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Agency and the Ontology of the Corporation

Christopher M. Bruner*

The degree to which corporate entities ought to be treated like natural entities—i.e., real people—has confounded legal theorists since the emergence of the corporate form. As Sir Edward Coke memorably put it in his 1614 report on *The Case of Sutton's Hospital*, “a corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law.”¹ Put differently, the corporation is a legal fiction—and an elusive one at that, synonymous with, yet distinct from, its various constituents. Though “but one person in law,” as Sir William Blackstone would explain in 1765, it is “a person that never dies: in like manner as the river Thames is still the same river, though the parts which compose it are changing every instant.”²

Modern business corporations remain as ontologically complex as they are commercially ubiquitous.³ To be sure, we routinely take for granted that corporations can themselves undertake many of the commercial activities that people do. Corporations can sue and be sued; buy, hold, and sell property; enter contracts; borrow and lend money, and so on.⁴ They can also hire agents to act on their behalf⁵—a critical capacity because, as Coke and Blackstone well understood centuries ago, a fictional entity cannot act on its own. Indeed, numerous aspects

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1. EDWARD COKE, 5 THE REPORTS OF SIR EDWARD COKE, KNT. IN THIRTEEN PARTS pt. X, at *32b (Lawbook Exchange 2000) (1826).

2. WILLIAM BLACKSTONE, 1 COMMENTARIES *456 (Cavendish Publishing 2001) (1765).

3. For further discussion see Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1387–95 (2008).

4. *E.g.*, DEL. CODE ANN. tit. 8, §§ 122(2), (4), (13)–(14) (2011).

5. *Id.* § 122(5).

of corporate life continue to defy straightforward analogy to our own lives. Particularly vexing problems have arisen where corporate law intersects with other complex areas of law and policy. Prominent and controversial examples in recent years have included corporate political speech,⁶ corporate criminal liability,⁷ and as Christine Shepard's superb Note explores, the corporate entity's posture vis-à-vis fraud committed by certain of its agents, yet undetected by others—specifically, officers cooking the books and auditors negligently failing to uncover it.⁸ In this unhappy circumstance, should we treat the corporate entity itself—and, therefore, innocent constituencies including public shareholders who want to sue on its behalf—as a *wrongdoer* by association with the officers, or as a *victim* of auditor negligence?

Determining how we ought to conceptualize the corporation, as such, in cases of corporate fraud raises some exceptionally thorny doctrinal problems. Whose acts count as “corporate” acts, and when? How do the policy aims of agency law relate to those of corporate law and other relevant fields? How do we optimally calibrate the incentives of those who, in one way or another, act on the corporation's behalf—including officers, directors, and outside professionals such as auditors?

Shepard's Note presents a clear, thorough, and persuasive critique of a muddled case law.⁹ She argues compellingly that courts have widely erred, both in law and in policy, in permitting auditors to defend malpractice actions by too readily characterizing the corporation itself as a wrongdoer—the so-called “*in pari delicto*” defense. This defense denies a remedy to a plaintiff deemed equally at fault, an outcome courts have reached by imputing the officer-fraudster's knowledge to the corporation

6. *E.g.*, *Citizens United v. Fed. Election Comm'n*, 130 S.Ct. 876, 886 (2010) (holding that the government may not suppress corporate political speech).

7. *E.g.*, Erik Luna, *The Curious Case of Corporate Criminality*, 46 AM. CRIM. L. REV. 1507 (2009) (exploring “the past, present, and future of corporate criminal law”).

8. Christine M. Shepard, *Corporate Wrongdoing and the In Pari Delicto Defense in Auditor Malpractice Cases: A New Approach*, 69 WASH. & LEE L. REV. 275 (2011). As Shepard clarifies, an auditor's duty is not to expose fraud, but to perform in accordance with established professional standards. *Id.* at 277 n.1.

9. *See id.* pt. II.C.

under agency law.¹⁰ In this comment I briefly review Shepard's analysis, highlighting the important contribution made to the relevant legal and policy debates, and discuss further avenues that might be explored in operationalizing the novel and sensible solution that she proposes.

Shepard's discussion of the current state of the law¹¹ emphasizes that the *in pari delicto* defense, on the one hand, and imputation under agency law, on the other, arose in different settings to further different policy aims. Effectively, *in pari delicto* is to law what the doctrine of unclean hands is to equity, favoring the defendant in a case of equal fault. Being historically rooted in equity, there is an inevitable imprecision about the *in pari delicto* defense, reflected most obviously in the "public policy" safety valve giving courts the ability to deny the defense where permitting it would contradict its purpose. As Shepard notes, this should preclude the defense where required to "prevent a wrongdoer from profiting from his own misconduct."¹² The agency doctrine of imputation, on the other hand, deems principals to know facts known to their agents in order to allocate most efficiently the risks associated with agent misconduct—the idea being that principals are typically better positioned to police their own agents than are third parties in the marketplace with whom those agents transact on their principals' behalf.¹³ To be sure, imputation itself is subject to exceptions, most notably the "adverse interest" exception, but this applies only where the agent intends to act "solely" for the benefit of someone other than the principal.¹⁴ Indeed, this narrow exception to imputation is itself subject to an exception (the result being imputation) "when necessary to protect the rights of a third party" dealing in good faith.¹⁵ In this sense, the doctrine of imputation similarly

10. *E.g.*, *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, 456 (7th Cir. 1982) (holding that the allegedly negligent auditors could invoke imputation as a defense when corporate management committed fraud on behalf of the corporation).

11. *See* Shepard, *supra* note 8, pt. II.

12. *Id.* at 293.

13. *Id.* at 280–81.

14. RESTATEMENT (THIRD) OF AGENCY § 5.04 (2006).

15. *Id.* § 5.04(a).

requires a delicate balancing of the equities.¹⁶ Critically, however, as Shepard rightly observes, the aims of *in pari delicto* and imputation are entirely unrelated—doubly so, in fact. The *in pari delicto* defense applies where the plaintiff is an equal wrongdoer, whereas imputation is not fault-based; the agency analysis simply does not turn on whether the principal is a “wrongdoer,” as such. Moreover, imputation was developed to deny a principal-defendant a defense, not to deny a principal-plaintiff a claim.¹⁷ Put differently, imputation was built to deny a shield, not to deny a sword.

As Shepard’s careful analysis of the case law reveals, courts have been all over the map in auditor malpractice cases brought on behalf of corporations at which fraud occurred, some permitting the *in pari delicto* defense to be raised more liberally, while others have been more restrictive—the difference turning most conspicuously on the scope of the adverse interest exception to imputation. The inconsistency in the case law, Shepard argues, has arisen because courts have, by and large, focused on the wrong question. The ultimate touchstone for the *in pari delicto* analysis should be whether the corporation was a “wrongdoer” in some pertinent respect—an issue to which the agency doctrine of imputation may be relevant but is not determinative.¹⁸

Shepard’s analysis of the case law and her clarification of the appropriate standard are substantial contributions in themselves. She continues, however, building upon this foundation by offering a pragmatic and reasonable proposal that follows quite logically from her account of the nature of these disputes. Determining the appropriate liability exposure for auditors negligently failing to detect corporate fraud must turn, to some degree, on the boundaries of the corporation itself—specifically, whose acts count as “corporate” acts in the relevant sense. To be sure, there is some recognition of the core ontological problem in the cases but little consistency in addressing it. On one view, the officer-fraudster’s acts and knowledge are straightforwardly the corporation’s acts and knowledge, rendering the *in pari delicto*

16. See Shepard, *supra* note 8, at 281–83, 286.

17. *Id.* at 324–27.

18. *Id.* at 316–18, 324–27.

defense readily available to auditors.¹⁹ On another view, however, the auditors themselves ought to be treated as “insiders”—agents, like officers, who are effectively internal to the corporate enterprise when it comes to ensuring the integrity of financial statements, and therefore should not benefit from the *in pari delicto* defense via imputation.²⁰

Perceiving that the problem, in essence, amounts to determining what acts—and more specifically, what wrongdoing—ought to be treated as “corporate” wrongdoing, Shepard proposes a solution that is both doctrinally consistent with approaches taken in other corporate disputes, and mindful of broader policy concerns regarding the scope of auditor liability. Observing that corporate law has already explored the relationship between the fiduciary duties of the board—the entity responsible for management of the corporation²¹—and the detection and prevention of fraud and other illegal conduct, she proposes that we use that preexisting framework as a means of conceptualizing “corporate” wrongdoing in auditor malpractice cases. Specifically, the monitoring and reporting systems that fiduciary duties already effectively require the board to adopt²² “may,” she suggests, “provide the best yardstick by which to measure a corporation’s acts.”²³ Her response to the underlying ontological problem is elegant and suitably tailored to the context at issue—whatever the corporation may “be” (in some metaphysical sense) vis-à-vis its agents, we can coherently judge whether the corporation itself should be treated as a wrongdoer by reference to the quality of its institutionalized efforts to prevent and detect wrongdoing by those who work for it.

While no corporate monitoring system can be perfect, Shepard’s approach would strongly reinforce preexisting incentives to devise an effective monitoring and reporting system—because doing so would help preserve the corporation’s

19. *Id.* at 321.

20. *Id.* at 310–13.

21. *E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2011).

22. *E.g.*, *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

23. Shepard, *supra* note 8, at 328.

ability to sue auditors for malpractice. She acknowledges that there is widespread debate regarding the appropriate level of liability exposure for “gatekeeper” professionals such as auditors—and reason to fear that excessive liability might deter them from offering needed services—but rightly notes that there are plenty of other levers to pull in seeking to achieve the optimal level of liability exposure.²⁴

Shepard’s proposed solution is a compelling one, and there is reason to believe that such an approach could bring clarity, consistency, and predictability to an incoherent case law. Her proposal effectively amounts to a general conceptual framework, however, leaving to future work the precise means of implementing it. This is fair enough—particularly given the considerable terrain covered, and contribution made, in her doctrinal and policy analyses. Accordingly, the thoughts expressed in the remainder of this comment should be interpreted not as implicit criticism but as taking up the conversation that Shepard initiates toward implementation of a worthy proposal.

As noted above, Shepard’s proposed approach to measuring corporate wrongdoing in auditor malpractice cases draws upon the fiduciary duty-based approach to the board’s monitoring obligations set forth in landmark Delaware cases including *Caremark*²⁵ and *Stone v. Ritter*,²⁶ which require good-faith effort to implement adequate monitoring and reporting systems.²⁷ As she observes, however, “Delaware courts have set a high hurdle for plaintiffs seeking to recover from individual directors.”²⁸ As set forth in *Caremark*, “only a sustained or systematic failure of the board to exercise oversight—such as *an utter failure to attempt* to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”²⁹ Given the policy aims legitimating the *in*

24. *Id.* at 320–24, 332, 335–37.

25. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

26. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

27. *See supra* note 22 and accompanying text.

28. Shepard, *supra* note 8, at 329.

29. *Caremark*, 698 A.2d at 971 (emphasis added); *see also Ritter*, 911 A.2d

pari delicto defense—which Shepard does not dispute—and valid concerns regarding excessive auditor liability, “evidence of more than the mere existence of systems may be desirable” to permit corporations at which fraud went undetected to proceed with malpractice suits against their auditors.³⁰ She adds that measuring fault in the manner proposed “would require a fact-intensive inquiry,”³¹ but does not explore how this inquiry might work—a nontrivial matter, given that one could readily imagine an excessively open-ended inquiry leading directly back to simplistic reliance on imputation and the inconsistency across jurisdictions that she rightly criticizes.

In building a doctrinal structure on the framework that Shepard proposes, the considerations that factored into the *Caremark* approach would provide a worthy starting point. *Caremark* was itself inspired by an approach taken to assessing corporate wrongdoing in another thorny area noted at the outset—corporate criminal liability. Then-Chancellor Allen, writing in 1996, noted “the potential impact of the federal organizational sentencing guidelines on any business organization,” concluding that “[a]ny rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers.”³² The strength of the incentives created by the Organizational Sentencing Guidelines,³³ coupled with their prominence in the marketplace, rendered it unthinkable to Allen that a fiduciary making a good-faith effort to discharge her obligations could ignore them. Promulgated in 1991, the Guidelines ultimately became a powerful driver in corporate compliance program design, further reflecting both market familiarity and their practical significance.³⁴

at 369.

30. Shepard, *supra* note 8, at 329.

31. *Id.* at 333.

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

33. See U.S. SENTENCING GUIDELINES MANUAL ch. 8 (2011).

34. Lynn Sharp Paine & Christopher M. Bruner, *Legal Compliance Programs* 1–2 (Harv. Bus. Sch. Pub., note 9-306-014, 2005) (on file with the Washington and Lee Law Review).

The Guidelines' core standard—whether the company has “an *effective* compliance and ethics program”³⁵—might be taken as a starting point for developing a standard useful in the *in pari delicto*/imputation context, and the factors identified in the Guidelines could in turn provide the starting point for a multi-factor test reducing the indeterminacy of an unavoidably fact-intensive inquiry. Factors identified in the Guidelines, for example, include establishing “standards and procedures to prevent and detect criminal conduct”; a “knowledgeable” board that exercises “reasonable oversight” regarding the program; designated “high-level personnel” exercising “overall responsibility” for the program, while delegating “day-to-day operational responsibility” to specific lower-level individuals; “reasonable efforts” to prevent those who have engaged in illegal or unethical conduct from having “substantial authority” to act for the corporation; providing “effective training programs”; monitoring, auditing, and evaluating the program, including a reporting system available to employees and agents; incentives and disciplinary procedures to promote enforcement; and appropriate responses to criminal conduct once detected.³⁶

The potential utility of such an approach is hardly diminished by the fact that *Caremark* itself substantially insulates directors from associated liability under corporate law for failing to implement such a system. The high hurdle that *Caremark* set before plaintiffs was driven by fear that excessive liability might render outside directorships unappealing—effectively the concern motivating the business judgment rule.³⁷ While the prospect of substantial auditor liability could raise similar concerns, Shepard rightly observes that there are plenty

35. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a) (2011) (emphasis added).

36. *Id.* § 8B2.1(b)–(c). For additional background on design and implementation issues, see Paine & Bruner, *supra* note 34, at 2–4.

37. *Caremark*, 698 A.2d at 971 (“[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely”); see also Christopher M. Bruner, *Good Faith, State of Mind, and the Outer Boundaries of Director Liability in Corporate Law*, 41 WAKE FOREST L. REV. 1131, 1157–59 (2006) (discussing director liability under the *Caremark* decision).

of ways to mitigate this risk, including caps, indemnification, and proportionate liability.³⁸ Accordingly, the system's effectiveness could remain an appropriate benchmark, more meaningfully illuminating the degree of corporate wrongdoing than would mere good-faith effort to implement any old system.

To be sure, other standards measured by different factors might do the job even better. The modest purpose of this discussion is simply to reinforce what Shepard's excellent Note already amply demonstrates—that a practically and conceptually superior approach to the *in pari delicto* defense in auditor malpractice cases is eminently achievable. Shepard supplies the framework for such an approach, and courts would do well to take up the challenge.

38. Shepard, *supra* note 8, at 324, 336–37. Efforts to calibrate auditors' liability exposure in the securities litigation context provide a menu of options. See, e.g., 15 U.S.C. § 78u-4 (2006) (imposing constraints on private securities litigation and associated liability, including a proportionate liability regime).