsian views of the individual. Each of these non-utilitarian theories stresses certain aspects of individual rights that cannot be overcome by social utility, and that cannot be explained by reference to social utility. Judge Posner even recognizes the point that a wealth-maximizing theory cannot explain our commitment to rights, that on a wealth-maximizing justification it would be perfectly permissible to encourage slavery or persecute religious minorities, for instance. See RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 375-82 (1990). Yet he ultimately gives up trying to provide a moral justification for wealth-maximizing as a theory of social organization, simply asserting that it works and that it can be defended on pragmatic grounds. See *id.* at 382. In contrast, I would argue that the fact that many corporate actions that can be justified by reference to wealth-maximizing do not comport with our moral intuitions about how people ought to be treated suggests that the wealth-maximizing framework is wrong or, at best, seriously incomplete.

by 0.1% of corporations (3100 corporations),<sup>436</sup> while the largest 200 corporations account for sixty percent of total U.S. industrial assets.<sup>437</sup> Many of the largest mega-corporations, such as the Exxon Corporation, General Motors, and IBM, have annual revenues far above most individual states within the United States, and their "value product exceeds that of most nations of the world."<sup>438</sup> Large mega-corporations exercise quasi-governmental powers, including economic planning powers (control of the supply of products, of the demand for labor and products, and of the provision of capital, for instance) and influence over government policy making.<sup>439</sup> It is a truism that the exercise of power entails responsibility, and yet the private-law vision of the corporation ignores this power and decries any claims of corporate social responsibility: "A corporation is incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having these obligations."<sup>440</sup>

Third, corporate power is exercised with increasing freedom from state control, as both labor and capital become more global and mobile (and thus corporations are able to engage in "regulatory arbitrage" with respect to financial regulations, and "regulatory avoidance" with respect to safety, health, environmental, and labor regulations in the United States).<sup>441</sup> Moreover, corporations have always operated free of the constitutional controls that constrain the state—the other powerful collective entity in modern society.<sup>442</sup>

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436. See O'KELLEY & THOMPSON, *supra* note 149, at 58 (citing STATISTICAL ABSTRACT OF THE UNITED STATES 523 (1985)). The most recent statistics place 83% of all assets of active corporations (worth over \$19 trillion) in the possession of 0.2% of corporations (7043 corporations). See INTERNAL REVENUE SERV., 1994 STATISTICS OF INCOME, CORPORATION INCOME TAX RETURNS 39-40 (1997).

437. See Walter Adams & James W. Brock, *Bigness and Social Efficiency: A Case Study of the U.S. Auto Industry*, in CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY, *supra* note 423, at 219, 219.

438. *Id.*

439. See JOHN KENNETH GALBRAITH, *THE NEW INDUSTRIAL STATE* 74, 76 (2d ed. 1971).

440. Fischel, *supra* note 45, at 1273.

441. See WILLIAM GREIDER, *ONE WORLD, READY OR NOT* 33 (1997). This is merely an acceleration of a trend observable since the late 1800s of loosening state control over the corporation, begun with the collapse of the grant or concession theory of the corporation, under which individual states granted corporations power for limited purposes and limited durations "to aid the provision of public services." See Gordon, *Mandatory Structure*, *supra* note 424, at 1551.

442. See Arthur S. Miller, *Corporations and Our Two Constitutions*, in CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY, *supra* note 423, at 241, 242. While contractarians target government power for fear and loathing, decrying "the nanny state" and "faceless bureaucrats," they have, on the whole, remained remarkably sanguine about corporate power, notwithstanding the greater constraints on the former

Again, it is a truism that freedom entails responsibility, but again, the private-law vision emphasizes corporate freedom without a concomitant recognition of responsibility.

Indeed, the only public-regarding constraints on the otherwise untrammelled freedom of corporations are, precisely, the laws and regulations that the law-as-price theory would serve to undermine. So, ultimately, the problem with the law-as-price view of *law* is the same problem inherent in the law-as-price view of the *corporation* and its social obligations: neither view contains a properly developed understanding of the importance of the concept of public power, public obligation, or public responsibility.

## VII. CONCLUSION

The law-as-price theory is grossly reductionist, distilling all that is important about law and political obligation into economic terms, evaporating the moral component of law and leaving a thin distillate that does not suffice to nurture social and political relationships. Law, in a democracy, is more than a price tag. It is a command in which we participate, a limit on unacceptable behavior, and an architecture for social, political, and economic interaction. As such, law implies obligation, even when the "price" of violations is affordable.

The law-as-price jurisprudential construct posit that citizens, including corporate citizens, have a choice when confronted with law, particularly civil, regulatory law: to obey the law or deliberately to disobey it and risk paying penalties. Either choice is thought an acceptable vindication of a citizen's political obligations. The Court in *Landgraf*, while not endorsing this view explicitly, articulated a rationale that implicitly rests upon a similar, penalty-driven view of law.<sup>443</sup> In a democracy, citizens have, in fact, a quite different choice: to make serious efforts to obey the law, even when penalties are low, or to work to change the law.<sup>444</sup> It would have greatly behooved our highest court to have adopted that theory of political obligation as well, instead of endorsing even a weak version of the view that suggests what really matters about law, ultimately, is the price.

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than the latter. See Bainbridge, *supra* note 403, at 893.

443. See *supra* notes 378-380 and accompanying text.

444. Civil disobedience can be understood as being within the category of "working to change the law." See *supra* notes 287-93 and accompanying text.

