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# Director Liability for Corporate Crimes: Lawyers as Safe Haven?

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## I. INTRODUCTION

The 2008–2009 financial and economic collapse and the earlier pre-Sarbanes-Oxley[1] round of debacles have prompted calls for more corporate regulation and compliance enforcement. This trend is almost certain to mean more fines and penalties imposed on corporations. Although the Justice Department carefully compiles data on crimes like muggings and sexual offenses, there seems to be no comparable data on corporate transgressions. We do not have exact aggregate figures on how much corporations are paying in fines and penalties for various financial violations, reporting violations, environmental violations, OSHA violations, discrimination violations, food and drug safety violations, airline maintenance violations, and all the many other regulatory violations that corporations commit. Even without exact figures, however, it is apparent that billions of dollars in fines and penalties are assessed against corporations every year, and the numbers have been growing.[2]

For the most part, the directors and senior management of corporations do not personally suffer the burden of these fines and penalties. They are assessed against the corporation and are, therefore, borne by the stockholders. However, directors and officers can, of course, sometimes be held accountable to the corporation when their breaches of duty lead to corporate losses. This accountability is typically enforced in derivative actions, and the attorneys' fees that such actions can yield are an ongoing incentive to bring them. With billions in corporate fines and penalties being assessed annually, the potential returns to derivative suits will be an increasingly tempting pot for derivative attorneys to aim for.

This article considers the legal bases for shifting corporate law enforcement losses back to the board of directors and precautionary measures that the directors can take to head off such liabilities. It considers first, in Part II, the intrinsic incentives within corporate management structures that lead employees to risk legal and regulatory penalties in the first place. Then, after distinguishing the directors' active and passive roles in corporate noncompliance in Part III, the article takes up each of these roles in turn, in Parts IV and V, and examines the implications for director liability. With respect to both active and passive involvement, we see how the use of lawyers in compliance monitoring can provide directors with a safe haven.

## II. INTRINSIC INCENTIVES

The pressures on corporate managers and employees to stint on legal and regulatory compliance are virtually intrinsic to the structure of complex enterprises. The conduct that laws prohibit is, almost by definition, conduct that "externalizes" costs, i.e., that shifts off the costs of doing business onto other people. Whenever a firm can pursue a productive activity without bearing the full cost of that activity,

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of Titles 11, 15, 18, 28, and 29 of the U.S. Code).

2. *See* George Draffan, *Multimillion Dollar Fines & Settlements Paid by Corporations*, http://www.endgame.org/corpfines1.html (last visited Sept. 8, 2010) (alphabetical listing over the past ten years or so).

the firm gains a greater net profit than if all the costs were internalized. This is a simple economic truth. Couple this truth with the constant top-down pressure on corporate divisions, branches, units, teams, and individual employees to "perform," and you have a systematic structure of incentives to externalize corporate costs. And what better way to externalize costs than to cut corners on "burdensome" regulations or laws?

To some extent, these pressures may be mitigated by periodic corporate seminars on the importance of legal compliance. But in the end, it is not a stellar record of compliance and "business ethics" that is valued in annual employee reviews. The rewards go to those who enhance the bottom line. Every supervisory employee knows the importance of having his or her division or unit perform up to expectations, as well as the consequences of comparative underperformance. In short, the most basic presuppositions of a business for profit generate endless incentives for line employees to under-comply with laws and regulations whenever the expected benefits exceed the risk-discounted penalties. And when they get caught, as they sometimes do, the company pays the price.

Some commentators go so far as to argue that, in the name of efficiency, the law should condone its own violation by corporate personnel.[3] After all, it is argued, violating the law can be profitable and therefore "rational"; it should accordingly be a permissible choice under the business judgment rule.[4] This idea seems similar to (and is no doubt borrowed from) the theory of efficient breach in the law of contracts.[5] According to efficient breach theory, when the cost of performing a contract is greater than the damages for breach, the promisor ought to default and pay the judgment. To perform the contract in such a case would be inefficient and, therefore, a waste of resources.

Extending the rationale of efficient breach theory to legal and regulatory contexts, the corresponding idea would be a kind of "theory of efficient crime." Under this theory, whenever the benefit to the corporation from legal or regulatory violations would exceed the applicable fines and penalties (presumably discounted to reflect the risk of getting caught), then the corporation should commit the violations. Forsaking

3. Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 Mich. L. Rev. 1155, 1168 n.36 (1982) ("Managers have no general obligation to avoid violating regulatory laws, when violations are profitable to the firm . . . ."); *see also, e.g.*, Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 592–93 (2009). Even if the corporation itself ought to be subject to criminal penalties, the claim seems to be that corporate management should not have fiduciary liability to the corporation for risking the penalties so long as doing so yields a net profit. "Individuals routinely make cost-benefit analyses before deciding to comply . . . . Is it self-evident that the directors of a corporation should be barred from engaging in similar cost-benefit analyses?" *Id.*; *see also* Thomas A. Uebler, *Shareholder Police Power: Shareholders' Ability to Hold Directors Accountable for Intentional Violations of Law*, 33 Del. J. Corp. L. 199, 216–19 (2008). *See generally* Cynthia A. Williams, *Corporate Compliance with the Law in the Era of Efficiency*, 76 N.C. L. Rev. 1265 (1998) (a comprehensive critique of the view that "efficiency" justifies lawbreaking).

4. Uebler, *supra* note 3, at 208–09. *Cf.* Bainbridge et al., *supra* note 3, at 592–94.

5. *See* John D. Calamari & Joseph M. Perillo, Cases and Problems on Contracts 596–98 (4th ed. 2004).

the benefits of breaking the law would be inefficient and a waste. So if a board makes a rational choice to take the corporation beyond the limits of the law, that choice (it is argued) should be protected by the business judgment rule.[6]

It is dubious, however, whether the contract theory of efficient breach can be logically extended to violations of laws or regulations. It is even more dubious whether the courts will ever allow it. For one thing, it is hard to imagine that the law will adopt a deliberate policy to encourage its own violation. That is simply not, institutionally, what the courts exist to do.

Another problem with a doctrine of efficient crime is that its "efficiency" gains are misleading. Suggestions that corporate choices to break the law can be "rational" seem to take into account only the costs and benefits *inside* the firm.[7] That is to say, they ignore externalities. But when corporate legal violations shift costs out to others, the external costs of breaking the law must also weigh in the equation. And when they do, chances are that the supposed "efficiency" will vanish.[8] At any rate, it is precisely the aim of criminal and regulatory restrictions to prevent firms from externalizing the costs and risks of their business activities. This is a policy that applies, moreover, whether the particular restriction is *malum in se* or *malum prohibitum*. Whichever kind of *malum* it may be, any attempt to boost profits by foisting costs on others is essentially the same as stealing.

The corporate benefits of breaking the law can roll in quickly, but the fines and penalties come later, when the firm is finally caught. This asynchronicity of benefits and costs may too work as an intrinsic incentive for directors and senior officers to risk legal and regulatory non-compliance. Meanwhile, however, the directors and senior officers have, in pursuit of their own near-term career and compensation goals, put stockholder wealth at risk, subjecting it to fines and penalties. That too is a form of cost externalization and thus a kind of stealing. However, from the language (if not the holdings) in cases like *Caremark*,[9] *Disney*,[10] and *Stone*,[11] we are not without legal theories for shifting the cost of corporate fines and penalties onto the directors whose acts or omissions facilitated them.[12]

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6. Uebler, *supra* note 3, at 208–09. *Cf.* Bainbridge et al., *supra* note 3, at 592–94.

7. *See, e.g.*, Bainbridge et al., *supra* note 3, at 592–93; Uebler, *supra* note 3, at 201, 216–20.

8. *See, e.g.*, Finley v. Teeter Stone, Inc., 248 A.2d 106 (Md. 1968) (allowing a corporation to get away with externalizing ruinous operations costs on a neighboring owner).

9. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996). This paper focuses on the corporation law of Delaware, as did the conference for which it was originally prepared.

10. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

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

12. Some have advocated for the so-called "New York Net Loss" rule, under which the damages owed by directors to reimburse corporate fines and penalties would be reduced to the extent that the illegal corporate activity increased the company's profits. *See, e.g.*, Bainbridge et al., *supra* note 3, at 592–93; Uebler, *supra* note 3, at 216–20. The appropriateness and viability of such a "net loss" rule are, however, questionable. First of all, the idea of allowing the fruits of crime to offset director liability would violate the spirit, if not the letter, of the principle that one may not claim one's own crime as a defense. Letting defendants invoke their own wrongdoing to reduce their liabilities would be at war with the law's general

In discussions of derivative suit liability, the role of the corporation's lawyers is often overlooked. For a couple of reasons, this oversight is odd. One reason is that the corporation's lawyers are almost always intimately involved in the planning, approval, and execution of any corporate activities that have serious legal implications. The corporation's lawyers have a prominent (indeed, statutory) role in protecting the directors and senior management from liability.[13] Another reason it is odd is that, as lawyers representing the corporation, they too are fiduciaries and, as such, may be subject to potential monetary liabilities.[14] True, in cases of corporate regulatory offenses, neither disciplinary action nor damage awards have so far (to my knowledge) been visited on corporate lawyers, but the potential is certainly there.[15] There seems to be no reason why, in a derivative suit to reimburse fines and penalties, the corporation's lawyers could not be added as defendants. The active role of the corporation's lawyers cannot be ignored.

## III. ACTIVE VS. PASSIVE DIRECTOR INVOLVEMENT IN CORPORATE WRONGDOING

There are two general categories of director conduct that can lead to corporate fines and penalties: the directors may either actively authorize or deliberately ignore the unlawful behavior, or they may be simply unaware of it. While active involvement presents the strongest case for director liability to reimburse fines and penalties,[16] it is probably the less likely to occur. The case for such liability would ordinarily require, as we shall see, showing an "intent to violate applicable positive law," or an intentional failure to act "in the face of a known duty to act, demonstrating a conscious disregard for his duties."[17] As long as the corporate legal counsel is paying attention, it is hard to imagine why an independent board of directors would ever, as such, knowingly risk authorizing or deliberately ignoring illegal behavior by corporate personnel.

policy against crime. In any case, the mechanics of any such offset would be highly impractical. Even assuming that corporations keep accurate records of their employees' criminal conduct and the associated revenues, the manipulable guesstimates of cost accounting provide only a weak basis for matching fines and penalties to profits. Take, for instance, the classic hypo of the double-parking package delivery firm. *See id.* In computing directors' liabilities, should a parking fine be offset only against the revenue from the particular delivery that produced it, should all fines in a given city or region be lumped together as an offset against all delivery revenues, or should the fines incurred by the company be treated as a single overhead item of the business as a whole? Compounding the accounting issues is the legal problem of proving causation and necessity. Within the financial results of a complex enterprise, it may be virtually impossible to say when any particular criminal act is the but-for cause of any particular bit of revenue. Although we can pinpoint with near certainty the fines and penalties that given crimes produce, it is much more speculative to say that the fruits of a given crime could not have been produced anyway (at least in part), without resort to illegal means.

13. *See* Del. Code Ann. tit. 8, § 141(e) (2001).

14. Restatement (Third) of the Law Governing Lawyers §§ 49, 16 cmt. b (2000).

15. For a somewhat analogous circumstance, recognizing the possibility of lawyer liability, see *Durkin v. Shea & Gould*, 92 F.3d 1510 (9th Cir. 1996).

16. *See infra* text accompanying notes 20–51.

17. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755–56 (Del. Ch. 2005) (citations omitted).

However, the fact that the directors may have remained merely passive in illegal corporate conduct does not necessarily guarantee exoneration. Despite the outside directors' distance from day-to-day operations, the board nonetheless has a duty to exercise oversight.[18] And while no system of oversight can be perfect, a breakdown in the oversight process nonetheless can supply a potential basis for director liability if proper precautions have not been taken.[19]

In Part IV, which immediately follows, we will consider the bases for imposing liability on directors who are actively involved in corporate illegality or non-compliance. After that, in Part V, we turn to a consideration of possible director liability based on a failure of oversight. With respect to both, we will see how the use of lawyers can provide safe haven.

## IV. ACTIVE INVOLVEMENT

### *A. The Fiduciary Duties of Care and Loyalty: Initial Considerations*

The purpose of a derivative suit is to enforce an obligation to the corporation.[20] As reconfirmed in the recent cases of *Stone v. Ritter*[21] and *Lyondell Chemical Co. v. Ryan*,[22] the fiduciary obligations that the directors owe to Delaware corporations fall broadly into two traditional categories: the duty of care and the duty of loyalty.

Of these two traditional categories, the duty of care is, in general, a most unlikely basis for derivative suit liability. One reason is the so-called "business judgment rule," under which courts leave the task of governing corporations to the duly constituted management, and generally decline to second-guess the decisions that management makes on the corporation's behalf.[23] The presumption is that, ordinarily, the board of directors is better situated than the courts to decide what actions are in the corporation's best interests.

The other reason that the duty of care is an unlikely basis for director liability is title 8, section 102(b)(7) of the Delaware Code.[24] This section authorizes provisions in the certificate of incorporation "eliminating or limiting . . . personal liability of . . .

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

19. *See infra* text accompanying notes 65–87.

20. *See generally* Harry G. Henn & John R. Alexander, Corporations 1035–40 (3d ed. 1983) (introducing derivative actions).

21. 911 A.2d 362 (Del. 2006).

22. 970 A.2d 235 (Del. 2009).

23. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.").

24. Del. Code Ann. tit. 8, § 102(b)(7) (2001). The discussion in this paper particularly pertains to Delaware corporations.

director[s] . . . for breach of fiduciary duty as a director."[25] For any Delaware corporation that has such a provision in its certificate of incorporation, the directors cannot be held liable for an ordinary breach of the duty of care.[26] So when fines or penalties are incurred due merely to the directors' failure to use the requisite care, the directors cannot be held personally accountable.

The Delaware legislature enacted section 102(b)(7) shortly after the decision in *Smith v. Van Gorkom*.[27] In *Van Gorkom*, the Delaware Supreme Court had directed a judgment requiring the defendant directors to indemnify stockholders for damages sustained due to the directors' breach of their duty of care.[28] This holding meant that directors, though they may have only a modest personal stake in the corporation's financial successes, could be saddled with disastrous liabilities if, due to some failure of oversight, the corporation or its stockholders sustained a major loss. Obviously, such a potential for personal ruin could deter honest, risk-averse individuals from serving on corporate boards.

The apparent motivation for section 102(b)(7) was to remove this duty-of-care liability so it would not be an impediment to attracting independent directors to corporate boards.[29] Historically, the fiduciary obligations of corporate directors gave rise to two kinds of money remedies: *disgorgement* of improper gains obtained at the corporation's expense, primarily for breaches of the "classic" duty of loyalty,[30] and *indemnity* for corporate losses, which has been primarily associated with the fiduciary duty of care.[31] Section 102(b)(7) was structured to let corporations take *indemnity* liability off the table while still leaving disloyal directors subject to disgorgement. The difference makes sound policy sense: it is one thing to make defrauders and self-dealers give back their ill-gotten gains; it is something else again to force people who make good-faith mistakes in judgment to dig into their own personal assets to indemnify others whom they were only trying to serve. Even though the use of a "gross negligence" standard in duty-of-care cases may offer *some* protection for honest directors,[32] truly prudent candidates may still be deterred from accepting directorships if it means exposing their personal and family financial futures to the vagaries of jury trials. The adoption of section 102(b)(7) helped meet this concern by allowing corporations to limit director liability to disgorgement.

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25. *Id.*

26. *Stone*, 911 A.2d at 367. Section 102(b)(7) does not apply to breaches of the duty of loyalty. *See infra* text accompanying notes 34–36.

27. 488 A.2d 858 (Del. 1985).

28. *Id.* at 864.

29. Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law* 41–42 (Harvard Law & Econs. Discussion Paper No. 630, 2009), *available at* http://ssrn.com/abstract=1349971.

30. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006) (describing "classic" disloyalty as "preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation").

31. That is, "director liability is predicated upon concepts of gross negligence." Aronson v. Lewis, 473 A.2d 805, 812–13 (Del. 1984).

32. *Disney*, 906 A.2d at 52–53 (quoting *Aronson*, 473 A.2d at 812–13).

The statutory text of section 102(b)(7) lists a number of non-exculpable exceptions for which director liability cannot be eliminated or limited,[33] the first being "breach of . . . the director's duty of loyalty" and "acts or omissions not in good faith."[34] However, since the section's enactment, the courts have further diluted its ability to protect directors by pouring significant new legal meanings into the words "loyalty" and "good faith," meanings that the words did not necessarily have at the time the statute was written.[35] Whatever the merits of this judicial re-expansion of the potential for director liability, it has almost certainly made it easier to maintain derivative suits against directors for reimbursement of fines and penalties assessed in law enforcement—an indemnity (as opposed to disgorgement) liability.

The non-exculpation situations that are most promising in suits to recover such reimbursement are:

1. Breach of the duty of loyalty;

2. Acts or omissions not in good faith;

3. Acts or omissions which involve intentional misconduct;

4. (Acts or omissions which involve) a knowing violation of law.[36]

The challenge for derivative plaintiffs is to characterize the directors' conduct as falling into one of these listed situations, and outside the scope of the business judgment rule. By asserting that the directors' conduct is a breach of the duty of loyalty due to "bad faith," the derivative plaintiff does both.

### *B. The Duty of Loyalty and Bad Faith*

When a board of directors is actively involved in law or regulatory violations, it should not be hard for a derivative plaintiff to find a basis for director liability in the duty of loyalty. It should also be easy to fit the case under one or more of the other non-exculpable categories listed in section 102(b)(7).[37]

With respect to the duty of loyalty, the Court of Chancery has recently said that, "by consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced to answer for the harm he has caused."[38] Even

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33. Del. Code Ann. tit. 8, § 102(b)(7) (2001).

34. *Id.*

35. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 367–70; *Disney*, 906 A.2d at 66–67.

36. § 102(b)(7). Notice that the first part of the fourth item is in parentheses because the actual wording of the statute leaves it unclear whether these words apply to this item or not, as will be explained further *infra* notes 47–51 and accompanying text.

37. *See supra* text accompanying note 36.

38. Desimone v. Barrows, 924 A.2d 908, 934 (Del. Ch. 2007) (citing *Disney*, 906 A.2d at 67) ("A failure to act in good faith may be shown . . . where [a] fiduciary acts with the intent to violate applicable positive law."); Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("[O]ne cannot act loyally as a

though approving or deliberately ignoring legal violations may not be disloyalty in the "classic sense,"[39] "the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary *fails to act in good faith*."[40] And good faith, the supreme court affirmed in *Stone v. Ritter*, is a "subsidiary element" or "condition" of the fundamental duty of loyalty.[41] Without good faith, there cannot be loyalty.

A failure to act in good faith may be shown in at least two ways: (1) "where the fiduciary acts with the intent to violate applicable positive law," or (2) "where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[42] Either of these two "articulated examples of bad faith"[43] should readily support director liability for breach of the duty of loyalty in a case where directors knowingly approve or deliberately ignore law or regulatory violations by corporate personnel.[44]

What is worse (for the board), the directors' breach of the duty of loyalty due to "bad faith" would not only provide a substantive basis for director liability to reimburse corporate fines and penalties. It would, in addition, make the situation

corporate director by causing the corporation to violate the positive laws it is obliged to obey."). The court in *Desimone* went on:

> Although directors have wide authority to take lawful action on behalf of the corporation, they have no authority knowingly to cause the corporation to become a rogue, exposing the corporation to penalties from criminal and civil regulators. Delaware corporate law has long been clear on this rather obvious notion; namely, that it is utterly inconsistent with one's duty of fidelity to the corporation to consciously cause the corporation to act unlawfully. The knowing use of illegal means to pursue profit for the corporation is director misconduct.

924 A.2d at 934–35.

39. *Disney*, 906 A.2d at 66 (describing "classic" disloyalty as "preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation").

40. *Stone*, 911 A.2d at 370 (emphasis added).

41. *Id.* at 369–70 ("The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,]' i.e., a condition, 'of the fundamental duty of loyalty.'" (quoting *Guttman*, 823 A.2d at 506 n.34)).

42. *Stone*, 911 A.2d at 369 (quoting *Disney*, 906 A.2d at 67).

43. *Disney*, 906 A.2d at 67.

44. *Stone*, 911 A.2d at 369–70. The Chancellor also wrote in *Disney* that "intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." *Disney*, 906 A.2d at 62 (quoting *In re* Walt Disney Co. Derivative Litig., C.A. No. 15452, 2005 Del. Ch. LEXIS 113, at *36). The supreme court said "we uphold the Court of Chancery's definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith." *Disney*, 906 A.2d at 67. In light of this definition, perhaps "intentional dereliction of duty" is the best species of director bad faith to cite as applicable in cases where the board consciously disregards illegality by corporate personnel. However, the board's duty to attempt reasonable oversight to prevent violations of law provides another route to the same end. *See* discussion *infra* text accompanying notes 65–87.

non-exculpable under section 102(b)(7).[45] Both a "breach of the duty of loyalty" as well as "acts or omissions not in good faith" are expressly listed as non-excludable.[46]

For good measure, section 102(b)(7) also provides two further exceptions to exculpation that would apply when a board approves or deliberately ignores corporate violations of law or regulations.[47] They are "intentional misconduct" and a "knowing violation of law."[48] These two can be taken together since they are, for present purposes, so closely related. The only real question raised by the statutory wording is whether the reference to a "knowing violation of law" refers only to a violation by the directors personally or, in the alternative, to violations by either the directors or the corporation.[49]

Unfortunately for clarity, the wording of section 102(b)(7) does not grammatically require one interpretation over the other, and the difference between the two readings might matter. Even when directors authorize or knowingly allow their corporation to violate the law, there is not necessarily a "knowing violation of law" on the part of the directors themselves—for example, if the directors authorize the corporation's truck drivers to systematically violate the laws against double-parking.[50] But can a tenable argument be made that section 102(b)(7) means to deny exculpation only when the directors *personally* violate the law?

Fortunately, in the present context, the difference between the two readings should be of little consequence: either way, the "intentional misconduct" exclusion most certainly would apply. Not all misconduct is necessarily a violation of law, but it would be startling for a court to agree that a "knowing violation of law" is not "misconduct." And section 102(b)(7) states without ambiguity that a charter provision "shall not eliminate or limit the liability of a director . . . (ii) for acts or omissions . . . *which involve* intentional misconduct."[51]

In sum, if a board of directors were either to knowingly authorize or deliberately ignore violations of law or regulatory non-compliance, that should suffice to provide the bad faith predicate for a breach of the duty of loyalty. Moreover, a derivative plaintiff should have no trouble fitting the case under at least three, if not all four, of the above-listed categories of non-exculpation in section 102(b)(7).

45. *See* Del. Code Ann. tit. 8, § 102(b)(7) (2001); *supra* text accompanying note 36.

46. § 102(b)(7).

47. *Id.*

48. *Id.*

49. Section 102(b)(7) can be read to provide that: "such provision shall not eliminate or limit the liability of a director . . . (ii) for acts or omissions . . . *which involve* . . . a knowing violation of law." *Id.* (emphasis added). Alternatively, it can be read to simply provide that: "such provision shall not eliminate or limit the liability of a director . . . (ii) for . . . a knowing violation of law." *Id.* The difference is that the first reading does not exculpate just because the violation is not personal to the director, while the second reading exculpates unless the director personally violates the law.

50. Stephen M. Bainbridge, *Does an Intentional Violation of Law = Bad Faith?*, ProfessorBainbridge.com, http://www.professorbainbridge.com/professorbainbridgecom/2006/06/does-an-intentional-violation-of-law-bad-faith.html (last visited Aug. 3, 2010).

51. § 102(b)(7) (emphasis added).

### C. *The Duty of Care and Business Judgment Rule*

Once the exculpation of section 102(b)(7) is out of the way, a derivative plaintiff may also be able to hold actively involved directors liable to reimburse fines and penalties as a breach of the duty of care. We saw earlier that the duty of care is a generally unlikely basis for derivative liability because courts decline, under the business judgment rule, to second-guess the decisions that the board makes on the corporation's behalf.[52] The rationale for that rule is that the board of directors is better able than the courts to decide what the corporation should do. It seems fair to assume, however, that neither the rationale of the business judgment rule nor the rule itself has any proper application to board decisions to break the law.

The courts may not be the equal of corporate boards when it comes to decisions about doing business, but they are at least as competent as corporate directors to decide about the law. And a corporate board of directors has absolutely no authority to determine whether the law should be followed.[53] When the directors decide to "authorize" or allow their corporation to break the law, it is simply beside the point whether the decision can be "attributed to any rational business purpose."[54] Decisions about whether to stay within the boundaries of the law are not a matter of private rationality but of public policy. So even though a board decision to pursue or allow illegal conduct may well be profitable and therefore "rational" from the standpoint of the firm (one need only think of criminal enterprises, which thrive on illegality), a decision to break the law is not one to which the courts will likely defer.[55]

### D. *Lawyers as Safe Haven*

We have seen that neither the business judgment rule nor exculpatory charter provisions under section 102(b)(7) would likely protect a board of directors from derivative-suit liability if the board knowingly authorizes or deliberately ignores corporate illegality leading to corporate fines and penalties. There appears to be, however, an effective way that directors can head off derivative actions brought to assert such liabilities; namely following the advice of counsel.

The board of a Delaware corporation should ordinarily be insulated from liability if it has a standard practice of seeking and following legal advice for matters having

52. *See supra* text accompanying note 23.

53. To think that states would deliberately create private entities to violate the law is, to my mind at least, a fantasy.

54. *Cf.* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.").

55. *See supra* text accompanying notes 3–8 (discussing the "theory of efficient crime"). Other rationales for board liability can also be piled on. There is the argument, for example, that a director's decision to commit the corporation to illegality should not "be respected by courts" because, in choosing that course, the directors "do not act in good faith." *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 n.62 (Del. 2006) (quoting Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000)).

significant legal implications. Under the Delaware General Corporation Law, board members are "fully protected" if they act in good faith reliance on reasonably chosen and trusted professional expertise.[56] Accordingly, the obvious antidote to director liability for corporate fines and penalties is to seek professional legal expertise.

Seeking legal expertise will help avoid liability in two ways. If the board consults with the corporation's lawyers whenever a proposed action (or omission) might result in illegality, it is much less likely that authorizations of corporate violations or deliberate ignorance of them would ever occur in the first place. And if violations do occur despite the effort to seek and follow legal counsel, they still would not support a successful (or high settlement-value) derivative claim.[57] Lawyers provide safe haven.

But, a cynic might wonder: Can't this safe haven be manipulated, allowing the benefits of legal violations to be achieved while, at the same time, still enjoying the safe haven's protection? Of particular concern is the possibility that a corporation's lawyers, perhaps acting at the behest of senior management, will give the directors skewed or flawed legal advice that lulls them into approving or, at least, ignoring an illegal course of conduct, leading to serious fines and penalties for the corporation.

This concern that senior management might be able to influence the independent judgment of corporate lawyers is not entirely far-fetched. Imagine, for example, that the senior management of a pharmaceutical company devises a plan to enhance the company's performance by incentivizing doctors to prescribe its drugs for off-label uses (i.e., uses that have not received FDA approval). When the board of directors asks, "Is this legal?," senior management responds by asking the corporation's lawyers to give an opinion—not a public opinion, of course, but private legal advice, subject presumably to the protection of the attorney-client privilege.

Let us suppose that the lawyers find the proposed program of incentives to be legally dubious, but they also feel pressures from senior management. After all, from the lawyers' perspective, the members of senior management practically *are* the corporation, with the de facto power to retain or discharge them or shift their legal business elsewhere. Senior management is the "human face" of the corporation; the only persons with whom the lawyers usually deal. But senior management serves at the pleasure of the board of directors and is, as a matter of institutional convention, under pressure to "perform." For them, legal and regulatory compliance is a huge nuisance, an impediment to good financial results. And while fines and penalties might lie years in the future, the senior manager who disappoints in the short run

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56. The section provides that:

> [a] member of the board of directors . . . shall, in the performance of such member's duties, be fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation . . . by any other person as to matters the member reasonably believes are within the other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

§ 141(e).

57. *See id.*

may find his position in the company or, at the very least, his amount of compensation, in jeopardy. So members of senior management signal to the lawyers what they want the legal opinion to say.

What are the lawyers to do? As far as ethics are concerned, Rule 1.13 the Model Rules of Professional Conduct,[58] which describes the duties of lawyers for organizations, might first come to mind, but it is probably not the most relevant. First and foremost, the corporation's lawyer is ethically bound to comply with Model Rule 1.2(d): "A lawyer shall not counsel a client to engage, *or assist* a client, in conduct that the lawyer knows is criminal or fraudulent. . . ."[59] If the corporation's lawyers give a faulty opinion that the proposed program of incentives to doctors is lawful, and the corporation is later penalized, the lawyers could, at least in theory, be subject to discipline.[60]

For the derivative plaintiff, however, there is a far more enticing possibility than discipline. The recourse of choice for the derivative plaintiff would be to include the corporation's lawyers as derivative defendants. The basis of the action would include the lawyers' erroneous legal opinion, which could create liability for malpractice. On top of that, the lawyers are (like the directors) also the corporation's fiduciaries. As such, their actions in counseling or assisting criminal or fraudulent behavior by corporate officers and employees, to the corporation's predictable detriment, also would provide a ground for liability. There would not, in such an action, likely be an "independent" and "disinterested" board whose "business judgment" not to sue the lawyers would be entitled to judicial deference. What is more, in the process of collecting its proof, the derivative plaintiff may find a discovery bonanza: once the board tries to defend itself by asserting that it is "fully protected" due to reliance on advice of counsel,[61] the derivative plaintiffs would have access to all of the privileged attorney-client communications relating to the advice.[62] These communications alone could practically make the case against the corporation's lawyers.

Of course, no corporate lawyer with her wits about her is likely to let things get this far, but that is not the point. The point here is that there are major pressures on a corporation's lawyers not to render dubious opinions of law or otherwise "assist"

58. Model Rules of Prof'l Conduct R. 1.13 (2009).

59. *Id.* R. 1.2(d) (2009) (emphasis added).

60. Disciplinary proceedings under Rule 1.2(d) are not all that common. One of the reasons is likely because the rule requires proof that the lawyer "knows" that the conduct is fraudulent or illegal at the time she gives her opinion or renders her assistance. This requirement is often difficult to meet. *See id.*

61. *See* § 141(e); *supra* text accompanying notes 56–57.

62. *See* Restatement (Third) of the Law Governing Lawyers § 80(1)(a) (2000) ("The attorney client privilege is waived for any relevant communication if the client asserts as to a material issue in a proceeding that . . . the client acted upon the advice of a lawyer or that the advice was otherwise relevant to the legal significance of the client's conduct."); Restatement (Third) of the Law Governing Lawyers § 80 cmt. b (2000) ("Waiver extends to all communications relevant to the issue asserted by the client."). A waiver of the attorney-client privilege also occurs if there is a voluntary partial disclosure of privileged communications. Charles W. Wolfram, Modern Legal Ethics 269–70, 273–74 (1986). In short, the directors cannot assert "advice of counsel" as a defense and then refuse to reveal the contents of the communications by means of which that advice was rendered.

illegal conduct.[63] Accordingly, once the possibility of lawyer liability (or, even, of just being a defendant) is figured in, the corporation's lawyers are unlikely, perhaps exceedingly unlikely, to bow at the behest of senior management. The lawyers will give reliable legal advice to the board, and such advice will, in turn, make it even more unlikely that the board will authorize or deliberately ignore violations of law on the part of corporate personnel.[64]

In short, the close involvement of corporate counsel in director-level decisions not only provides a safe haven for the directors, but also serves as a significant barrier to board decisions that knowingly run afoul of the law. Despite the billions of dollars per year of corporate fines and penalties, one should not expect knowing board involvement to be common.

## V. PASSIVE INVOLVEMENT

### *A. Failing to Perform a "Known Duty to Act"*

Though aggregate corporate losses due to fines and other penalties may be currently ranging in the billions, a board's involvement in corporate criminal conduct is probably most often passive. It is probably rare (or at least rarely provable) to find that the directors have authorized or had solid reason to suspect the violations.[65] Nonetheless, even when the board is entirely passive in legal or regulatory violations by corporate personnel, director liability remains a possibility.

The analysis is similar to the case of active involvement. The central difference in the case of passive involvement is that, instead of focusing on whether there has been a "knowing violation of law," the crucial question is whether the board "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard

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63. *See also* Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. §§ 205.1–205.7 (2003) (codified in various sections of Title 15 of the U.S. Code) (implementing Sarbanes-Oxley Act by requiring lawyers of public companies to report breaches of fiduciary duties by corporate personnel to the board or equivalent).

64. A board wishing to persist in a plan that the lawyers have opined to be illegal would essentially have three choices:

    1. Disregard the advice of counsel on the question of legality.
    2. Deliberately decide to avoid seeking legal counsel despite the fact that there is reason to believe that a proposal is illegal.
    3. Deliberately shop for "favorable" legal counsel from lawyers known to be ethically-challenged.

    For reasons considered below in the remainder of this article, none of these three would comply with the requirement of good faith that is the condition of the directors' duty of loyalty. That is to say, each of them would expose the directors to liability to the corporation, enforceable in a derivative suit.

65. I am setting to one side the fraught question of how much certainty a person must have about a reasonable suspicion or surmise in order to be said to "know" a fact. The legal ethics rules seem to have a somewhat variable standard. For example, the rules set the bar very high when the issue is whether the lawyer "knows" the client intends to commit perjury, while the bar is very low for other purposes, such as when the question is whether the lawyer "knows" a person is represented by another lawyer (and therefore subject to the no-contact rule).

for [its] duties."[66] In the passive situation, the relevant "duty to act" is the board's obligation to exercise oversight.[67] For the derivative plaintiff to prevail against the board, he would have to show that the board intentionally failed to perform its duty of oversight—a complete failure of oversight. To see what this would specifically mean, let us consider the *Caremark* case.[68]

### *B. Directors' Duty of Oversight:* Caremark

The defendant in *Caremark*, a health service provider, had been previously charged with multiple federal felonies and, after pleading guilty to one of them, paid fines and various reimbursements totaling approximately $250 million.[69] The central criminal charge was paying doctors to refer Medicare patients to the defendant's health services business—in effect, kickbacks.[70]

The large payments required to settle the prosecution prompted a derivative suit against the directors. The Court of Chancery concluded that there was no "knowing" violation of law even though the board knew about the payments to doctors: "Certainly the Board understood that the company had entered into a variety of contracts with physicians, researchers, and health care providers and it was understood that some of these contracts were with persons who had prescribed treatments that Caremark participated in providing."[71] The court accepted as well that the board knew that the corporation was subject to the "no kickback" rule under federal law.[72] "But," wrote the court, "the Board appears to have been informed by experts that the company's practices while contestable, were lawful."[73]

However, the *Caremark* court went on to say that, in an appropriate case, directors could be held liable for losses "predicated on ignorance of liability creating activities" provided there is "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."[74] The duty of good faith would be the rationale for liability, according

66. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006) (citations omitted).

67. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

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

69. *Id.* at 960–61.

70. *Id.* Although the corporation did not make such payments outright, it did confer research grants and make consultation agreements with doctors who prescribed or recommended the corporation's services or products to Medicare recipients. It was on the basis of these grants and agreements that the corporation was indicted. *Id.* at 964–65.

71. *Id.* at 971.

72. *Id.*

73. *Id.* ("There is no evidence that reliance on such reports was not reasonable. Thus, this case presents no occasion to apply a principle to the effect that knowingly causing the corporation to violate a criminal statute constitutes a breach of a director's fiduciary duty.").

74. *Id.* (emphasis added).

to the court. Specifically, a board's "sustained or systematic failure . . . to exercise reasonable oversight" would evidence a "lack of good faith."[75]

The *Caremark* standard was approved by the Delaware Supreme Court in *Stone v. Ritter*.[76] Departing from *Caremark*, however, the supreme court in *Stone* said the lack of good faith from failure of oversight breached the fiduciary duty not of care, but of *loyalty*.[77] By making the failure of oversight a matter within the duty of loyalty, the *Stone* court dissolved any obstacles to director liability under section 102(b)(7)[78] and made clear that the basis of liability was not the negligence type of conduct associated with the duty of care. The basis of liability in *Stone* was, instead, a "fail[ure] to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities."[79]

By placing the basis of liability under the duty of loyalty, *Stone* helped derivative plaintiffs by preventing exculpation under section 102(b)(7). To the detriment of derivative plaintiffs, however, it also created a very high bar for the plaintiffs to meet. In order for a derivative plaintiff to prevail under the duty of loyalty, the plaintiff must not only show that the directors "knew that they were not discharging their fiduciary obligations,"[80] but must also show either that the directors "utterly failed to implement any reporting or information system or controls" or that, "having implemented such a system or controls, [they] consciously failed to monitor or oversee its operations."[81]

### *C. The "Utter Failure" Standard*

Of course, the very fact that a corporation has to pay large fines or penalties due to legal or regulatory enforcement is prima facie evidence that, whatever reporting or information system it had, it was not properly functioning. But this fact by itself is not enough for a derivative plaintiff to win. The court in *Stone* made clear that directors could not be held liable based merely on a reporting-system malfunction or a flawed setup; there has to be an *utter failure to attempt* to implement or monitor a reasonable system or controls.[82]

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75. *Id.* In *Caremark*, the court stated that "the record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function. To the contrary, . . . the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts." *Id.*

76. *See* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).

77. *Id.* at 370. *Caremark* had treated the lack of good faith in oversight as a breach of the duty of *care*. 698 A.2d at 960.

78. *See Stone*, 911 A.2d at 367; *supra* text accompanying notes 24–28.

79. *Stone*, 911 A.2d at 370.

80. *Id.*

81. *Id.*

82. *Id.* at 370–73.

This "utter failure to attempt" standard for liability is obviously not meant to be a reasonableness or "due care" standard in disguise.[83] It is a binary standard: either the board makes the requisite attempt or it does not. While the goal of the standard is that the board's systems and controls be "reasonable," the board's attempt to create them can pass muster under *Stone* even if the attempt is *not* reasonable.[84]

Nonetheless, there surely has to be a lower limit. Without a lower limit on how feeble and inconsequential the directors' attempt can be and still count, the standard in *Stone* would be meaningless. For even though "there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties,"[85] there comes a point when an "inadequate" attempt is such a sham or pretence as to demonstrate a conscious disregard of duty.

A sham attempt is not, *Stone* makes clear, enough to satisfy the duty of loyalty. Rather, the directors must make "a *good faith judgment* that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations."[86] The requirement of a "good faith judgment" means a sham or a pretence cannot suffice. To take an obvious limiting case, an information and reporting system designed by third-graders, no matter how well-meaning, would be a sham. It seems fair to say, as well, that even a system designed by educated business people would be, in the known absence of appropriate expertise, a sham. And where the duty in question is the duty to monitor and oversee compliance with complex laws and regulations, it is hard to see how the directors can seriously contend they made "an attempt to assure a *reasonable* information and reporting system" unless they drew on the expertise of lawyers.

In summary, in implementing a "reporting or information system" for corporate legal compliance, a board of directors would be very vulnerable if it chooses not to closely involve the corporation's counsel or other legal experts. It would be vulnerable to the charge, made in a derivative suit, that its efforts at implementation were not in good faith. In contrast, by bringing in the lawyers and relying on their expertise, the directors would be "fully protected."[87] Lawyers provide safe haven.

## VI. CONCLUDING THOUGHTS

Several things seem to be reasonably evident. First, as corporations become ever more subject to regulatory and legal controls, the fines and penalties assessed against them, already running to billions per year, are growing. The directors' potential liability to reimburse these fines and penalties to the corporation will be an

83. *See id.* at 370; *accord* Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009).

84. As is fitting for a standard under the duty of loyalty, as opposed to under the duty of care.

85. *Lyondell*, 970 A.2d at 243.

86. Stone v. Ritter, 911 A.2d 362, 368 (Del. 2006) (quoting *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996)).

87. *See* Del. Code Ann. tit. 8, § 141(e); *supra* notes 56–57 and accompanying text.

increasingly tempting target for derivative attorneys and will make directors increasingly vulnerable.

Second, a board of directors cannot directly monitor or prevent most violations by corporate personnel, but it can do so indirectly, by means of information and reporting systems and controls. To the extent that these monitoring and oversight systems are not perfect, however, derivative plaintiffs will be motivated to seek reimbursement from the directors.

Third, in derivative suits brought for reimbursement of fines and penalties, the directors' best line of defense will be to show they have made a genuine attempt to assure reasonable information and reporting systems and controls. In Delaware, moreover, directors will be "fully protected" if they rely in good faith on the advice of counsel.[88]

Fourth, the good faith judgment requirement of *Stone*,[89] coupled with the ability to be "fully protected" under section 141(e),[90] means that directors can best protect themselves from liability to reimburse corporate fines and penalties by closely involving lawyers in the process of creating and operating corporate legal compliance controls.

Fifth, the lawyers' advice will be dependable because the lawyers will have their own strong incentives to do what they can to head off legal and regulatory violations by corporate personnel in the matters where their expertise is sought.

What will be the upshot of all this? The most hopeful possibility is that systems in corporations to detect and root out illegal employee conduct will become much more effective than they are today. As lawyers are inserted ever more prominently into the mix, things will have to be different. Unlike corporate directors, lawyers do not enjoy the benefit of the business judgment rule or exculpatory corporate charter provisions under section 102(b)(7). If the lawyers fail to use ordinary care and the corporation is fined or penalized, the lawyers may be liable as defendants in derivative suits. Lawyers will therefore have a strong and personal interest in developing and counseling the use of compliance systems that work. And their efforts will produce safe havens.

88. *See* § 141(e); *supra* notes 56–57 and accompanying text.

89. *See supra* note 86 and accompanying text.

90. *See* § 141(e); *supra* notes 56–57 and accompanying text.