ON THE SUFFICIENCY OF CORPORATE REGULATION AS AN ALTERNATIVE TO CORPORATE CRIMINAL LIABILITY

Lisa M. Fairfax*

One question posed by the 2010 SEALS Roundtable on Re-Evaluating Corporate Criminal Liability was: "Is corporate regulation sufficient to handle corporate misconduct?" My remarks and this Article seek to address that question and its implications for corporate criminal liability. In so doing, I will make two points about corporate regulation. First, the corporate regime has essentially removed personal liability of directors and officers from the range of remedies used to shape corporate conduct.[1] Second, as a result of this first point, corporate regulation of corporate misconduct is sufficient only if we have confidence that the imposition of such personal liability is not necessary to deter or otherwise prevent corporate malfeasance. After making these points, I will discuss their implications for corporate criminal liability.

I. CORPORATE REGULATION AND PERSONAL LIABILITY: THE EXONERATION TREND

A. Corporate Law

Under state law, especially the law of Delaware, which governs the conduct of most public corporations[2]—and hence most

 Leroy Sorenson Merrifield Professor of Law, The George Washington University School of Law. J.D., *cum laude*, Harvard University Law School, 1995; A.B., *cum laude*, Harvard College, 1992. Many thanks to Ellen Podgor for inviting me to participate in the 2010 SEALS Roundtable on Reevaluating Corporate Criminal Liability, and to the Roundtable participants for their helpful comments and suggestions on earlier versions of this Article. All errors, of course, are mine.

1. Bernard Black et al., *Outside Director Liability*, 58 Stan. L. Rev. 1055, 1059–1060 (2006); Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity versus Individual Liability*, 42 Wake Forest L. Rev. 627, 627–628 (2007).

2. Langevoort, *supra* n. 1, at 631 (noting that most large firms incorporate in Delaware).

directors and officers—it is very difficult to hold directors and officers personally liable for breaching their fiduciary duties.[3]

As an initial matter, procedural and substantive hurdles have hindered the ability of shareholders to bring successful actions holding directors and officers liable for breaching their fiduciary duty. Procedural rules such as the demand requirement[4] limit shareholders' ability to bring legal action aimed at holding directors and officers liable for violating their fiduciary duty. These rules give boards or board committees significant discretion to terminate shareholder lawsuits before such suits reach trial.[5] Even when shareholders overcome procedural hurdles, the business judgment rule, the substantive standard under which courts assess whether directors have breached their fiduciary duty,[6] has insulated directors from liability in all but the most egregious cases.[7] Indeed, the business judgment rule reflects the courts' reluctance to interfere with board decisions, and thus gives significant deference to board decisions outside of those deemed to be in bad faith.[8] The combination of these procedural and substantive rules has meant that shareholders rarely succeed in their breach-of-fiduciary-duty actions. Empirical studies confirm this rarity, uncovering fewer than a dozen cases in which directors have been held liable for breaches of their fiduciary duty when no self-dealing was involved.[9]

Even when shareholders manage to succeed on the merits of their fiduciary-duty actions, that success almost never translates into out-of-pocket damages for directors. This is because in those few instances in which directors or officers are found liable, a host

3. Black et al., *supra* n. 1, at 1060 (noting that personal liability is rare due to multiple factors, including substantive, procedural, indemnification, insurance, and settlement incentives).

4. Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 Minn. L. Rev. 1339, 1349 (1993).

5. John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Colum. L. Rev. 261, 326 (1981); Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. Corp. L. 417, 437 (1996); Swanson, *supra* n. 4, at 1349.

6. Swanson, *supra* n. 5, at 437.

7. *See e.g. In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036 at *13 n. 13 (Del. Ch. Jan. 31, 1989) (stating that the business judgment rule protects directors from liability unless the judgment under review is "egregious").

8. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

9. Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability*, 42 Hous. L. Rev. 393, 410 n. 94 (2005).

of mechanisms ensure that corporations either directly or indirectly bear the expense.[10] Such mechanisms include corporate directors' and officers' ("D&O") insurance and corporate indemnification provisions which make corporations responsible for covering directors' and officers' damages.[11] Also included are state exculpatory statutes, which allow corporations to limit or eliminate liability for breaches of the fiduciary duty of care by directors.[12] These three devices combine to insulate directors and officers from financial liability. Hence, the most comprehensive study of out-of-pocket liability for outside directors unearthed only one corporate law decision holding directors personally liable, either as a result of judgment or settlement.[13] To be sure, the study focuses only on outside directors. The rarity of successful fiduciary duty cases, however, suggests that these findings may also apply to officers and other directors. Indeed, the one case unearthed holding directors personally liable was *Smith v. Van Gorkom*.[14] *Van Gorkom* triggered tremendous angst and consternation in the corporate community,[15] and it is the reason that states formulated and passed exculpatory statutes enabling corporations to prevent shareholders from holding directors personally liable for breaches of fiduciary duties.[16] Such prevention has worked. Empirical evidence reveals that since the *Van Gorkom* decision, no other corporate law case has imposed personal liability on outside directors.[17] In other words, it has been almost thirty years since an outside director has been held personally liable for money damages.

As this discussion reveals, procedural and substantive rules, together with the trinity of D&O insurance, indemnification provisions, and exculpatory statutes, have combined to make outside directors' risk of personal liability under corporate law virtually non-existent.[18] To be sure, there may be a greater risk of liability

10. Black et al., *supra* n. 1, at 1059–1060.
11. *Id.*
12. Del. Code Ann. tit. 8, § 102(b)(7) (Lexis 2001); Model Bus. Corp. Act Ann. § 2.02(b)(4) (ABA 2009).
13. Black et al., *supra* n. 1, at 1067.
14. 488 A.2d 858, 893 (Del. 1985).
15. Fairfax, *supra* n. 9, at 410–411; Swanson, *supra* n. 5, at 435.
16. Fairfax, *supra* n. 9, at 412–413.
17. Black et al., *supra* n. 1, at 1060.
18. *Id.* at 1075–1076.

for directors who are insiders, hence executives. Because even these directors can be shielded from liability through the demand requirement, indemnification provisions, and D&O insurance, it is not clear if a different pattern would emerge with respect to those directors.[19]

B. Securities Law

State corporate law is not the only mechanism that can hold directors liable for failing to fulfill their obligations. Securities laws at the state and federal level impose responsibilities on directors for which they can be held liable, ranging from violations of corporate disclosure obligations[20] to charges of securities fraud.[21] Empirical evidence reveals that—likely because of the procedural hurdles under corporate law—shareholders bring more securities law claims than corporate law claims against directors.[22] But evidence also reveals that with respect to personal liability for directors and officers under securities law claims, the end result parallels those of corporate law claims.[23]

Hence, outside directors' risk of personal liability due to securities law actions is relatively small. In their twenty-five year study, Bernard Black and his coauthors did not discover any cases in which outside directors were found liable at trial.[24] Moreover, the study revealed only twelve cases in which outside directors were held liable for money damages as a result of settlements.[25] Two of those cases involved the much-publicized WorldCom and Enron settlements.[26] Heightened pleading standards, as well as substantive rules related to causation and scienter, appear to be

19. Fairfax, *supra* n. 9, at 409 (noting the board committees' ability to terminate suits brought against inside and interested directors); Langevoort, *supra* n. 1, at 640–648 (raising concerns regarding the sufficiency of state law liability for executives).

20. Langevoort, *supra* n. 1, at 658 (noting the complicated disclosure obligations for firms in Delaware).

21. Black et al., *supra* n. 1, at 1064–1065 (noting the high number of federal securities claims); Langevoort, *supra* n. 1, at 631 (noting that most litigation against executives takes the form of federal securities law actions).

22. Black et al., *supra* n. 1, at 1064–1065.

23. *Id.* at 1065–1066.

24. *Id.*

25. *Id.* at 1060.

26. *Id.* at 1057–1058, 1074.

responsible for the relatively low risk of personal liability for outside directors in the securities law realm.[27]

Importantly, SEC enforcement actions appear to follow a similar trend. Empirical evidence reveals that beyond the insider-trading context, in which the SEC's enforcement efforts have generated significant out-of-pocket liability, the SEC's enforcement efforts have not yielded significant penalties.[28] This revelation caused researchers to conclude that "while careless or incompetent outside directors face theoretical financial risk due to SEC enforcement, they have had little to fear up to this point."[29] Also, while the SEC has the resources to impose sanctions on individual directors and officers, some scholars have noted that "often the SEC does not, choosing instead to settle cases without impressive sanctions against the individuals involved."[30]

C. Oversight Breaches

It should be noted that directors' risk of liability is also exceedingly low with respect to breaches of their obligation to ensure that corporations implement and maintain effective internal control systems for detecting fraud. Recent caselaw and federal statutes have made clear that directors must maintain and oversee an internal control system aimed at detecting fraud, particularly financial fraud. As a matter of corporate law, cases such as *Caremark*[31] and *Stone v. Ritter*[32] confirm directors' fiduciary responsibility to maintain information and reporting systems that enable them to remain informed of risks and other problems that arise within the corporation.[33] This responsibility is generally referred to as oversight liability.[34] Federal law, including the Sarbanes–Oxley Act,[35] also imposes on directors and managers the obligation to maintain and oversee financial-control systems. Im-

27. *Id.* at 1078–1079.
28. *Id.* at 1131–1133.
29. *Id.* at 1135. *See also* Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 Bus. Law. 1375, 1379 (2006) (noting the dearth of actions against independent directors).
30. Langevoort, *supra* n. 1, at 654.
31. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).
32. 911 A.2d 362 (Del. 2006).
33. *Id.* at 370; *In re Caremark*, 698 A.2d at 970–971.
34. *Stone*, 911 A.2d at 370.
35. 15 U.S.C. § 7262 (2006).

portantly, many commentators concur that maintaining these systems is critical to detecting and preventing corporate fraud, while some insist that the one primary justification for corporate criminal liability arises in those circumstances in which the corporation has failed to maintain and properly monitor its internal control system.[36]

Nevertheless, directors' risk of liability for breaches of their oversight duty is even lower than such risk in the context of other breaches. Indeed, the Delaware Supreme Court recently made clear that cases involving oversight liability are based on "the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[37] And even more recently, Delaware courts have suggested that oversight cases alleging directors' failure to properly manage risk may be almost impossible to win.[38] The fact that a director's risk of liability for an oversight breach is even lower than such risk associated with other forms of breaches clearly underscores the virtual non-existence of liability risk in this area.

D. Future Trends

Viewed together, it appears that the corporate regime has taken personal liability off the table for outside directors. Of course, after Enron and WorldCom, there was considerable fear on the part of corporate directors and officers, alongside enhanced expectation on the part of regulators, that there would be an increased risk of personal liability for corporate officers and directors.[39] Research has suggested, however, that such fears are groundless. An analysis of the few cases imposing personal liability on directors indicates that most of those cases stem from a unique set of facts unlikely to emerge in today's governance envi-

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36. *See* James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 L. & Contemp. Probs. 1, 16–17 (1997) (discussing duty-based entity liability linked to the maintenance of effective control and compliance systems).

37. *Stone*, 911 A.2d at 372 (citing *In re Caremark*, 698 A.2d at 967).

38. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 125 (Del. Ch. 2009) (finding that a plaintiff stating a claim for personal director liability has "an extremely high burden" to overcome the business judgment rule, exculpatory clauses, and the requirements of the *Caremark* decision).

39. Black et al., *supra* n. 1, at 1058.

ronment.[40] As a result, the prediction is that instances in which directors are held personally liable will continue to be exceedingly rare.[41] Thus far, this prediction has been realized, demonstrating that even after Enron and WorldCom, essentially no new cases have emerged either in the corporate or securities law context under which directors have been held liable for money damages.[42]

II. IMPLICATIONS FOR CORPORATE CRIMINAL LIABILITY

To the extent that there is no meaningful threat of individual liability in the context of corporate and securities laws, what is the impact on discussions regarding the propriety of corporate criminal liability? This Part briefly explores a few implications.

A. The Individual-Liability Alternative

Some critics of corporate criminal liability base their criticism on the notion that imposing individual liability represents a more effective and efficient means of regulating corporate misconduct. This critique, however, appears to presume the existence of an adequate and even robust regime of individual liability. That presumption is unfounded with respect to corporate and securities law. Instead, the discussion in Part I indicates that individual directors, and even officers, experience very little risk of personal liability under the corporate and securities law regime, particularly with respect to actions not involving self-dealing. This indication raises doubts about individual liability as an alternative to entity liability, criminal or otherwise.

To be sure, there are other mechanisms outside of direct personal liability that may impact director and officer behavior. Thus, "market incentives, reputation," and other extra-legal sanctions may shape corporate conduct.[43] And there are many scholars who insist that, for purposes of corporate and securities law, such sanctions are not only adequate, but are more appropriate than legal liability.[44] Others, however, contend that extra-legal sanc-

40. *Id.* at 1128–1129.
41. *Id.* at 1061, 1139.
42. *Id.* at 1060.
43. *Id.* at 1140.
44. *Id.*; *see also* Jayne W. Barnard, *Reintegrative Shaming in Corporate Sentencing*, 72 S. Cal. L. Rev. 959, 966 (1999) (noting that shaming sanctions of top executives can be an

tions alone are insufficient to curb corporate misconduct, insisting that a realistic threat of personal liability plays an important role in buttressing these other non-legal sanctions.[45] Regardless of the merits of these two positions, it is clear that the corporate regime relies almost exclusively on extra-legal remedies for deterring and preventing corporate misconduct.[46] Hence, it is also clear that reliance on the corporate regime as an alternative to corporate crim-criminal liability means relying on a regime that has basically foreclosed individual liability. Thus, such reliance reflects an appropriate alternative to corporate criminal liability only if we are confident that such foreclosure is appropriate.

B. The Innocent-Shareholder Critique

There are some who reject corporate criminal liability, and in fact any form of entity liability, because such liability inappropriately inflicts harm on innocent shareholders.[47] To be sure, any corporate liability is ultimately borne by the shareholders. Thus, such liability could be viewed as victimizing shareholders twice—once when they are victims of corporate fraud, and then a second time when they must pay sanctions associated with that fraud. In this respect, individual liability may be deemed more appropriate because it ensures that payments are borne by culpable directors and officers as opposed to innocent shareholders. Of course, some have questioned whether shareholders can truly be characterized as innocent in the context of fraudulent conduct, from which they may have benefitted through increased stock prices or otherwise. Regardless of the merits of that characterization, the innocent-shareholder critique may not be a sufficient justification for preferring individual liability in the context of corporate and

effective influence on behavior of both the individual and the corporation); Fairfax, *supra* n. 9, at 428 (discussing arguments in favor of extra-legal sanctions).

45. Fairfax, *supra* n. 9, at 443–446 (noting that extra-legal sanctions may not deter misconduct because of a failure to detect such conduct, and that legal sanctions help to define behavior that is considered objectionable).

46. *See* Black et al., *supra* n. 1, at 1056 (noting that the principal threat for directors is the "time, aggravation, and potential harm to reputation" caused by the lawsuit itself rather than direct financial harm).

47. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691, 699–700 (stating that enterprise liability in fraud-on-the-market cases punishes the victim shareholders instead of those actually responsible for wrongdoing).

securities matters. That is because such liability essentially amounts to entity liability, and thus, like corporate criminal liability, essentially shifts payments away from directors and officers and toward shareholders. Indeed, one of the primary reasons why directors escape out-of-pocket liability under corporate law is because corporations cover that liability through indemnification provisions and D&O insurance policies. While directors "are frequently sued under the securities laws and state corporate law, . . . the actual payments are nearly always made by the companies involved."[48] Hence, critiques of corporate criminal liability based on the inappropriateness of cost-shifting to shareholders apply with similar force with respect to so-called individual liability in the corporate and securities realm. As a result, that critique may be an insufficient basis for preferring one form of liability over another.

C. The Oversight Problem

As noted in Part I, although oversight obligations are deemed critical for preventing and deterring corporate fraud and misconduct, directors' risk of liability for breaching their oversight responsibilities is almost non-existent. If some form of liability is necessary to ensure effective maintenance of internal control systems, then it does not appear we can rely on corporate and securities laws. As a result, corporate criminal liability may be a necessary gap-filler.

III. CONCLUSION

To the extent the imposition of individual liability is important for regulating corporate misconduct, then corporate and securities laws may be ill-equipped on their own to handle such regulation. The operative question then becomes whether individual criminal liability, some form of entity liability, or some combination should be used to fill this regulatory deficiency. While this Article cannot fully answer that question, the examination of the corporate and securities law regime with respect to individual liability suggests there may be flaws in some of the

48. Black et al., *supra* n. 1, at 1059.

arguments used to discount corporate criminal liability, at least to the extent that those arguments appear to be based, or otherwise rely, on the existence of such liability.