DePaul Law Review

Volume 45
Issue 3 *Spring 1996*

Article 6

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DOES THE CORPORATE DIRECTOR HAVE A DUTY ALWAYS TO OBEY THE LAW?

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I. INTRODUCTION

It is taken for granted that the corporate board of directors has a duty to adopt and enforce policies and procedures regarding institutional compliance with law.[1] Indeed, after the promulgation of the new Federal Sentencing Guidelines for organizations, which substantially reduce fines for corporations having an effective program to prevent and detect violations of law, it would be a rare corporation of any size without such a program.[2] With respect to law compliance by the director himself, the American Law Institute's *Principles of Corporate Governance* says that, with very limited exceptions, a director who knowingly causes the corporation to disobey the law violates his duty of care.[3]

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1. Section of Business Law, A.B.A., *Corporate Director's Guidebook—1994 Edition*, 49 BUS. LAW. 1243, 1249, 1251, 1267 (1994) (explaining that the support of the board of directors and the Chief Executive Officer for compliance with law should be clearly evidenced in an effective code of corporate conduct).

2. UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL § 8C2.5(f) (1994); *see also* Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs As a Defense to Criminal Liability: Can a Corporation Save Its Soul?*, 47 RUTGERS L. REV. 605, 607-08 (1995) (proposing that an effective compliance program should be a defense to corporate criminal liability, not just a mitigating factor); *see generally* Dan K. Webb et al., *Understanding and Avoiding Corporate and Executive Criminal Liability*, 49 BUS. LAW. 617, 657-59 (1994) (explaining that the implemented compliance program must generally be effective in preventing and detecting criminal conduct).

3. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 2.01(b)(1) cmt. g, 4.01 cmt. d (1992) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE]; *see generally* Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's* Principles of Corporate Governance, 66 WASH. L. REV. 413, 466-91 (1991) (discussing the director's duty of law compliance under the American Law Institute's *Principles of Corporate Governance*).

There is no question that the corporation itself is liable to criminal prosecution and punishment for crimes committed by its managers and agents; the United States Supreme Court long ago rejected the nineteenth century doctrine that a corporation cannot have criminal intent.[4] While the corporation cannot be imprisoned, it can be fined, and even "put to death" under the Federal Sentencing Guidelines, which allow imposition of a fine sufficient to divest the organization of all of its net assets in an appropriate case.[5] The responsible agents of the corporation can also be prosecuted criminally, although it is unclear what degree of involvement is required for conviction.[6]

It is debatable what role the shareholders play, or should play, in this situation. The conventional wisdom seems to be that the shareholders may have the right to hold the board of directors liable if it was the directors that caused the corporation to break the law.[7] It is not clear why the board of directors, alone of all the business persons in the world, must bear personal liability to their employer if they do not adhere strictly to the letter of the law. One would think that at the least there would be some acknowledgment that there are degrees of crime and wrong, as recognized in the law, for example, with respect to suits on illegal contracts.[8] The ALI's *Principles of Corporate*

4. New York Cent. & Hudson River R.R. v. United States, 212 U.S. 481, 494-95 (1909) (stating that there is no "good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred them" with respect to certain types of crimes). Under the collective knowledge doctrine, the corporation may be convicted of a crime even if no one corporate agent intended the violation. *See* Anthony Ragozino, Comment, *Replacing the Collective Knowledge Doctrine with a Better Theory for Establishing Corporate Mens Rea: The Duty Stratification Approach*, 24 SW. U. L. REV. 423 (1995) (criticizing the doctrine as inequitable); *cf.* SEWARD W. BRICE, A TREATISE ON THE DOCTRINE OF ULTRA VIRES 367 (1880) (explaining that there is no corporate criminal liability for felonies or misdemeanors requiring malice or willfulness); Gerhard O. W. Mueller, *Mens Rea and the Corporation: A Study of the Model Penal Code Position on Corporate Criminal Liability*, 19 U. PITT. L. REV. 21, 22-24 (1957) (describing the history of the notion that a corporation cannot incur criminal liability).

5. *See* Edward Felsenthal, *Corporate Death Sentence*, WALL ST. J., May 20, 1994, at B6 (reporting that a federal court judge ordered American Precision Components, Inc. of Farmingdale, N.Y. to go out of business permanently following a criminal conviction); UNITED STATES SENTENCING COMMISSION, *supra* note 2, § 8C1.1 (making penalty applicable to organizations operated primarily for a criminal purpose or primarily by criminal means).

6. *See generally* 1 KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY ch. 5 (1992) (discussing the attribution of criminal conduct to corporate officers, managers, and supervisors).

7. Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974) (citing Roth v. Robertson, 118 N.Y.S. 351 (Sup. Ct. 1909) for the proposition that even though committed to benefit the corporation, illegal acts may amount to a breach of fiduciary duty). The *Miller* case was dismissed on remand for lack of personal jurisdiction over any of the defendant directors. *Miller*, 394 F. Supp. 58, 61 (E.D. Pa. 1975), *aff'd*, 530 F.2d 964 (3d Cir. 1976).

8. *See* 17A AM. JUR. 2D *Contracts* § 308 (1991) (stating that the "rule that courts will not enforce illegal agreements is not absolute and is not without exceptions"); RESTATEMENT (SECOND) OF CONTRACTS §§ 197-198 (1979) (stating that generally a party has no claim in restitution

Governance rejects any cost-benefit justification for lawbreaking and, by way of illustration, forbids a trucking corporation to instruct its drivers to exceed the speed limit to improve corporate profits.[9] Yet the Board of the United Parcel Service of America, Inc. apparently allowed its drivers in 1994 to run up over $1.5 million in parking tickets in New York City alone.[10] Why are the directors not held liable for this conduct?

The law of agency has never held an agent liable to his principal for criminal behavior in the conduct of business where the principal knew or had reason to know of the illegality.[11] Also, a principal who gives his agent money for a commercial bribe cannot necessarily enlist the aid of the courts to recover the money even if the agent keeps it,[12] nor can he require the agent to account for the proceeds of an authorized illegal act which is more than a minor offense.[13] Yet it is said that a

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under an illegal contract unless denial would cause disproportionate forfeiture or the party claiming restitution is excusably ignorant or not equally in the wrong).

9. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 2.01 cmt. g, illus. 10. The recently repealed 1974 federally mandated 55 mph speed limit is a particularly poor choice as an example of a law which should command undeviatingly strict compliance. *See* Quentin Hardy, *Westerners Rev Up to Speed Legally Again*, WALL ST. J., Nov. 13, 1995, at B1 (reporting that the top speed of 85% of cars on the road is 64.1 mph, and 74.7 mph on Western rural roads).

10. Robert Frank, *Forget Potholes, Potshots; Urban Scourge of Delivery-Truck Drivers Is "No Parking,"* WALL ST. J., June 21, 1995, at B1. The ALI's *Principles of Corporate Governance* do allow a director to escape liability for violation of a penal statute which is chiefly intended to raise tax revenues. *See, e.g.*, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.19 cmt. f, illus. 1 (citing a prohibition against the sale of colored margarine). Such conduct is not considered a "culpable" violation of law for purposes of the protection of a certificate of incorporation provision limiting damages against a director except for, among other things, a "knowing and culpable violation of law." *Id.* § 7.19(1). The *Principles of Corporate Governance* refers to such a statutory violation as a "regulatory offense" that does not carry "significant criminal penalties." *Id.* at cmt. f.

11. *See* RESTATEMENT (SECOND) OF AGENCY § 34 cmt. g (1958) (stating that if illegal conduct is customary, consent of the principal is implied); *cf. id.* § 411 cmt. c (stating that if both agent and principal know of illegality, neither indemnifies the other); 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 556 (Boston, Little, Brown & Co. 2d ed. 1886) (explaining that a director's liability to the corporation for violation of statute is based on agency law, which prohibits unauthorized acts).

12. *See* Stone v. Freeman, 82 N.E.2d 571, 572 (N.Y. 1948) (stating that courts should not "referee between thieves"); *see also* Smith v. Richmond, 70 S.W. 846, 849 (Ky. 1902) (explaining that a partner cannot recover unpaid bribes from another partner who kept the money); E.H. Schopler, Annotation, *Recovery of Money or Property Entrusted to Another for Illegal Purposes, but Not So Used*, 8 A.L.R. 2D 307 (1949) (considering the question "whether, as a matter of common law, money or property entrusted to another for an illegal purpose may be recovered back as long as it has not been so used, either wholly or in part").

13. RESTATEMENT (SECOND) OF AGENCY § 412(3) (1958); *cf. id.* § 412(2) (stating that an agent must account unless a very serious crime is involved).

shareholder who ratifies illegal conduct is still not barred from bringing a derivative suit against the board of directors.[14]

One need only glance at a newspaper to see that criminal wrongdoing by corporations is commonplace.[15] In fact, it might be said that there is no such thing as a corporation, or other business for that matter, in compliance with law; rather, there are only corporations (and businesses) out of compliance with the law to varying degrees. Despite that fact, there are no modern cases holding directors liable to shareholders for breaking the law.[16] There may be reasons why directors are innocent of most corporate criminal behavior,[17] but obviously there are times when they are not. Some explanation is needed for the absence of decided cases supporting the conventional wisdom.

It is the thesis of this article that while the traditional business judgment rule is not applied to shield directors from liability for intentional violation of law, the same result is reached indirectly through application of two other rules. The first rule is that a shareholder may

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14. See W.S.R., Annotation, *Laches as Affecting Right of Corporation or Its Stockholders to Relief Against Directors for Violation of Trust*, 10 A.L.R. 370 (1921) (explaining that it is well settled that the right to relief against a director of a private corporation for breach of trust may be barred by laches if not brought in a reasonable amount of time); *cf.* Runcie v. Corn Exch. Bank Trust Co., 6 N.Y.S.2d 616, 622 (Sup. Ct. 1938) (stating that shareholders cannot ratify illegal acts which are ultra vires in character).

15. *See* Andy Pasztor, *U.S. to Charge Litton Unit with Fraud*, WALL ST. J., Sept. 24, 1993, at A3 (reporting that more than sixty-five defense firms and individuals have been convicted of criminal conduct to date as a result of Operation Ill Wind); *see also Statement of the Commission Regarding Disclosure Obligations of Companies Affected by Government Defense Contract Procurement Inquiry*, 53 Fed. Reg. 29,226 (Aug. 3, 1988) (reminding companies of disclosure obligations in connection with defense contract procurement inquiry); ANDY PASZTOR, WHEN THE PENTAGON WAS FOR SALE (1995) (giving an account of Operation Ill Wind).

16. John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1173 (1977) (stating that there do not appear to be any modern cases imposing liability for deliberate law violation).

17. *See* RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING 45 (1994) (explaining that top managers have reason to be risk averse with respect to personal involvement in criminal conduct since the benefits go to firm and the penalties to the individual). There are certainly many instances where the board is not informed of criminal activity by subordinates who know that such behavior would not be tolerated. *See In re* Gutfreund, Exchange Act Release No. 31,554, 1992 SEC LEXIS 2939, at *49 (Dec. 3, 1992) (stating that supervisory personnel at Salomon Brothers, Inc., who had knowledge of illegal activities of employee Paul W. Mozer, should have considered reporting to the firm's Board of Directors that management was not taking corrective action). There are also undoubtedly corporate soldiers who believe with Admiral Poindexter that they are expected to engage in desired criminal activity without informing their superiors so as to provide an alibi for those superiors against later discovery. *Iran-Contra Investigation: Joint Hearings Before the House Select Committee to Investigate Covert Arms Transactions with Iran and the Senate Select Committee on Secret Military Assistance to Iran and the Nicaraguan Opposition*, 100th Cong., 1st Sess. 37 (1987) (reporting the testimony of John M. Poindexter where he announced, "I made a very deliberate decision not to ask the President so that I could insulate him from the decision and provide some future deniability for the President if it ever leaked out").

not bring a derivative suit for a past violation of law unless the corporation has been damaged, the so-called "net-loss" rule.[18] The second rule is that in a shareholder's derivative action, a pre-suit demand must generally be made on the board of directors, which may decide not to sue a director for past violations of law, and even if demand is excused, a special litigation committee of disinterested members of the board has authority to decide not to maintain such a suit.[19]

After reviewing the case law on director liability for violations of law and the net-loss rule,[20] the article will examine the impact of statutory provisions which prohibit insulating the director from, or indemnifying or insuring him against, such liability.[21] Finally, the article will examine two recent examples of corporate violation of law with a view to applying the rules in practice.[22]

II. THE CASE LAW DOCTRINAL UNDERPINNING

Any discussion of the cases in this area must begin with the same handful of New York cases, particularly *Roth v. Robertson*.[23] In *Roth*, the defendant Samuel L. Robertson was the majority shareholder[24] and manager of a family corporation, the S. L. Robertson Amusement Company, which ran an amusement park with a roller coaster at Niagara Falls.[25] The three members of the Board of Directors included Mr. Robertson, his brother, and his uncle.[26] A large part of the company's business was conducted on Sunday, when tourists visited the

18. *See infra* notes 91-103 and accompanying text (discussing the net-loss rule).

19. *See infra* notes 49-60, 244-45 and accompanying text (discussing requirements and limitations on shareholder derivative suits).

20. *See infra* notes 23-90 and accompanying text (reviewing the case law on director liability for violations of the law).

21. *See infra* notes 104-76 and accompanying text (examining the impact of statutory provisions that deal with director liability).

22. *See infra* notes 177-306 and accompanying text (examining two recent examples of corporate violation of law).

23. 118 N.Y.S. 351 (Sup. Ct. 1909); *see* Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974) (citing *Roth* for the proposition that even though committed to benefit the corporation, illegal acts may amount to a breach of fiduciary duty); 3 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1021-1022 n.4 (perm. ed. rev. vol. 1993 & Supp. 1995) (explaining that a director is liable for ultra vires or illegal acts); 2 SEYMOUR D. THOMPSON & JOSEPH W. THOMPSON, COMMENTARIES ON THE LAW OF CORPORATIONS 945 n.52 and accompanying text (3d ed. 1927) (citing *Roth* for the proposition that "there may be recovery for corporate moneys unlawfully paid to silence complaint against the conduct of business in violation of the law"); Coffee, *supra* note 16, at 1167-68, 1173 n.274, 1192-94; Ryan, *supra* note 3, at 449-50; Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 60 n.230 (1980) (describing *Roth* as a "relatively pure—and rare—expression of the interventionist style").

24. *Roth*, 118 N.Y.S. at 354.

25. *Id.* at 352.

26. *Id.* at 354.

Falls.[27] Threats were made by unspecified persons that unless money was paid, steps would be taken to close the business on the Sabbath as required by state law.[28] After consulting with his co-director Hofheins, who was also the company treasurer, Mr. Robertson paid $800 to buy the complainants' silence.[29] This payment was acquiesced in by the directors and even by the plaintiff minority shareholder Roth.[30] The court held that the payment was blackmail, and since it was not only ultra vires, that is, outside the powers of the corporation, but also morally wrong, *malum prohibitum* or *malum in se*, the plaintiff was not estopped to challenge it.[31] The court ordered the defendant Robertson to pay the sum of $800 back into the corporate treasury.[32] Demand on the corporation as a precondition to bringing this shareholder's derivative action was excused as unnecessary because Robertson controlled the corporation.[33]

As discussed above,[34] if the company had been a sole proprietorship or partnership, the suit would have been dismissed. The stated reason for a different decision in the case of a corporation was the then controlling doctrine of ultra vires, which appeared "as a guiding, or rather misleading principle in the legal system" in about the year 1845.[35]

The Sunday Blue Laws of New York were eventually declared unconstitutional, not on the frequently urged grounds that they violated the establishment of religion clause, but on grounds of vagueness and lack of a rational connection between the legislative purpose and the provisions of the statute, which contained many exceptions.[36] However, in 1909, the *Roth* court was quite correct in believing that the defendant's operations violated the New York statute.[37] The court also was correct in holding that, based on the prevailing doctrine at

27. *Id.* at 352.
28. *Id.*
29. *Id.*
30. *Id.* at 353-54.
31. *Id.* at 352-53.
32. *Id.* at 354.
33. *Id.*
34. *See supra* notes 11-13 and accompanying text (discussing the role of agency law in determining liability).
35. *See* BRICE, *supra* note 4, at vii, ix-x ("The doctrine of ultra vires is constantly cropping up in unexpected quarters, and manifesting its effects in an unforeseen and unwelcome manner."); *see generally* HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 240-69 (rev. ed. 1946) (discussing the "evils, quibbles and uncertainties of the pathological, ill-founded decisions on ultra vires").
36. People v. Abrahams, 353 N.E.2d 574, 579 (N.Y. 1976) (declaring the Sunday Blue Laws of New York unconstitutional).
37. *See* United Vaudeville Co. v. Zeller, 108 N.Y.S. 789 (Sup. Ct. 1908) (holding that movie theater violates statute); People v. Poole, 89 N.Y.S. 773 (Sup. Ct. 1904) (holding that baseball game violates statute).

that time, the plaintiff shareholder could not estop himself from suit, since while shareholders might generally ratify actions voidable as ultra vires,[38] even all of the shareholders together could not ratify an act made illegal by statute.[39] At the turn of the century, it is conceivable that the corporation might have lost its charter for violation of the Sabbath laws.[40]

There are at least three very troublesome aspects to the *Roth* decision. The first aspect is the statute itself, a prohibition taken from the Old Testament with a history of governmental enforcement spanning sixteen centuries as far back as the Roman Emperor Constantine in 321 A.D.[41] Criminalizing roller coaster rides on a Sunday afternoon smacks of questionable state interference with civil liberties and establishment of religion, even allowing for a possible difference in attitudes at the turn of the century. It is exactly the sort of law that seems bound to invite evasion and avoidance, corruption of public authorities and inconsistent enforcement.[42] The amusement park was, after all, operated openly in full view of the authorities, not the sort of clandestine activity usually made the subject of important criminal statutes.

The second problematic aspect of the *Roth* case is the plaintiff's unclean hands, which should have barred him from any relief in a court of equity. When it suited his convenience, the plaintiff approved and ratified the payment; then he changed his mind, apparently because of some falling out between him and the majority shareholder on unrelated matters referenced in the decision. The defendant Robertson concededly acted for the benefit of the corporation after con-

38. Wormser v. Metropolitan St. Ry., 76 N.E. 1036, 1038 (N.Y. 1906); Holmes v. Willard, 25 N.E. 1083, 1083-84 (N.Y. 1890); Kent v. Quicksilver Mining Co., 78 N.Y. 159 (1879).

39. Continental Sec. Co. v. Belmont, 99 N.E. 138, 142 (N.Y. 1912) (citing Kent v. Quicksilver Mining Co., 78 N.Y. 159 (1879)).

40. *Cf.* State *ex rel.* Pitts v. Nashville Baseball Club, 154 S.W. 1151 (Tenn. 1913) (reversing chancellor's decree dissolving the Club for violating the Sabbath by playing baseball because the Sabbath statute was not passed on three readings on three days in the state Senate as required by the state constitution). A corporation can still be judicially dissolved for illegal conduct. *See* People v. Oliver Sch., Inc., 619 N.Y.S.2d 911, 913 (App. Div. 1994) (affirming dissolution of corporation under New York statute which allows for dissolution on various grounds, including the "persistently fraudulent or illegal" conduct of business).

41. People v. Abrahams, 353 N.E.2d 574, 575 (N.Y. 1976) ("As a precept of civil government, however, the Sunday laws are over 16 centuries old having been originated by the Roman Emperor Constantine in 321 AD who ordered all Judges and inhabitants of cities to rest on Sunday.").

42. The ALI's *Principles of Corporate Governance* cites a Sunday Blue Law which has not been enforced for many years, does not have community support, and is ignored by many retail businesses as the type of law that can legitimately be violated without departing from the norm of compliance with law. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 2.01 cmt. g, illus. 9.

sultation with, and the approval of, his fellow directors. As expressed a century ago, the doctrine of ultra vires had become "a species of Frankenstein" which rode roughshod over all accepted doctrines of law and equity, including the doctrine of unclean hands.[43]

The third problem with the *Roth* case is the lack of harm to the corporation, which apparently benefitted from the payment and, as a result of the decision, was allowed to keep the benefit while not bearing any of the expense. From a moral perspective, the decision changed nothing except that the court made the majority shareholder bear the expense alone, while the supposedly objecting minority shareholder kept his *pro rata* share of the profits, enhanced by the lack of related expense. Insofar as the decision allows suit in the absence of injury to the corporation, it cannot be regarded as currently authoritative in light of subsequent cases adopting the New York "net-loss" rule.[44]

Roth was distinguished in a later New York case, *Hornstein v. Paramount Pictures, Inc.*[45] In *Hornstein*, the plaintiff shareholders brought a derivative suit on behalf of Paramount Pictures, Inc. to compel its directors and officers to repay $100,000 in bribes paid to two labor union officials who threatened to call a strike.[46] The New York Court of Appeals held that the victim of labor organization extortion does not violate the criminal law by paying the bribe.[47] The trial court distinguished *Roth* on the ground that the corporation in *Roth* operated in violation of the law.[48]

Roth also has not survived the advent of the special litigation committee in New York. In the famous case of *Auerbach v. Bennett*,[49] the directors and auditors of General Telephone & Electronics Corporation were sued in a shareholder's derivative action to recover more

43. BRICE, *supra* note 4, at ix-x. *Roth* was distinguished in Diamond v. Diamond, 107 N.Y.S.2d 508, 523 (Sup. Ct. 1951), *aff'd*, 121 N.Y.S.2d 280 (App. Div. 1953), *modified*, 120 N.E.2d 819 (N.Y. 1954) (which held that 50% shareholder cannot sue other 50% shareholder where both consented), on the grounds that in *Roth* there were other shareholders involved that were innocent; however, that fact does not appear in the *Roth* opinion.

44. *See infra* notes 91-103 and accompanying text (discussing the net-loss rule).

45. 37 N.Y.S.2d 404 (Sup. Ct. 1942), *aff'd*, 41 N.Y.S.2d 210 (App. Div. 1943), *appeal denied*, 43 N.Y.S.2d 751 (App. Div. 1943), *aff'd*, 55 N.E.2d 740 (N.Y. 1944) (per curiam).

46. *Id.* at 407.

47. 55 N.E.2d at 742.

48. *Hornstein*, 37 N.Y.S.2d at 413-14; *accord In re* Vaniman Int'l, Inc., 22 B.R. 166, 189-91 (E.D.N.Y. 1982) (concluding that the defendant directors were not liable for payment of $35,000 commercial bribe to procure $220,000 profit). The ALI's *Principles of Corporate Governance* does not agree. *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 2.01, illus. 7 (stating that the payment of solicited commercial bribe to obtain a contract is a violation of the principle of obedience to the law).

49. 393 N.E.2d 994 (N.Y. 1979).

than $11 million paid in bribes and kickbacks to public officials and political parties in foreign countries.[50] These payments had been made with the knowledge and personal involvement of at least four members of the corporation's Board of Directors, according to a report filed with the Securities and Exchange Commission by the board's audit committee.[51] The audit committee of the board of directors had conducted an investigation with the assistance of a special independent counsel and Arthur Andersen & Co., the corporation's outside auditors.[52]

After the commencement of the derivative action, the Board created a special litigation committee comprised of three newly appointed disinterested directors, which determined that the asserted claims lacked merit and that it would not be in the best interests of the corporation for the action to proceed.[53] A unanimous panel of the New York Supreme Court, Appellate Division, held that the decision of the special litigation committee could not foreclose a suit challenging acts of officers and directors which offended public policy, citing *Roth v. Robertson*.[54] The New York Court of Appeals reversed this decision and dismissed the complaint, holding that the decision of the special litigation committee, composed of disinterested directors, reached after a full inquiry and deliberation, was entitled to the protection of the business judgment rule.[55]

At least one commentator has suggested that the New York Court of Appeals would decide *Auerbach* differently today, in light of devel-

50. *Id.* at 996-97; *see also* Burks v. Lasker, 441 U.S. 471 (1979) (holding that federal courts will generally defer to state law on effect to be given decision of special litigation committee); Abbey v. Control Data Corp., 603 F.2d 724, 730 (8th Cir. 1979), *cert. denied*, 444 U.S. 1017 (1980) (dismissing derivative suit charging violations of criminal law in connection with corporation's guilty plea and $1.4 million in penalties; decision of independent board committee entitled to business judgment rule protection under pre-*Zapata* Delaware law); Gall v. Exxon Corp., 418 F. Supp. 508, 518 (S.D.N.Y. 1976) (holding that if committee is proved to be independent, decision not to sue for recovery of $59 million in illegal bribes and political payments made to Italian political parties and others is protected by business judgment rule under New Jersey law).

51. *Auerbach*, 393 N.E.2d at 996-97.

52. *Id.*

53. *Id.* at 997.

54. 408 N.Y.S.2d 83, 87 (App. Div. 1978), *modified*, 393 N.E.2d 994 (N.Y. 1979).

55. *Auerbach*, 393 N.E.2d at 1002-1004; *see also In re* General Tire and Rubber Co. Sec. Litig., 726 F.2d 1075, 1080-82 (6th Cir.), *cert. denied*, 469 U.S. 858 (1984) (stating that independent committee decision not to pursue remedies for improper and illegal conduct was entitled to respect under Ohio law; settlement of shareholder suits approved); Lewis v. Anderson, 615 F.2d 778, 780-83 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980) (applying *Burks* and *Auerbach* to give effect to special litigation committee decision under California law to dismiss derivative suit regarding new stock option plan); General Elec. Co. v. Rowe, No. 89-7644 1992 U.S. Dist. LEXIS 15036 (E.D. Pa. Sept. 30, 1992) (dismissing shareholder derivative suit, charging damages based on criminal conviction of the company under False Claims Act resulting in $10 million fines on basis of special litigation committee decision).

opments in the law such as the Supreme Court of Delaware's decision to allow the court to use its own business judgment in deciding whether to dismiss a derivative suit at the request of a special litigation committee.[56] Nonetheless, the New York Court of Appeals reaffirmed the *Auerbach* decision two years later,[57] and the Delaware Supreme Court brought its position closer to *Auerbach* four years later by holding that the court need not, but may, exercise its own business judgment.[58] Few courts have found it desirable to exercise their own business judgment after going through the first step of the Delaware procedure of finding committee independence and proper inquiry.[59] Even where a court has exercised its own contrary judgment, it has done so because of doubts as to committee independence and proper inquiry, so that the two steps tend to collapse into one.[60]

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56. Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981); *see* Ryan, *supra* note 3, at 461 n.191 (noting that New York was the earliest of the state law trilogy of special litigation committee cases, which included the highest courts of New York, Delaware, and North Carolina).

57. *See* Parkoff v. General Tel. & Elec. Corp., 425 N.E.2d 820, 822 (N.Y.), *reh'g denied*, 427 N.E.2d 1192 (N.Y. 1981) (dismissing shareholder's derivative suit charging illegal domestic bribes and political contributions on the grounds of *res judicata*); *see also* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979) (dismissing shareholder's action asserting that same actions violated state and federal law).

58. Kaplan v. Wyatt, 499 A.2d 1184, 1192 (Del. 1985). *Contra* Alford v. Shaw, 358 S.E.2d 323, 328 (N.C. 1987) (holding that the court *must* exercise its own business judgment). The North Carolina Supreme Court had some difficulty in reaching this decision since it had just reached the opposite conclusion one year earlier. Alford v. Shaw, 349 S.E.2d 41, 56 (N.C. 1986), *withdrawn after reh'g*, 358 S.E.2d 323 (N.C. 1987) (adopting *Auerbach* position); *cf.* Houle v. Low, 556 N.E.2d 51, 59 (Mass. 1990) (stating that independent committee decision if properly reached should be respected unless "contrary to the great weight of evidence"); *see generally* Charles W. Murdock, *Corporate Governance—The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 89-96 (1993) (analyzing judicial approaches to special litigation committees); Jay M. Zitter, Annotation, *Propriety of Termination of Properly Initiated Derivative Action by "Independent Committee" Appointed by Board of Directors Whose Actions (Or Inaction) Are Under Attack*, 22 A.L.R. 4TH 1206 (1983) (discussing various state and federal cases which have considered "the propriety of the termination of a derivative suit by the board of directors of a corporation pursuant to a decision by a committee . . . that further prosecution of the suit was not in the best interests of the corporation").

59. *See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 13.8 (1994) (explaining judicial deference in corporate arenas).

60. *See* Peller v. Southern Co., 911 F.2d 1532, 1538-39 (11th Cir. 1990) (rejecting the committee's decision, expressing doubts as to committee independence, good faith and proper evaluation of evidence); Johnson v. Hui, 811 F. Supp. 479, 490 (N.D. Cal. 1991) (finding no basis under Delaware law for the court's taking the "extraordinary step" of substituting its own business judgment for that of the committee); Lewis v. Fuqua, 502 A.2d 962, 966 (Del. Ch. 1985), *appeal denied*, 504 A.2d 571 (Del. 1986) (questioning certain committee members' independence); *cf.* Davidowitz v. Edelman, 583 N.Y.S.2d 340, 344 (Sup. Ct. 1992), *aff'd*, 612 N.Y.S.2d 882 (App. Div. 1994) (applying New York law to reject committee recommendation for lack of committee independence and lack of a "thorough and reasonable inquiry").

Another New York case frequently discussed in this area is *Abrams v. Allen*.[61] The National Labor Relations Board (NLRB) had charged Remington Rand, Inc. with refusal to bargain and other unfair labor practices in connection with a May 1935 strike at its New York facilities; the federal courts had issued an order in 1938 enforcing a prior NLRB order to cease and desist from such practices.[62] As a result, shareholders brought suit against the directors and officers of the company, charging that during the years 1934-1937, management dismantled corporate plants and curtailed production for the sole purpose of punishing striking employees and not for any legitimate business purpose.[63] The Supreme Court, Appellate Division had dismissed the complaint for failure to state a cause of action.[64] The court stated that the National Labor Relations Act had only become effective on July 5, 1935, and management therefore had the right to challenge the constitutionality of this new legislation, which was not affirmed by the United States Supreme Court until April of 1937.[65] James H. Rand, Jr., Remington's president, deliberately invited a judicial test of the requirement of bargaining with the union and consistently followed that course of action.[66]

New York's highest court reversed the dismissal in a four-to-three decision, stating that the directors' actions might "fall into one or more of the categories of acts for which directors are liable" to the corporation.[67] The categories enunciated were: (1) lack of due care; (2) waste of corporate assets; (3) willful conversion or misapplication of the company's goods; and (4) using the corporation's property for

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61. 74 N.E.2d 305 (N.Y.), *reh'g denied*, 75 N.E.2d 274 (N.Y. 1947). For a discussion of *Abrams*, see Miller v. AT&T, 507 F.2d 759, 762 (3d Cir. 1974); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 4.01 cmt. d; Coffee, *supra* note 16, at 1190-92; Ryan, *supra* note 3, at 450.

62. NLRB v. Remington Rand, Inc., 94 F.2d 862, 864-66, 874-75 (2d Cir.), *cert. denied*, 304 U.S. 576, *and cert. denied*, 304 U.S. 585 (1938); *see* M. L. Cross, Annotation, *Lockout or Removal of Place of Employment to Avoid Labor Difficulties or Punish Employees as Actionable Wrong*, 173 A.L.R. 674 (1948) (discussing *Abrams v. Allen* and officers and directors of a corporation's liability for damages for mismanagement of the corporation).

63. *Abrams*, 74 N.E.2d at 306.

64. 65 N.Y.S.2d 421 (App. Div. 1946) (per curiam), *rev'd*, 74 N.E.2d 305 (N.Y. 1947). An earlier complaint challenging the same action had been upheld in Leech v. Fuller, 19 N.Y.S.2d 98 (Sup. Ct. 1939), *aff'd*, 20 N.Y.S.2d 398 (App. Div.), *leave to appeal denied*, 20 N.Y.S.2d 666 (App. Div. 1940), presumably by a different panel of the Appellate Division.

65. 65 N.Y.S.2d at 422.

66. *Remington Rand*, 94 F.2d at 868. The ALI's *Principles of Corporate Governance* states explicitly that causing the corporation to disobey the law openly in order to test the validity or interpretation of a law would not be considered a violation of the corporation's duty of obedience to law or the director's duty of care. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 2.01 cmt. g, § 4.01 cmt. d.

67. *Abrams*, 74 N.E.2d at 306.

the doing of an unlawful or immoral act (citing several ultra *vires* decisions).[68] At trial, the plaintiffs apparently presented their case based solely on a lack of due care taken by the directors; thereafter, the court dismissed the complaint, holding that the directors' actions were entitled to protection under the business judgment rule.[69]

If anything, then, *Abrams* stands for the proposition that directors are *not* automatically liable for breaking the law, since the corporation in the case unquestionably broke the law with the knowledge of the Board. The *Abrams* case, like the *Roth* case, was relied upon by the Supreme Court, Appellate Division in *Auerbach*,[70] where it held that a special litigation committee could not dismiss a plaintiff shareholder's complaint charging unlawful bribes. This decision, one will recall, was reversed by the New York Court of Appeals;[71] therefore, the *Abrams* doctrine must be considered subservient to the power of the special litigation committee.

Even where the directors have caused the corporation to break the antitrust laws, resulting in a criminal conviction of the corporation and its directors, they are still not liable in a shareholder's derivative action for damage to the corporation where they did not know or have reason to know that their actions were unlawful.[72] Particularly where the directors have relied on the opinion of counsel as to the legality of a course of action, they are not liable for resulting damage to the cor-

68. *Id.* at 306-07 (citing the following three ultra vires cases: Berkey v. Third Ave. Ry., 155 N.E. 58, 59-61 (N.Y. 1926), *reh'g denied*, 155 N.E. 914 (N.Y. 1927) (refusing to find a parent liable for tort of subsidiary; alleged implied assignment of street railroad franchise from subsidiary to parent without state commission approval would be a criminal act, could not be ratified by shareholders, and will not be inferred); Continental Sec. Co. v. Belmont, 99 N.E. 138, 140-42 (N.Y. 1912) (holding that the plaintiff need not make demand on shareholders before bringing action to challenge issuance of $1.5 million of corporation's capital stock for grossly inadequate consideration and shareholders cannot ratify fraudulent or unlawful action of the board); Bath Gaslight Co. v. Claffy, 45 N.E. 390, 390-93 (N.Y. 1896) (holding that the lease of all its properties by gas corporation was ultra vires since made without legislative sanction, but plaintiff may recover against lessee and its sureties for rent during lessee's occupation of the premises since lease, while illegal and void involves no moral turpitude).

69. 113 N.Y.S.2d 181, 185, 190 (Sup. Ct. 1952).

70. Auerbach v. Bennett, 408 N.Y.S.2d 83, 87 (App. Div. 1978), *modified*, 393 N.E.2d 994 (N.Y. 1979); *see supra* notes 49-60 and accompanying text (discussing *Auerbach* in full).

71. 393 N.E.2d at 994.

72. *See* Simon v. Socony-Vacuum Oil Co., 38 N.Y.S.2d 270, 272-73 (Sup. Ct. 1942), *aff'd*, 47 N.Y.S.2d 589 (App. Div. 1944) (holding that directors were not liable for damages unless it can be shown that they acted "fraudulently, negligently, corruptly or in bad faith"); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 129-30 (1979) (explaining that the presumption against liability does not apply where actions "clearly contrary to law"); Harlan M. Blake, *The Shareholders' Role in Antitrust Enforcement*, 110 U. PA. L. REV. 143, 177 (1961) (arguing that director liability should be confined to situations where "there is no reasonable doubt as to the illegality of a proposed course of conduct").

poration unless their reliance was unreasonable.[73] There does not seem to be any question, however, that directors are and should be liable where they knowingly and unreasonably violate the law and cause damage to the corporation as a result.[74]

The third case in the asserted lineup of New York cases supporting the conventional wisdom[75] is actually a federal court decision purportedly applying New York law, *Miller v. AT&T*.[76] The *Miller* case was a

73. *See* Schwartz v. Romnes, 495 F.2d 844, 848 n.5 (2d Cir. 1974) (finding that even had there been a violation of law, the case must be remanded to determine directors' liability, if any at all); Spirt v. Bechtel, 232 F.2d 241, 246-48 (2d Cir. 1956) (holding that the officer of a corporation is not liable for injury to the corporation because the officer reasonably relied on the advice of legal counsel); *see generally* Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976) (discussing the evolution and boundaries of the reliance doctrine).

74. *See* Hill v. Murphy, 98 N.E. 781, 781-83 (Mass. 1912) (holding that judgment creditor of corporation entitled to enforce directors' liability to corporation for damages sustained by the corporation where directors maliciously and for personal reasons libeled plaintiff in the name of the corporation); *see also* Wilshire Oil Co. v. Riffe, 409 F.2d 1277, 1283-85 (10th Cir. 1969) (holding that corporation may recover amount of fine for antitrust violation against former employee whose misconduct caused the violation); Di Tomasso v. Loverro, 293 N.Y.S. 912, 917 (App. Div.), *aff'd*, 12 N.E.2d 570 (N.Y.), *reh'g denied*, 12 N.E.2d 601 (N.Y. 1937) (holding directors liable to corporation for loss caused by unlawful contract in which they had a personal interest); Knopfler v. Bohen, 225 N.Y.S.2d 609, 610 (App. Div. 1962) (determining complaint sufficient and demand excused where directors alleged to have damaged corporation by violating federal antitrust laws); Elizabeth T. Tsai, Annotation, *Right of Corporation to Indemnity for Civil or Criminal Liability Incurred by Employee's Violation of Antitrust Laws*, 37 A.L.R. 3D 1355, 1357 (1971) (discussing *Wilshire Oil Co. v. Riffe* in the context of the rule that right to indemnity depends on the employee's breach of fiduciary duty). However, it has been held that illegal acts directed at third parties, intended to benefit the corporation but the discovery of which instead causes damage to the corporation, do not give rise to a derivative shareholder's cause of action under the Racketeer Influenced and Corrupt Organizations (RICO) Act due to a lack of proximate cause. Mendelovitz v. Vosicky, 40 F.3d 182 (7th Cir. 1994); *In re* American Express Co. Shareholder Litig., 39 F.3d 395 (2d Cir. 1994); *In re* Teledyne Defense Contracting Derivative Litig., 849 F. Supp. 1369 (C.D. Cal. 1993).

75. For sources discussing the Third Circuit's holding in *Miller* that a plaintiff in a shareholder derivative action must prove the elements of the statutory violation as part of her claim, see PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 401 cmt. d; Coffee, *supra* note 16, at 1192-94; Ryan, *supra* note 3, at 451.

76. 507 F.2d 759 (3d Cir. 1974). AT&T was also sued in a shareholder's derivative action in federal court in New York for making a $50,000 contribution in support of a proposed New York state public transportation bond issue to be submitted for a referendum vote, allegedly in violation of state law prohibiting corporate payments for "political purposes." Schwartz v. Romnes, 495 F.2d 844 (2d Cir. 1974). The court dismissed the suit, saying that a non-partisan referendum was not a political purpose within the meaning of the statute, nor was the contribution in violation of the New York Public Service Law or otherwise ultra vires. *Id.* at 853-54; *see also* Marsili v. Pacific Gas & Elec. Co., 124 Cal. Rptr. 313 (Cal. Ct. App. 1975) (holding that the political contribution of $10,000 made by public utility to defeat nonpartisan initiative proposal was not ultra vires, gift or waste of corporate assets nor contrary to state public policy); Kristine C. Karnezis, Annotation, *Power of Corporation to Make Political Contribution or Expenditure Under State Law*, 79 A.L.R. 3D 491 (1977) (discussing the power of a corporation to make a political contribution under the corporation's own charter, general corporation laws, or state statutes); *cf.* Stern v. General Elec. Co., 837 F. Supp. 72, 79 (S.D.N.Y. 1993), *aff'd*, 23 F.3d 746

shareholder's derivative action brought against the directors of AT&T alleging that the Board refused to take action to collect a debt of about $1,500,000 for telephone and other communication services rendered to the Democratic National Committee during the 1968 Democratic National Convention.[77] The district court, noting that over $250,000 had been paid on the account since the commencement of the suit, applied the business judgment rule and dismissed the action for failure to state a claim.[78] The Third Circuit Court of Appeals reversed and remanded the lower court's decision, citing both *Roth* and *Abrams*[79] for the proposition that the business judgment rule could not insulate the directors from their alleged contribution to the Democratic National Committee in violation of a federal prohibition on corporate campaign spending.[80]

On remand, the district court dismissed the action for lack of personal jurisdiction over any of the defendant directors, and the Third Circuit affirmed without opinion.[81] Since the *Miller* court purportedly applied New York law and followed *Roth* and *Abrams*, the case does not add anything to the force of those two decisions; however, in *Miller*, the allegedly illegal conduct had not yet been completed when the plaintiff filed suit for damages, since the debt could still be collected.

In *Cramer v. General Telephone & Electronics Corp.*,[82] the same court that decided *Miller* dismissed a shareholder's derivative action alleging fraud on the part of the corporation in the purchase and sale

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(2d Cir.) (per curiam), *cert. denied*, 115 S. Ct. 293 (1994) (finding no waste of corporate assets in corporate expenditures for political action committee).

77. *Miller*, 507 F.2d at 761.

78. 364 F. Supp. 648 (E.D. Pa. 1973), *rev'd*, 507 F.2d 759 (3d Cir. 1974).

79. *Miller*, 507 F.2d at 762-63.

80. *Id.* at 763. The United States Supreme Court later held that corporate shareholders were not entitled to bring an implied cause of action under the statute. Cort v. Ash, 422 U.S. 66 (1975) (dismissing suit by shareholders of Bethlehem Steel based on a corporate advertising campaign in connection with the 1972 Presidential election). However, the decision in *Cort* cited *Miller* for the proposition that a remedy might be available under state law for breach of fiduciary duty in addition to the doctrine of ultra vires. *Id.* at 72-74 & 74 n.6, 84.

It should be noted that the time between the District Court and the Court of Appeals decisions in *Miller* was a time of unprecedented national upheaval. The Office of the Watergate Special Prosecutor had uncovered evidence of use of corporate funds for illegal domestic political contributions, which had caused the Securities and Exchange Commission to publish a statement concerning disclosure of such payments in documents filed with the Commission. Disclosures Relating to the Making of Illegal Campaign Contributions, Securities Act Rel. No. 5466 [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,669, at 83,873 (Mar. 8, 1974). Richard M. Nixon resigned as President of the United States on August 8, 1974. The Court of Appeals could not have been unaffected by these momentous developments.

81. 394 F. Supp. 58 (E.D. Pa. 1975), *aff'd*, 530 F.2d 964 (3d Cir. 1976).

82. 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

of securities.[83] The suit was based on the GT&E Audit Committee report that had been the subject of the New York state court action in *Auerbach v. Bennett*.[84] The court did not reach the question whether the Special Litigation Committee's finding that the suit was not in the best interests of the corporation would bar the action.[85] However, the court did dismiss the action for failure to comply with the requirement that a demand must first be made on the Board of Directors in the absence of adequate excuse.[86] The court distinguished *Miller* on the basis that the plaintiffs in that case alleged that the directors' decision not to collect the debt was itself an illegal act.[87] This same distinction has been made in other suits, namely that the directors' decision not to pursue corporate remedies for completed illegal action by other directors is not in itself illegal, immoral or ultra vires; therefore, such conduct does not amount to ratification of fraud.[88]

It should be further noted that the *Miller* court held that under New York law, the plaintiff could not state a cause of action simply by alleging breach of a federal statute without also alleging that the breach caused independent damage to the corporation.[89] This aspect of the problem is known as the "net loss" rule.[90]

III. THE NEW YORK NET LOSS RULE

The *Miller* court was quite right in holding that the New York cases required proof of damage to the corporation to support a shareholder's derivative action alleging violation of law by one or more directors.[91] This requirement was made clear in several lower court New York decisions.[92] The *Miller* court suggests that *Runcie v. Bank-*

83. *Id.* at 270-77.

84. *Id.* at 264-65. *See supra* notes 49-60 and accompanying text (explaining the factual and procedural history of *Auerbach v. Bennett*).

85. *Id.* at 276.

86. *Id.* at 276-77.

87. *Id.* at 274.

88. *See* Gall v. Exxon Corp., 418 F. Supp. 508, 518 (S.D.N.Y. 1976) (holding that a decision not to bring suit for past illegal conduct is not itself a violation of law); *cf.* S. Solomont & Sons Trust, Inc. v. New England Theatres Operating Corp., 93 N.E.2d 241, 248 (Mass. 1950) (holding that a pre-suit demand on the corporation is required even where the acts complained of are ultra vires or otherwise illegal).

89. 507 F.2d 759, 763 n.5 (3d Cir. 1974).

90. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.18 cmt. e.

91. *Miller*, 507 F.2d at 763 n.5.

92. For decisions dismissing shareholders' derivative actions for failure to adequately plead violation of the federal antitrust laws or injury to the corporation, see Diamond v. Davis, 31 N.Y.S.2d 582, 583-84 (N.Y. App. Div. 1941); Borden v. Cohen, 231 N.Y.S.2d 902, 903 (N.Y. Sup. Ct. 1962); *see also* Spinella v. Heights Ice Corp., 62 N.Y.S.2d 263 (N.Y. Sup. Ct. 1946) (dismissing complaint since damages cannot be presumed merely from imposition of antitrust fine); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.18 n.7 (citing several New York cases that

ers Trust Co.[93] contradicts this rule, but *Runcie* holds only that directors cannot continue to violate a mandatory statute requiring fidelity bonds on bank employees to be written by domestic insurance companies by asserting that it is cheaper to obtain such bonds from a foreign underwriter such as Lloyd's of London.[94] This case involved a continuing illegal course of conduct rather than a completed one. In the related case of *Runcie v. Corn Exchange Bank Trust Co.*,[95] the court held that since the bank had ceased to accept Lloyd's policies, an affirmative defense that the corporation had not only suffered no damages but had benefitted financially was sufficient in law and would not be stricken in a suit for violation of the same statute.[96]

The ALI's Principles of Corporate Governance suggests that the decision by the New York Court of Appeals in *Diamond v. Oreamuno*[97] cast doubt on the New York net loss rule.[98] That is not at all true. *Diamond* was a shareholder's derivative suit intended to hold the chairman of the board and the president liable to the corporation for losses they avoided by selling shares of the corporation's stock based on undisclosed knowledge of a seventy-five percent decrease in corporate earnings.[99] The court of appeals held that the complaint stated a valid cause of action for recovery of the proceeds derived from a misuse of confidential corporate information, even though the corporation had not been injured.[100] The court cited the Restatement (Second) of Agency as authority.[101] This case illustrates the general rule that where an agent has profited from a breach of his fiduciary

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required the plaintiff to prove that the damages from the illegal activity exceeded any profits); *cf.* Citron v. Merritt-Chapman & Scott Corp., 407 A.2d 1040, 1045 (Del. 1979) (finding that convictions of perjury and willful filing of false SEC report are not grounds for forfeiture of compensation of chief executive officer and director where illegal actions benefitted the corporation).

93. 6 N.Y.S.2d 623 (Sup. Ct. 1938); *see Miller*, 507 F.2d at 763 n.5 (distinguishing *Runcie* from the New York rule that an alleged breach of a federal statute is insufficient to state a cause of action absent independent damage to the corporation).

94. 6 N.Y.S.2d at 624.

95. 6 N.Y.S.2d 616 (Sup. Ct. 1938).

96. *Id.* at 621.

97. 248 N.E.2d 910 (N.Y. 1969).

98. *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.18 cmt. e (discussing *Diamond*'s impact on the net-loss rule); *see also* Ryan, *supra* note 3, at 456 (arguing that the net-loss rule may have been undermined by *Diamond*).

99. 248 N.E.2d at 911.

100. *Id.* at 912.

101. *Id.* at 914; *see* RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958) (explaining that an agent who sells securities based on inside information holds the profits in constructive trust for the principal).

duty, injury to the principal is not required for recovery.[102] This rule does not apply to the situation where the agent has not profited.

The Principles of Corporate Governance proposes to change the net loss rule in three ways: (1) by prohibiting the court from offsetting losses from one transaction against profits from other identical but separate transactions; (2) by allowing the court to refuse to offset profits that it finds contrary to public policy; and (3) by placing on the defendant the burden of proving profits.[103] There is no justification for any of these changes. The courts should have the authority to decide in a particular case whether or not a corporation has suffered damages as a result of an illegal course of conduct.

IV. STATE STATUTES LIMITING DIRECTOR LIABILITY TO CORPORATION

In the aftermath of the controversial 1985 decision of the Delaware Supreme Court in *Smith v. Van Gorkom*,[104] many states revised their corporation statutes to protect corporate directors against personal liability to the corporation and its shareholders (and creditors, in some instances) for violation of the duty of care.[105]

Most of these new corporate statutes contain exceptions for certain types of conduct for which a director is not immune from suit.[106] For example, the Delaware statute does not allow director immunity from a suit for damages arising from, among other things, "acts or omissions not in good faith or which involve intentional misconduct or a

102. *See id.* § 389 cmt. c (stating that harm to principal is not required); *see also* Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 278 (2d Cir. 1975) (distinguishing *Diamond* in suit where defendants were not fiduciaries); *In re* Symbol Technologies Sec. Litig., 762 F. Supp. 510, 517-18 (E.D.N.Y. 1991) (explaining reasoning behind *Diamond* decision); Excelsior 57th Corp. v. Lerner, 553 N.Y.S.2d 763, 764-65 (N.Y. App. Div. 1990) (citing *Diamond* for proposition that damages to plaintiff are not required for disgorgement of proceeds of fiduciary self-dealing and conflict of interest).

103. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.18(c), cmt. e.

104. *See* 488 A.2d 858 (Del. 1985) (holding directors personally liable for approving cashout merger without adequate consideration).

105. *See* 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS, ch. 16 (5th ed. 1993) (discussing state statutes). This concern for insulating business managers from duty of care litigation has also been incorporated into statutes governing other forms of business organizations, such as the partnership and the limited liability company, in order to give greater protection to owners and managers. *See* UNIF. LTD LIAB. CO. ACT § 409(c) & (h) (NCCUSL Draft Mar. 8, 1995) (explaining that members and managers owe a duty of care to refrain from "engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law"); UNIF. PARTNERSHIP ACT § 404(c) (1994) (stating that members of the partnership owe a duty of care to refrain from "engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law").

106. 2 KNEPPER & BAILEY, *supra* note 105.

knowing violation of law."[107] The New York statute similarly contains an exception to immunity for acts or omissions which were "in bad faith or involved intentional misconduct or a knowing violation of law."[108] These statutes do not distinguish between violations of civil law, as by a breach of contract, and violations of criminal law, although some state statutes do exclude only violations of criminal law.[109] The American Bar Association's Committee on Corporate Laws, in its most recent formulation of the Revised Model Business Corporation Act, provides an exclusion for "an intentional violation of criminal law," and the Official Comment makes clear that "intentional" means a specific intent to violate the criminal law.[110]

Other statutory exclusions, as in California, have been phrased to withhold immunity for "acts or omissions that involve intentional misconduct or a knowing *and culpable* violation of law."[111] The Principles of Corporate Governance endorses this language, defining "culpable" as "morally reprehensible under generally prevailing stan-

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107. DEL. CODE ANN. tit. 8, § 102(b)(7)(ii) (Supp. 1994). The statute also excludes liability for improper dividends or stock repurchases, breach of the duty of loyalty, or receipt of an improper personal benefit. *Id.* § 102(b)(7). The Delaware Supreme Court recently construed the statute to allow immunity from suit for breach of the fiduciary duty of candor in disclosing material facts to shareholders in connection with a merger. Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1287 (Del. 1994) (en banc). The *Arnold* decision impliedly overrules the contrary holding of Zirn v. VLI Corp., 621 A.2d 773, 783 (Del. 1993). *See* 2 KNEPPER & BAILEY, *supra* note 105, at 7 (explaining that the *Zirn* court held that the Delaware statute did not shield the directors from liability for fraud). Two of the justices on the *Zirn* court, Justices Moore and Horsey, no longer sit on the Delaware Supreme Court. Richard B. Schitt, *Delaware Supreme Court Justice Could be Denied a Second Term*, WALL ST. J., May 12, 1994, at B10. For an explanation of the Delaware statute, see E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399 (1987).

108. N.Y. BUS. CORP. LAW § 402(b)(1) (McKinney Supp. 1995).

109. For statutes excluding violations of criminal law unless the director had reasonable cause to believe his conduct was lawful or no reasonable cause to believe it was unlawful, see, e.g., FLA. STAT. ANN. § 607.0831(1)(b)(1) (West 1993); WIS. STAT. ANN. § 180.0828(1)(b) (West 1992). The analogous Virginia provision excludes "willful misconduct or a knowing violation of the criminal law or of any federal or state securities law, including, without limitation, any claim of unlawful insider trading or manipulation of the market for any security." VA. CODE ANN. § 13.1-692.1 (Michie 1993). This exception proved the undoing for the director defendants in Sandberg v. Virginia Bankshares, Inc., 979 F.2d 332, 343 (4th Cir. 1992), *vacated*, No. 91-1873(L), 1993 U.S. App. LEXIS 33286 (4th Cir. Apr. 7, 1993) (holding directors liable for damages of over $12.2 million for knowing violation of the securities law). The case was settled on March 12, 1993. Norwood P. Beveridge, Jr., *Director Liability: Recent Developments*, 47 CONSUMER FIN. L. Q. REP. 220 (1993).

110. REVISED MODEL BUS. CORP. ACT § 2.02(b)(4)(D), cmt. 3(i) (1990).

111. CAL. CORP. CODE § 204(a)(10)(A)(i) (West 1990) (emphasis added). The Connecticut statute permits limitation of a director's liability to his compensation during the year in question, except, among other things, for "knowing and culpable violation of law by the director." CONN. GEN. STAT. ANN. § 33-290(c)(2)(A) (West Supp. 1995).

dards."[112] Under this formulation, a knowing violation of even a criminal law does not necessarily need to be "culpable," and a life-threatening violation of a civil law might be "culpable" even if not considered criminal.[113]

For present purposes, these director exculpatory statutes have considerable significance, since it is obviously undesirable to have any conflict between desired conduct by the director and immunity from suit. Thus, for example, a director should not be entitled to statutory immunity for an intentional and unreasonable violation of law causing damage to the corporation, and none of these statutes provide such immunity. Note that these statutes should not be read to imply that a director will necessarily be held liable in damages for a knowing violation, only that he may be sued for such a violation. The statutes only insulate a director from suits for damages, so that a suit for injunction or other equitable relief is still possible.[114] Therefore, director violation of law, whether civil or criminal and whether knowing or unintentional, can still presumably subject the director to a shareholder's suit for an injunction against continued violations.

V. STATE STATUTES ON CORPORATE INDEMNIFICATION OF DIRECTORS

State statutes which provide for indemnification of directors against liability arising from their status as directors also provide exceptions for certain types of conduct which will bar indemnification.[115] Again, it is undesirable to have any basic conflict between desired conduct by the director and the statutory right of indemnification, although it is recognized that in some circumstances a director may be indemnified for conduct constituting a breach of duty.[116] However, a director should not be indemnified, for example, against the consequences of

112. *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.10(a)(1)-(2), cmt. f(i) (withholding business judgment rule protection from a board or committee decision to seek dismissal of a shareholder derivative suit charging such a violation); *id.* § 7.19(1), cmt. f (withholding protection of charter provision shielding director from liability for such violation).

113. *Id.* § 7.19(1), cmt. f.

114. *See, e.g.*, CAL. CORP. CODE § 309(c) (West 1990) (providing that a company's articles of incorporation can only limit director liability for monetary damages).

115. *See generally* 2 KNEPPER & BAILEY, *supra* note 105, § 22 (discussing indemnification in various contexts).

116. *See* REVISED MODEL BUS. CORP. ACT § 8.50, at 8-291 (1990) (providing that a director acting in good faith and with a reasonable belief that his conduct was in the best interests of the corporation may be indemnified even if his conduct was a violation of a statutory or common law duty); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, § 7.20(a)(1), cmt. e (stating that a director acting in good faith and with a reasonable belief that the conduct was in the best interest of the corporation may be indemnified even if his conduct was a violation of a statutory or common law duty); *cf.* CAL. CORP. CODE §§ 204(a)(11), 317(g) (West 1990) (dictating that a

intentional and unreasonable violation of law which causes damage to the corporation.

These state statutes generally divide indemnification into two categories, permissive and mandatory.[117] Permissive indemnification authorizes, but does not require, the corporation to indemnify the director against certain liability, thereby removing questions present at corporate common law about the corporation's authority to indemnify.[118] Typically, permissive indemnification provisions are further divided into two categories: (1) suits brought by or on behalf of the corporation against the director; and (2) suits brought by third parties, public or private.[119] Mandatory indemnification requires the corporation to indemnify the director against certain liability, typically where the director has been successful in his defense against the asserted liability.[120] Further, most statutes provide that the statutory provisions are nonexclusive of other rights which the director may have to indemnification by contract or otherwise.[121] Finally, most statutes provide for corporate advancement of expenses if the director agrees to repay in the event he is ultimately held not to be entitled to indemnification.[122]

Significantly, all of these statutes provide in some fashion for exclusion of a right to indemnity for conduct that violates the law, particularly the criminal law.[123] Taking the Delaware statute as an example, in suits by or in the right of the corporation, the director may be indemnified against expenses (including attorneys' fees but not includ-

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corporation may not indemnify a director for breach of duty to the corporation for acts which cannot be included in the certificate of incorporation's director immunity provisions).

117. 2 KNEPPER & BAILEY, *supra* note 105, § 22-3. However, the New York statute makes permissive indemnification available to directors even where the corporation refuses to grant any indemnification unless, prior to the act in question, a corporate standard exists prohibiting or limiting indemnification in general. N.Y. BUS. CORP. LAW §§ 724, 725(b)(2) (McKinney Supp. 1995); *see* Sequa Corp. v. Gelmin, 828 F. Supp. 203, 207 (S.D.N.Y. 1993) (holding that a former officer sued for RICO violation by corporation was entitled to advance of expenses even though the board refused advance and made findings of lack of good faith and reasonable belief).

118. 2 KNEPPER & BAILEY, *supra* note 105, § 22-1.

119. *Id.* §§ 22-7, 22-8.

120. *Id.* § 22-11.

121. *Id.* § 22-13.

122. *Id.* § 22-14.

123. One New York court denied indemnification to a corporate officer who had settled a sexual harassment suit by a female employee, finding an absence of good faith or reasonable belief that the officer's actions were in the best interests of the corporation. Kaufman v. CBS, Inc., 514 N.Y.S.2d 620 (N.Y. Civ. Ct. 1987). However, the court then transferred the action to the New York State Supreme Court for lack of subject matter jurisdiction. *Id.* at 621; *see generally* Pamela H. Bucy, *Indemnification of Corporate Executives Who Have Been Convicted of Crimes: An Assessment and Proposal*, 24 IND. L. REV. 279 (1991) (surveying statutes and cases dealing with indemnification of officers for criminal convictions).

ing amounts paid in settlement) actually and reasonably incurred by him in the defense or settlement of the action "if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation."[124] The inquiry into the director's good faith and reasonable belief is made by: (1) a majority of the disinterested directors, even if less than a quorum; (2) independent legal counsel in a written opinion; or (3) the stockholders.[125] If the director is adjudged liable to the corporation, indemnification for expenses (but not the amount of the judgment) may be made only pursuant to a determination by the court that the director is "fairly and reasonably entitled to indemnity" despite the adjudication.[126] Finally, if the director is successful "on the merits or otherwise" in defense of the action, he is entitled to indemnification as a matter of right.[127]

In the case of any action other than one by or in the right of the corporation, the director can be indemnified against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement if he acted in good faith and in a manner he reasonably believed to be

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124. DEL. CODE ANN. tit. 8, § 145(b) (1991); *see also* N.Y. BUS. CORP. LAW § 722(c) (McKinney Supp. 1995) (providing that a director may be entitled to indemnity if, in good faith, he reasonably believed his conduct to be in, or in the case of requested service with another company, not opposed to, the best interests of the corporation); *cf.* CAL. CORP. CODE § 317(c) (West 1990) (allowing indemnification if the person "acted in good faith, in a manner the person believed to be in the best interests of the corporation and its shareholders"). Both the New York and California statutes apparently allow indemnification of expenses and amounts paid in settlement, but only with the approval of the court in which the action was brought. *See* CAL. CORP. CODE § 317(c) (West 1990) (allowing indemnification of settlement awards with court approval); N.Y. BUS. CORP. LAW § 722(c) (McKinney Supp. 1995) (indemnification of settlement awards permissible only with court approval). For a discussion of the California statute, see HAROLD MARSH, JR., MARSH'S CALIFORNIA CORPORATION LAW § 10.44 (3d ed. 1990).

125. DEL. CODE ANN. tit. 8, § 145(d) (Supp. 1994); *cf.* CAL. CORP. CODE § 317(e) (West 1990) (stating that determination is made by a majority of a quorum of disinterested directors, or if such is not available, then by independent counsel in a written opinion, or by disinterested shareholders, or by the court where the proceeding is pending). In New York, no indemnification may be made except by a court in the case of settlement or loss of a suit or threatened suit by or in the right of the corporation. N.Y. BUS. CORP. LAW § 722(c) (McKinney Supp. 1995); WHITE ON NEW YORK CORPORATIONS, BUSINESS CORPORATION LAW ¶ 722.05 (Isidore Kantrowitz & Sol Slutsky, eds., 13th ed. 1995).

126. DEL. CODE ANN. tit. 8, § 145(b) (Supp. 1991); *see* Yiannatsis v. Stephanis by Sterianou, 653 A.2d 275, 280-81 (Del. 1995) (holding that a director who usurped corporate opportunity was not fairly and reasonably entitled to indemnity); *see also* 2 KNEPPER & BAILEY, *supra* note 105, § 22-10 (discussing court-approved indemnification when director found liable and parties reach settlement). For statutes stating that a director adjudged to be liable can only receive indemnification if the court determines that he is fairly and reasonably entitled to it, see N.Y. BUS. CORP. LAW § 722(c) (McKinney Supp. 1995); CAL. CORP. CODE § 317(c)(1) (West 1990).

127. DEL. CODE ANN. tit. 8, § 145(c) (1991); *see also* CAL. CORP. CODE § 317(d) (West 1990) (awarding indemnification only when success "on the merits"); N.Y. BUS. CORP. LAW § 723(a) (McKinney Supp. 1995) (granting indemnification when success on the merits or otherwise).

in or not opposed to the best interests of the corporation.[128] An adverse judgment in the action does not create any presumption that the director failed to act in good faith or with such reasonable belief.[129] In the case of a criminal action, the director also must have "had no reasonable cause to believe his conduct was unlawful;" however, a conviction does not create any presumption that he had such reasonable cause.[130] As with settlement of a suit by or on behalf of the corporation, the director's eligibility for indemnification in the loss or settlement of a third-party suit is determined by a majority of the independent directors, independent counsel, or the shareholders;[131]

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128. DEL. CODE ANN. tit. 8, § 145(a) (1991); *see* Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 344 (Del. 1983) (holding that former directors were entitled to indemnification for expenses incurred during proxy contest litigation in which they were plaintiffs). *But see* Shearin v. E.F. Hutton Group, Inc., 652 A.2d 578, 593-95 (Del. Ch. 1994) (finding that a corporate officer who was a plaintiff in an unsuccessful RICO suit against the corporation was not entitled to indemnification since the suit was not brought in her official capacity to benefit the corporation). In New York, as in the case of actions by or on behalf of the corporation, the director may be indemnified if he reasonably believed his acts were in, or in the case of requested service with another company, not opposed to, the best interests of the corporation. N.Y. BUS. CORP. L. § 722(a) (McKinney Supp. 1995). In California, as in actions by or on behalf of the corporation, the director may be indemnified if he acted in good faith and with a reasonable belief that the action served the best interests of the corporation. CAL. CORP. CODE § 317(b) (West 1990).

129. DEL. CODE ANN. tit. 8, § 145(a) (1991). For analogous statutes in other jurisdictions, see, e.g., CAL. CORP. CODE § 317(b) (West 1990); N.Y. BUS. CORP. L. § 722(b) (McKinney Supp. 1995). In Plate v. Sun-Diamond Growers, 275 Cal. Rptr. 667 (Cal. Ct. App. 1990), the court held that an employee found liable for inducing the corporation to terminate its contract with the plaintiff so that the corporation could enter into a similar agreement with him committed intentional wrongdoing precluding a finding of good faith which would have entitled the employee to statutory indemnity. *Id.* at 673.

130. DEL. CODE ANN. tit. 8, § 145(a) (1991). For analogous corporate statutes in other jurisdictions, see, e.g., CAL. CORP. CODE § 317(b) (West 1990); N.Y. BUS. CORP. L. §§ 722(a)-(b) (McKinney Supp. 1995). In Associated Milk Producers, Inc. v. Parr, 528 F. Supp. 7 (E.D. Ark. 1979), a case arising under Kansas law, the plaintiff was an officer of the defendant corporation who had been convicted, upon a plea of guilty, of using corporate funds to make unlawful contributions to campaigns for federal office. *Id.* at 7. The plaintiff sued to be indemnified for the fines, legal fees and expenses he incurred as a result of the criminal litigation. *Id.* The court found that the plaintiff reasonably believed the contributions to be in the best interests of the corporation, and that they had been made with the knowledge and acquiescence of the board of directors. *Id.* at 8. Nevertheless, the court held that plaintiff had no reason to doubt that the payments were unlawful and, therefore, he could not establish the good faith necessary for indemnity. *Id.*; *cf.* Cambridge Fund, Inc. v. Abella, 501 F. Supp. 598, 617-18 (S.D.N.Y. 1980) (holding that an SEC consent decree reciting findings of willful securities law violations did not constitute an adjudication of wrongdoing which would bar indemnification); Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 141-43 (Del. Super. Ct. 1974) (holding that a conviction, based on pleas of *nolo contendere*, to perjury and filing false documents with the SEC constituted adjudication of wrongdoing which barred mandatory indemnification, but permitting indemnification for other charges which were dropped).

131. DEL. CODE ANN. tit. 8, § 145(d) (Supp. 1994). In California, this determination is made first by a majority of a quorum of disinterested directors, or if not available, by independent counsel in a written opinion, the disinterested shareholders, or the court where the action is pending. CAL. CORP. CODE § 317(e) (West 1990). Under New York law, unlike in the case of

his right to indemnity is absolute in the event of a successful defense.[132]

The question often arises as to what constitutes a successful defense "on the merits or otherwise." Generally, any successful defense, in whole or in part (in which case fees are prorated), has been held to qualify, such as where the government withdraws certain counts of an indictment in return for a *nolo contendere* plea on another count.[133] However, a dismissal without prejudice because identical litigation is pending elsewhere does not constitute success on the merits or otherwise.[134] Where a case is settled and dismissed with prejudice without

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loss or settlement of a suit by or on behalf of the corporation, the determination in third-party suits may be made by a quorum of independent directors, the board upon the opinion of independent counsel, or the shareholders. N.Y. BUS. CORP. L. § 723(b) (McKinney Supp. 1995). However, the Supreme Court may award permissive indemnification to a director or officer acting in good faith and with a reasonable belief despite the refusal of the corporation or a contrary determination by the board or the shareholders, unless such indemnification is prohibited by a corporate standard in effect at the time of the director's actions. *Id.* §§ 724-725(b)(2) (McKinney Supp. 1995).

132. DEL. CODE ANN. tit. 8, § 145(c) (1991); *see also* CAL. CORP. CODE § 317(d) (West 1990) (providing for mandatory indemnification only upon a successful defense on the merits); N.Y. BUS. CORP. L. § 723(a) (McKinney Supp. 1995) (providing for mandatory indemnification for a successful defense on the merits or otherwise). In Green v. Westcap Corp., 492 A.2d 260 (Del. Super. Ct. 1985), the plaintiff, former chief financial officer of the defendant corporation, had been acquitted of criminal charges that he defrauded a lender to the corporation by supplying false financial statements. *Id.* at 262. The court ruled that since plaintiff had been successful in his defense, he did not have to establish good faith or reasonable belief, although affirmative defenses of laches, estoppel and waiver remained to be tried. *Id.* at 265; *see also* McLean v. International Harvester Co., 902 F.2d 372, 374-76 (5th Cir. 1990) (holding that a former corporate officer was entitled under Delaware law to legal fees for his successful *pro se* defense of a criminal charge alleging violation of the Foreign Corrupt Practices Act where adequate counsel was not provided by the corporation); Stewart v. Continental Copper & Steel Indus., 414 N.Y.S.2d 910, 915-16 (N.Y. App. Div. 1979) (finding that a former president who was the target of investigation but not indicted was entitled under Delaware law to mandatory indemnification related to his testimony before grand jury); *cf.* American Nat'l Bank & Trust Co. v. Schigur, 148 Cal. Rptr. 116, 117-18 (Cal. App. Ct. 1978) (denying mandatory indemnity where no determination was made that the corporate officer's defense was meritorious); People v. Uran Mine Corp., 216 N.Y.S.2d 985, 991 (N.Y. App. 1961) (denying indemnification for a successful defense where the defendant failed to prove good faith conduct).

133. Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 140 (Del. Super. Ct. 1974). *But see* Merritt-Chapman & Scott Corp. v. Wolfson, 264 A.2d 358 (Del. Super. Ct. 1970) (finding director unsuccessful in gaining indemnification where conspiracy count modified by dismissing securities fraud charge); *see also* MCI Telecommunications Corp. v. Wanzer, Nos. 89C-MR-216, 89C-SE-26, 1990 Del. Super. LEXIS 222 (Del. Super. Ct. June 19, 1990) (awarding mandatory indemnification where ex-employee successfully defended three counts of a civil complaint yet failed to successfully defend the fourth count for breach of fiduciary duty); Dornan v. Humphrey, 106 N.Y.S.2d 142 (N.Y. App. Div. 1951), *modified other grounds*, 112 N.Y.S.2d 585 (N.Y. App. Div. 1952) (dismissing action because statute of limitations bar constitutes a successful defense for purposes of indemnification); Tichner v. Andrews, 85 N.Y.S.2d 760 (N.Y. Sup. Ct. 1949), *appeal dismissed*, 90 N.Y.S.2d 920 (N.Y. App. Div. 1949) (dismissal for failure to post security for costs constitutes a successful defense for purposes of indemnification).

134. Galdi v. Berg, 359 F. Supp. 698, 701-02 (D. Del. 1973).

any payment by one of several defendants, that defendant may claim that he has been successful for purposes of indemnification.[135] However, in *Waltuch v. ContiCommodity Services*,[136] where a corporation paid $37 million to settle charges of fraud allegedly due to the plaintiff employee's unlawful trades in the silver market, the court held that the plaintiff had not been successful and, therefore, was not entitled to indemnification for $2.3 million in legal expenses, even though he had been released from liability without payment as a co-defendant.[137]

The Delaware statute also provides that its terms are not exclusive of any other rights to indemnification under contract or otherwise.[138] Finally, the statute provides that a corporation may advance funds to a director who undertakes to repay the advance if the court ultimately decides that he is not entitled to indemnification.[139] The right to advances is independent of the right to indemnification, since advances must be made if agreed to by contract regardless of the ultimate right to indemnification.[140] Conversely, even if the corporate bylaws pro-

135. B & B Inv. Club v. Kleinert's, Inc., 472 F. Supp. 787, 791 (E.D. Pa. 1979) (holding that under Pennsylvania law, dismissal with prejudice of suit charging securities fraud due to co-defendant's payment of settlement is success for purposes of indemnification).

136. 833 F. Supp. 302 (S.D.N.Y. 1993).

137. *Id.* at 310-11.

138. DEL. CODE. ANN. tit. 8, § 145(f) (1991). In Choate, Hall & Stewart v. SCA Servs., 495 N.E.2d 562 (Mass. App. Ct. 1986), the plaintiff represented the former president and chairman of the board of the defendant corporation. Despite the officer's guilty plea to a criminal charge of filing false information with the SEC, the court found he was entitled to contractual indemnification of the expense of defending against a related SEC civil investigation. *Id.* at 565. While the plaintiff did not make any claim for services relating to the guilty plea, the trial court noted that the plea would not be disqualifying even if such a claim had been made. *Id.* at 568; *cf.* N.Y. BUS. CORP. L. § 721 (McKinney Supp. 1995) (providing that while the statute is nonexclusive, no director shall be indemnified if a judgment or other final adjudication adverse to the director "establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated"). In California, statutory indemnification for third-party suits is non-exclusive, but a director's breach of duty to the corporation can only be indemnified under the statute, or under an articles of incorporation provision consistent with Section 204(a)(11), which prohibits indemnification of actions from which a director may not be relieved of liability under Section 204(a)(10), such as intentional misconduct or a knowing and culpable violation of law. *Id.* § 317(g). Indemnification of an agent other than a director or officer may be broader. *Id.*; *see* Branson v. Sun-Diamond Growers, 29 Cal. Rptr. 2d 314, 322-23 (Cal. Ct. App. 1994) (holding that non-director/officer employee may have contractual indemnification rights broader than those permitted under Section 317(e)).

139. DEL. CODE ANN. tit. 8, § 145(e) (1991). In Greenspan v. Mesirow, 485 N.E.2d 1196 (Ill. App. Ct. 1985), the court found that under Delaware law, the defendant directors charged with misconduct were not entitled to advance their own expenses without approval by other, disinterested directors. *Id.* at 1201; *see also* CAL. CORP. CODE § 317(f) (West 1990) (stating that expenses may be advanced if the director undertakes to repay them in the event he is not entitled to indemnification); N.Y. BUS. CORP. L. §§ 723(c), 724(c), 725(a) (McKinney Supp. 1995) (containing similar provisions, with the exception that the court may order the corporation to pay expenses upon a determination that the director has raised genuine issues of fact or law).

140. Citadel Holding Corp. v. Roven, 603 A.2d 818, 822 (Del. 1992).

vide that "the corporation shall indemnify" directors to the extent permitted by Delaware law, such a provision does not entitle the director to advances.[141] The Delaware Chancery Court has exclusive jurisdiction to decide all actions for advances or indemnification, whether pursuant to the statute or otherwise.[142]

A review of the various state statutes reveals that none of them seriously interfere with the desired goal of corporate director compliance with the law.[143] One author's recent conclusion that corporations are "routinely" and "willingly, even eagerly" indemnifying their executives who have been convicted of crimes is not supported by the facts.[144] The author cites the pre-statutory New York case of *Simon v. Socony-Vacuum Oil Co.*[145] as an example of eager indemnification of criminals in violation of public policy.[146] The author, a former federal prosecutor, failed to mention the fact that the directors in that case did not deliberately intend to violate the antitrust laws.[147] The findings of the court in the subsequent shareholder's derivative suit were as follows:

> The evidence supports this conclusion. It does not show that defendants acted fraudulently, negligently, corruptly or in bad faith. . . . Applying these principles, it would seem that defendants did not fail in their duty of reasonable care. At most, they made an honest and reasonable mistake or error of judgment or of law. . . . It seems to follow that, as defendants did not knowingly exceed their authority or the authority of the corporation, and did not know or believe or have reason to believe that their participation in the buying program was prohibited by the Sherman Act, they cannot be held personally liable for damages.[148]

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141. Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82, 84 (Del. Ch. 1992). *Contra* Barry v. Barry, 28 F.3d 848, 858 (8th Cir. 1994) (holding that under Minnesota law, a director is entitled to advances and indemnification unless the corporation alters this scheme).

142. DEL. CODE ANN. tit. 8, § 145(k) (Supp. 1994). This recently enacted provision should eliminate the possibility of obtaining punitive damages for wrongful failure to indemnify. *See, e.g.*, Salaman v. National Media Corp., C.A. No. 92C-01-161, 1994 Del. Super. LEXIS 353 (Del. Super. Ct. July 22, 1994) (denying motion for judgment notwithstanding the verdict and upholding jury award of $1.55 million in punitive damages).

143. *See supra* note 123 (discussing state statutory regulations limiting indemnification of directors).

144. *See, e.g.*, Bucy, *supra* note 123, at 279, 281 (discussing the willingness of corporations to indemnify their directors).

145. 38 N.Y.S.2d 270 (N.Y. Sup. Ct. 1942), *aff'd*, 47 N.Y.S.2d 589 (N.Y. App. Div. 1944).

146. *See* Bucy, *supra* note 123, at 281 n.7, 314-15 (discussing the indemnification of the directors in the *Simon* case who pled *nolo contendre* to criminal antitrust charges).

147. 38 N.Y.S.2d at 272-73.

148. *Id.* at 273-74. Professor Bucy also cites Koster v. Warren, 297 F.2d 418 (9th Cir. 1961), in support of her thesis, which also is a case where it is doubtful that any deliberate violation of the antitrust laws occurred. *See* MARSH, *supra* note 124, at 740-42, 750 (suggesting that the defendant might very well have established that his conduct was entirely lawful). Finally, Professor

Given the author's clear understanding of the principle that the government need not prove specific intent (or any intent) to violate the law in order to obtain a criminal conviction,[149] it is hard to understand her public policy arguments. Commentators have argued just as strenuously that there is generally no reason under either corporate or criminal law to shift corporate loss to executives after criminal prosecution of the corporation.[150] This position must also be regarded as extreme.

VI. THE IMPACT OF INSURANCE ON DIRECTOR BEHAVIOR

Almost all states statutorily permit a corporation to purchase insurance at corporate expense in order to indemnify directors and officers against any liability asserted by reason of their service or corporate status.[151] Typically, as provided in the Delaware statute, insurance may be provided against liability "whether or not the corporation would have the power to indemnify [the director or officer] against such liability," so the limitations discussed above concerning indemnification would not apply.[152] However, New York law, for example, does not allow the corporation to provide insurance where the contract of insurance fails to include "a retention amount and . . . coinsurance" in a manner acceptable to the New York superintendent of

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Bucy cites for support an article in Harper's magazine on the conviction of the Fruehauf Corp. and two of its top officers for federal excise tax evasion. Pamela H. Bucy, *Indemnification of Corporate Executives Who Have Been Convicted of Crimes: An Assessment and Proposal*, 24 IND. L. REV. 279, 281 n. 7 (1991). That conviction was upheld in United States v. Fruehauf Corp., 577 F.2d 1038 (6th Cir.), *cert. denied*, 439 U.S. 953 (1978). However, a related stockholder's derivative suit against the officers was dismissed as barred by the statute of limitations; the facts of the case are not evident from the opinion. *See* Nathan v. Rowan, 651 F.2d 1223, 1226-27 (6th Cir. 1981) (concluding that the lower court's dismissal of the case due to a lapse of the statute of limitations period barred the plaintiff's claim under the doctrine of *res judicata*).

149. *See* Bucy, *supra* note 123, at 293-303 (explaining that a criminal conviction does not always require proof of specific intent); *see also* United States v. Weitzenhoff, 35 F.3d 1275, 1286 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 939 (1995) (holding that the government need not prove that corporate managers knew that their acts violated the Clean Water Act or the company's discharge permit in order to obtain felony conviction); *accord* U.S. v. Hopkins, 53 F.3d 533, 539 (2d Cir. 1995), *cert. denied*, 116 S. Ct. 773 (1996) (concluding that the government did not need to prove that the officer knew his conduct to be unlawful to establish liability under the Clean Water Act).

150. *See, e.g.*, Richard I. Werder, Jr., *A Critical Assessment of Intracorporate Loss Shifting After Prosecutions Based on Corporate Wrongdoing*, 18 DEL. J. CORP. L. 35 (1993) (arguing that due to notions of collective responsibility and problematic behavior by plaintiffs' attorneys, the objectives of corporate and criminal law may actually be undermined by loss-shifting litigation).

151. *See* 2 KNEPPER & BAILEY, *supra* note 105, § 23-4 (discussing state statutory authorization of director and officer liability insurance).

152. *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(g) (1991) (providing that a corporation may maintain insurance for an officer regardless of whether or not the corporation has the authority to indemnify that officer).

insurance.[153] New York law also prohibits insurance other than for the cost of defense where the risk is uninsurable under state law, or where a judgment establishes that the director or officer was guilty of, among other things, "acts of active and deliberate dishonesty."[154]

Even if the statute permits any kind of insurance, this does not mean that insurance is available for intentional wrongdoing, for a variety of reasons.[155] For example, the definition of loss against which insurance is provided typically excludes "fines, penalties, or multiple damages imposed by law, or matters which are uninsurable under the law."[156] Thus, where a judgment was entered against a condominium association and certain of its directors for treble damages for civil theft (conversion) and punitive damages for tortious interference with contract, the court held that such damages were uninsurable as a matter of public policy.[157] Similarly, where a corporate president and vice-president were sued for deliberately failing to pay corporate federal and state withholding, fuel and sales and use taxes, the court held that such liability was uninsurable as a matter of law.[158]

Where the policy defines "wrongful act" for which insurance is provided as "any negligent act, error, omission, misstatement or misleading statement," it has been held that an intentional act, such as firing an employee for filing an employment discrimination suit, is not covered.[159] In addition, violation of many statutes such as the Foreign Corrupt Practices Act, RICO or the federal securities acts, may be expressly excluded from insurance coverage, as well as many other liabilities, including liability for dishonest, criminal or fraudulent con-

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153. N.Y. BUS. CORP. L. § 726 (McKinney Supp. 1995).

154. *Id.*

155. *See* Bucy, *supra* note 123, at 331-36 (explaining that insurance not available for deliberate and willful acts).

156. *See* 2 KNEPPER & BAILEY, *supra* note 105, at 401-02 (citing the definition of "loss" that appears in most corporate officer insurance policies).

157. Country Manors Ass'n v. Master Antenna Sys., 534 So. 2d 1187, 1195 (Fla. Dist. Ct. App. 1988).

158. St. Paul Fire & Marine Ins. Co. v. Briggs, 464 N.W.2d 535, 539 (Minn. Ct. App. 1990); *cf.* International Surplus Lines Ins. Co. v. Princehorn, No. 16463, 1994 Ohio App. LEXIS 2039 (Ohio Ct. App. May 11, 1994), *appeal denied*, 639 N.E.2d 795 (Ohio 1994) (concluding that liability is insurable if nonpayment was unintentional).

159. *See* Golf Course Superintendents Ass'n v. Underwriters at Lloyd's, London, 761 F. Supp. 1485, 1487 (D. Kan. 1991) (holding that the intentional firing of an employee did not constitute a wrongful act); 2 KNEPPER & BAILEY, *supra* note 105, § 24-4, at 400 (discussing the insurance definition of "wrongful acts"). In Coit Drapery Cleaners, Inc. v. Sequoia Ins. Co., 18 Cal. Rptr. 2d 692, 697-98 (Cal. Ct. App. 1993), the court held that the California Insurance Code and public policy barred suit against an insurer for coverage based upon the willful sexual harassment and assault of a female employee by the founder, president, chairman of the board and major stockholder of the insured corporation.

duct.[160] Where the policy provides that "acts of active and deliberate dishonesty" must be established by a judgment against the director or officer, some courts have held that this finding must be made in the underlying litigation and cannot be raised by the insurer after settlement of that suit; however, other cases have held to the contrary depending upon the express language of the policy.[161] Newer policies have been reworded to eliminate the requirement of a prior judgment to establish dishonesty, thereby allowing the insurer to raise this issue in the first instance during the coverage litigation.[162]

Where the director is sued together with the corporation, problems of coverage and allocation arise since the directors and officers' liability policy only covers liability of the director, or required or permitted indemnification of the director by the corporation, rather than the liability of the corporation itself.[163] Thus, where a savings association and five of its officers were the target of a grand jury investigation into charges of obtaining loan commitment fees through fraudulent representations, the savings association entered a plea of *nolo contendere* to a federal criminal information and made full restitution of fees totalling $795,000 in return for the government's agreement not to prosecute the individual officers.[164] When the association filed suit against its directors' and officers' insurer, the court held that the directors had not sustained any loss since no claims for the payment of money had been made against them, although such claims could have been made.[165]

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160. *See* 2 KNEPPER & BAILEY, *supra* note 105, at ch. 25 (discussing insurance exclusions generally).

161. *See id.* § 25-4 (discussing cases in which courts have held that the finding of dishonesty had to be made during the initial litigation, not the subsequent coverage litigation); *see also* Atlantic Permanent Fed. Sav. & Loan Ass'n v. American Casualty Co., 839 F.2d 212, 214-15 (4th Cir.), *cert. denied*, 486 U.S. 1056 (1988) (holding that insurer could not raise issue of exclusion); National Union Fire Ins. v. Seafirst Corp., 662 F. Supp. 36 (W.D. Wash. 1986) (holding exclusion not available); *cf.* Finci v. American Casualty Co. v. State Deposit Ins. Fund Corp., 593 A.2d 1069, 1086-87 (Md. 1991) (granting summary judgment for insured where no evidence of dishonesty proffered by insurer). For decisions holding that insurer could raise defense where policy does not require a prior judgment, see American Casualty Co. v. United S. Bank, 950 F.2d 250, 254-55 (5th Cir. 1992); Stargatt v. Avenell, 434 F. Supp. 234, 242-44 (D. Del. 1977).

162. *See* 2 KNEPPER & BAILEY, *supra* note 105, § 25-4, at 441 (discussing the recent practice among courts of allowing the insurer to raise the issue of dishonesty during the coverage litigation); Arthur J. Washington, *Directors' and Officers' Liability Insurance: Coverage Disputes, in* DIRECTORS' AND OFFICERS' LIABILITY INSURANCE (PLI Comm. Law & Practice Course Handbook Series No. 415, 1987).

163. *See* 2 KNEPPER & BAILEY, *supra* note 105, § 23-2, at 337 (noting that director liability policies do not insure the corporation against its own liability).

164. MGIC Indem. Corp. v. Home State Sav. Ass'n, 797 F.2d 285, 286 (6th Cir. 1986).

165. *Id.* at 287-88.

To illustrate the problem of allocation, consider a class action "fraud on the market" lawsuit brought against Raychem Corporation and twelve of its directors and officers under section 10(b) of the Securities Exchange Act of 1934, based upon allegedly false and misleading public statements regarding Raychem's historical and projected earnings.[166] The lawsuit was settled for $19.5 million, of which the insurer paid $11.25 million and Raychem paid $8.25 million.[167] Raychem then indemnified the individual defendants for the $8.25 million and $1.6 million in defense costs, and brought suit for reimbursement against Federal Insurance Company, the insurer under the directors' and officers' liability policy.[168]

The court held that neither federal nor state law prohibited indemnification of the directors and officers since there had been no admission or finding of a violation of the securities laws, and the disinterested Raychem directors found that the defendants acted in good faith and with a reasonable belief that their actions were in the best interests of the corporation.[169] However, the court allowed the insurer to conduct discovery on the issue of whether indemnification in the case was made in good faith.[170] The court further held that the settlement and defense costs were not "matters uninsurable under the law" within the meaning of the policy exclusion, yet the court allowed discovery as to whether the defendants' actions in the case were uninsurable.[171] The court reasoned that while scienter (an "intent to deceive or defraud") is a required element for a section 10(b) violation, lower federal courts have held that reckless conduct (an "extreme departure from the standards of ordinary care") will satisfy the

166. Raychem Corp. v. Federal Ins. Co., 853 F. Supp. 1170, 1173 (N.D. Cal. 1994). An explosion of fraud on the market lawsuits occurred following the four-Justice plurality decision by the United States Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224 (1988). The opinion in *Basic* was authored by Justice Blackmun and joined by Justices Brennan, Marshall and Stevens. *Id.* at 225. All four Justices had been dissenters in a series of conservative Supreme Court securities law cases decided beginning in 1975. Justices Rehnquist, Scalia and Kennedy recused themselves for undisclosed reasons. *Id.* at 250. Justices White and O'Conner dissented with respect to the holding of a presumption of reliance based upon the "fraud on the market" theory that a stock trader relies upon the "integrity" of the market price and, therefore, is damaged for purposes of Section 10(b) of the Securities Exchange Act when a misleading statement is made because it is presumed that the market price reflects that statement. *Id.* at 255-57 (White, J., dissenting). No reliance on the misleading statement itself is required and this is the contention with which the dissent disagreed. *Id.*

167. *Raychem Corp.*, 853 F. Supp. at 1174.

168. *Id.*

169. *Id.* at 1177-78.

170. *Id.* at 1185-86.

171. *Id.* at 1179-80, 1186.

scienter requirement, and reckless conduct is not "intentional" or "willful" conduct which otherwise would be uninsurable.[172]

Finally, the insurer argued that the settlement had to be allocated since uninsured third parties were also liable, namely the corporation itself and non-officer or director employees of the corporation.[173] However, the court held that allocation was inappropriate and instead adopted what has become known as the "larger settlement rule," that allocation is proper only when the settlement and defense costs are higher than they would have been had only insured parties been defended.[174] To the extent that the liability of the corporation itself is only derived from conduct of insured parties, the insurer may not complain; if uninsured third parties contributed to the underlying wrongful conduct without increasing defense or settlement costs, then the insurer may pursue its right to contribution through subrogation.[175] Other courts have taken different approaches to the allocation problem depending on the particular circumstances involved.[176]

In summary, the existence of insurance against liability does not appear to present any significant opportunity for directors to escape the consequences of intentional and unreasonable violation of law causing damage to the corporation.

VII. A SELECTIVE SURVEY OF THE CONTEMPORARY SCENE: SOME CURRENT EXAMPLES OF CORPORATE VIOLATION OF LAW

There is certainly no shortage of current examples of illegal corporate activity. Two selected cases illustrate the general principles dis-

172. *Id.*

173. *Id.* at 1180.

174. *Id.* at 1181-84; *accord* Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1432 (9th Cir. 1995) (stating that the "larger settlement rule" is best effectuated through the reasonable expectations of the insured); Safeway Stores, Inc. v. National Union Fire Ins. Co., 64 F.3d 1282, 1288 (9th Cir 1995) (stating that the "larger settlement rule" would be applied to determine liability of insurer who insured against wrongful acts by directors or officers).

175. *Raychem Corp.*, 853 F. Supp. at 1182.

176. *See* Slottow v. American Casualty Co., 10 F.3d 1355, 1359-60 (9th Cir. 1993) (holding that settlement must be allocated between insured president and uninsured bank); *see also* Pepsico, Inc. v. Continental Casualty Co., 640 F. Supp. 656, 662 (S.D.N.Y. 1986) (providing that insurer has the burden of proving what portion of the settlement costs should be attributed to the defense of PepsiCo and its accountants); Health-Chem Corp. v. National Union Fire Ins. Co., 559 N.Y.S.2d 435, 438 (N.Y. Sup. Ct. 1990) (permitting allocation if factually possible, but the insurer has the burden of proving what portion of the expenses was incurred in defense of a non-covered party); *see generally* Julie J. Bisceglia, Comment, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L. REV. 690 (1985) (discussing the ramifications of corporate officers' liability insurance); *Directors' and Officers' Liability Insurance: A Case Study on Allocation of Defense Costs and Settlements*, Annual Meeting, American Bar Association, Section of Business Law, New Orleans, La. (1994).

cussed above and demonstrate how these principles are applied in practice.

A. Salomon Brothers, Inc. and the Treasury Auction Scandal

On August 9, 1991, the financial world was stunned when Salomon Brothers issued a press release disclosing that the firm had uncovered irregularities and rule violations in connection with its submission of bids in certain auctions of Treasury securities.[177] The press release also disclosed that the firm had suspended two managing directors: Paul Mozer, the head of its government trading desk, and Thomas Murphy, its chief trader in government securities.[178]

On August 14, 1991, under pressure from government officials, Salomon Brothers issued a second press release which disclosed that three top Salomon executives had known since late April of 1991 that Mozer submitted an illegal bid during the February 21, 1991, Treasury notes auction in violation of U.S. Treasury rules.[179] These three executives were John Gutfreund, chairman and chief executive officer; Thomas Strauss, president; and John Meriwether, vice chairman, head of fixed income trading and Mozer's immediate superior.[180]

On August 18, 1991, these executives resigned their positions with both Salomon Brothers and Salomon, Inc.;[181] Mozer and Murphy were fired the same day; and Donald Feuerstein, chief legal officer of Salomon, Inc., resigned on August 23.[182] During the third quarter of 1991, Salomon, Inc. recorded a $200 million charge against earnings to reflect expected losses.[183] Warren Buffet became the interim chairman and chief executive officer of Salomon, Inc. and Salomon Broth-

177. SALOMON, INC., JUNE 30, 1991 QUARTERLY REPORT on Form 10-Q, pt. II, item 5 & ex. 28(d). During the 1980's, Salomon Brothers became a dominant figure in the United States government bond market, the corporate security underwriting business and the securitized mortgage market; *see generally* MICHAEL M. LEWIS, LIAR'S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET (1989) (providing an earlier history of the firm and its major figures and activities); MARTIN MAYER, NIGHTMARE ON WALL STREET (1993) (providing a detailed account of Salomon Brothers and the 1991 scandal). Pursuant to its authority under the Government Securities Act Amendments of 1993, the Treasury Department recently issued proposed regulations designed to prevent the conduct exposed in the Salomon scandal. *See* Government Securities Act Regulations: Large Position Rules, 60 Fed. Reg. 65,214 (1995) (to be codified at 17 C.F.R. pts. 400, 420) (requiring any person or entity controlling $2 billion or more in a Treasury security to preserve certain records).

178. *In re* Salomon, Inc., No. 91 Civ. 5442, 1994 U.S. Dist. LEXIS 8038, at *1, 7-10 (S.D.N.Y. June 16, 1994).

179. *Id.*; *see* SALOMON, INC., JUNE 30, 1991 QUARTERLY REPORT on Form 10-Q 15.

180. *In re* Salomon, Inc., 1994 U.S. Dist. LEXIS 8038, at *1, 7-10.

181. SALOMON INC., SEPTEMBER 30, 1991 QUARTERLY REPORT on Form 10-Q 11.

182. *Id.*

183. *Id.* at 7.

ers.[184] Prior to assuming this post, Mr. Buffet had been a director of Salomon, Inc. since 1987 as well as its largest shareholder through Berkshire Hathaway, Inc.[185]

On May 20, 1992, the government reached a settlement with Salomon, Inc. and Salomon Brothers.[186] The firms were to pay $100 million to establish a civil claims fund for private litigants and an additional $190 million to the United States Treasury as civil penalties and asset forfeitures.[187] The Federal Reserve Bank of New York decided to retain Salomon Brothers' designation as a primary dealer in U.S. Treasury securities, but suspended the firm from trading with or submitting customer bids to the Federal Reserve until August 3, 1992.[188] No criminal charges were brought against the companies.[189] In the second quarter of 1992, Salomon, Inc. recorded a charge of $185 million against earnings in addition to the $200 million already reserved, for a total loss of $385 million.[190]

On December 3, 1992, Gutfreund, Strauss, and Meriwether, consented to entry of an SEC order without admission or denial of the Commission's facts, findings or conclusions.[191] Gutfreund was assessed a civil penalty in the amount of $100,000 and ordered not to associate in the future, in the capacity of chairman or chief executive officer, with any firm regulated by the SEC; Strauss was assessed a

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184. *Id.* at 11.

185. SALOMON, INC. PROXY STATEMENT FOR THE ANNUAL MEETING OF SHAREHOLDERS 2, 6 (May 1, 1991). In 1987, Berkshire acquired all 700,000 shares of Salomon's voting convertible Preferred Stock for $700 million, and these shares represented about 14.3% of the outstanding voting power of the corporation. *Id.* at 6, 12.

186. SALOMON, INC., JUNE 30, 1992 QUARTERLY REPORT on Form 10-Q 7.

187. *Id.*

188. *Id.*

189. *See* Linda Himelstein, *When the Company Becomes a Cop*, BUS. WK., June 6, 1994, at 118 (noting that Salomon set the standard for cooperation by giving the government open access to virtually all relevant documents and witnesses and waiving the attorney-client privilege); *see generally* R. Lane Sisung, Comment, *The Law of Salomon: A History of the Regulation of Government Securities, an Accounting of the Salomon Brothers Scandal and an Analysis of the Government Securities Act Amendments of 1993*, 40 LOY. L. REV. 313 (1994) (providing a comprehensive account of the Salomon scandal and the resulting Government Securities Act Amendments of 1993).

190. SALOMON, INC., JUNE 30, 1992 QUARTERLY REPORT on Form 10-Q 8.

191. *In re* Gutfreund Exchange Act, Release No. 31,554, 1992 SEC LEXIS 2939 (Dec. 3, 1992). Donald Feuerstein also consented to issuance of the order without admitting or denying any of its statements. *Id.* at *2. The suggestion that Feuerstein may not have acted appropriately caused a furor in the securities bar. *See* William R. McLucas & Jeffrey Hiller, *The Salomon Case and the Supervisory Responsibilities of Lawyers and Compliance Personnel*, INSIGHTS, May 1993, at 3 (discussing the legal consequences of imposing liability on non-line supervisors); Sam S. Miller & George E. Scargle, *The Feuerstein Report: Legal and Compliance Officers On the Line*, INSIGHTS, Feb. 1993, at 5 (criticizing the SEC for failing to give non-line supervisors adequate notice and guidance).

penalty of $75,000 and suspended from associating for a period of six months with any such firm; and Meriwether was assessed a penalty of $50,000 and suspended for three months.[192] Donald Feuerstein indicated that he did not intend to work in the securities industry in the future.[193]

According to the SEC's findings, the U.S. Treasury Department had for some time limited the maximum bid of any one bidder in an auction of Treasury securities at any given yield to 35 percent of the auction amount.[194] At the February 21, 1991 auction of $9 billion of five-year notes, Salomon Brothers submitted a bid in its own name of $3.15 billion (35 percent of the notes) at 7.51 percent.[195] The firm also submitted two false bids for the same amount in the names of two established Salomon customers, Quantum Fund and Mercury Asset Management, without their knowledge.[196] As a result, when the bids were prorated, Salomon and its "customers" received a combined total of 56.7 percent of the auction amount.[197] Mozer then directed a clerk at the firm's government trading desk to make fictitious entries "selling" the $1.701 billion allocations to each of the customers, then "selling" them back to Salomon with instructions not to send written confirmations of the trades to the customers.[198] Unfortunately for Mozer, S.G. Warburg, another primary dealer in U.S. Treasury securities and an affiliate of Mercury Asset Management, had submitted its own bid in the February 21 auction for $100 million at 7.51 percent.[199] This unforeseen development meant that S.G.Warburg had violated the 35 percent limit, and the Treasury Department so advised Warburg, Mercury Asset Management and Mozer by letter dated April 17, 1991.[200]

Mozer promptly told the Senior Director at Mercury that he was embarrassed by this situation, which he said resulted from a clerk's error, and asked that the matter be kept confidential; Mercury honored his request.[201] Mozer then told Meriwether that he had submitted a false bid to satisfy demand for the securities from the firm's government trading and government arbitrage desks.[202] Shocked by

192. *In re Gutfreund*, 1992 SEC LEXIS 2939, at *50-51.
193. *Id.* at *46 n.23.
194. *Id.* at *5.
195. *Id.*
196. *Id.*
197. *Id.* at * 5-6.
198. *Id.* at *7.
199. *Id.* at *8.
200. *Id.* at *8-10
201. *Id.*
202. *Id.* at *11.

this information, Meriweather informed Strauss, his superior, and Strauss informed both Gutfreund and Feuerstein.[203] Feuerstein advised all three executives that the false bid constituted a criminal act which, although probably not legally required, should be reported to the federal government.[204] Gutfreund did not report the false bid to the government until August 9, 1991, nor did he inform the Salomon Board of Directors until August 8.[205]

Meanwhile, Mozer submitted two more false bids at the April 25 and May 22 Treasury note auctions.[206] In June and July of 1991, officials of the U.S. Treasury Department and the Antitrust Division of the Justice Department began an investigation into reports of a "squeeze" (unavailability of notes to cover "short" positions) in the market for the May 22 two-year Treasury notes which resulted from the fact that Salomon and two of its customers had bought about 86 percent of the issue.[207] Salomon initiated its own internal investigation, which disclosed other false bids submitted in Treasury auctions in 1990 and 1991, and finally issued a press release on August 9.[208]

Mozer eventually entered into a plea agreement with the U.S. Attorney's Office on November 19, 1992, under which he agreed to plead guilty to two counts of making false statements to an agency of the United States.[209] The court accepted Mozer's plea,[210] and he was sentenced in December of 1993 to four months in prison and a $30,000 fine.[211] On July 13, 1994, Mozer also consented to the entry of a judgment enjoining him from violating the Securities Exchange Act and assessing a civil penalty in the amount of $1.1 million, which included a penalty for insider trading based upon his sale of Salomon, Inc. com-

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203. *Id.* at *11-12.

204. *Id.* at *13-14.

205. *Id.* at *21, 29 n.11.

206. *Id.* at *18-21.

207. *Id.* at *23-26.

208. *Id.* at *26-30. According to an SEC order consented to by Daiwa Securities America, Inc., Salomon had submitted false Treasury bids at least as far back as August 10, 1989. Daiwa, another primary dealer in U.S. Treasury securities, had submitted a $3 billion bid in a Treasury auction on that day, although the bid was in fact submitted on behalf of Salomon. *In re* Daiwa Sec. Am., Inc., Exchange Act Release No. 31,924, 1993 SEC LEXIS 378 (Feb. 25, 1993). Daiwa is reportedly unrelated to Daiwa Bank Ltd., which was recently charged with criminal conduct in covering up $1.1 billion in trading losses. *See* Timothy L. O'Brien, *In a Signal to Japan, U.S. Bars Daiwa Bank, Indicts It and Officials*, WALL ST. J., Nov. 3, 1995, at A1 (discussing the severity of the potential sanctions against Daiwa Bank).

209. United States v. Mozer, 828 F. Supp. 208 (S.D.N.Y. 1993). Making false statements to a government agency is prohibited by 18 U.S.C. §§ 1001-1002 (1988).

210. Margaret A. Jacobs, *Paul Mozer Pleads Guilty in Case Tied to Treasury Bids*, WALL ST. J., Oct. 1, 1993, at B8.

211. John Connor, *Ex-Bond Trader for Salomon to Pay $300,000*, WALL ST. J., Dec. 31, 1993, at 2.

mon stock several days prior to the disclosures in the August 9, 1991 press release.[212] In addition, Mozer consented to an SEC order permanently barring him from employment in the securities industry or submission of any bid in a Treasury auction except for his own account or that of his immediate family.[213]

In late 1992 and early 1993, Salomon settled the compensation claims of three of the four senior officers who left the company in August of 1991; the claim of the fourth officer, John Gutfreund, was submitted to arbitration under the rules of the New York Stock Exchange.[214]

In January and February of 1993, Salomon settled claims with forty-two states and the District of Columbia concerning the 1991 Treasury auction by placing $2 million in a multistate Investor Protection Trust Fund and paying $2.15 million to the District of Columbia and the states involved.[215] The private lawsuits against Salomon and its directors and officers had begun on the business day following the August 9, 1991 press release. These suits can be categorized into three groups:

(i) *The Securities Litigation.* The first "fraud on the market" suit was filed on August 12, 1991, in federal court in New York City.[216] Other suits followed this one, and ultimately thirteen individual and class action lawsuits were consolidated.[217] The defendants included Salomon Inc., Salomon Brothers, Inc., and individual defendants Gut-

212. SEC v. Mozer & Murphy, Litigation Release No. 14,159, 1994 SEC LEXIS 2033 (S.D.N.Y. July 14, 1994).

213. *Id.* Nonetheless, Mr. Mozer's career as an unregulated investment adviser may not be over. *See* Michael Siconolfi, *Paul Mozer Wants to Start a Hedge Fund*, WALL ST. J., June 22, 1995, at C1 (reporting that Mozer has requested SEC approval to serve as an unregistered investment advisor). Murphy, who had earlier entered into a consent order with the SEC, paid a civil penalty of $300,000 and consented to an industry bar for a term of years and an injunction against further violations. SEC v. Mozer & Murphy, 1993 SEC LEXIS 3624 (Dec. 29, 1993).

214. SALOMON, INC., 1993 ANNUAL REPORT on Form 10-K 5-6, 1993; *see* James C. Hyatt, *Salomon Reaches Compensation Pacts with 2 Aides Who Left Amid Inquiry*, WALL ST. J., Jan. 5, 1993, at A5 (reporting settlements with Strauss and Meriwether). On May 13, 1994, the NYSE arbitration panel denied Gutfreund's claims of $55.3 million in their entirety, and Gutfreund filed an action in New York Supreme Court on August 12, 1994, seeking to vacate the arbitrators' decision. SALOMON, INC., SEPTEMBER 30, 1994 QUARTERLY REPORT on Form 10-Q 11. On December 31, 1994, the court confirmed the arbitrators' decision and Gutfreund filed an appeal. SALOMON, INC., 1994 ANNUAL REPORT on Form 10-K 4.

215. SALOMON, INC., 1992 ANNUAL REPORT on Form 10-K 2.

216. This action was captioned Mann v. Salomon, Inc., 91 Civ. 5442, filed August 12 in the U.S. District Court for the Southern District of New York. *See* SALOMON, INC., JUNE 30, 1991 QUARTERLY REPORT on Form 10-Q 14 (discussing the nature of this litigation). As other parties filed suit, the cases were consolidated into *In re* Salomon, Inc. Secs. Litig., No. 91 Civ. 5442, 1994 U.S. Dist. LEXIS 8038 (S.D.N.Y. June 16, 1994).

217. *In re* Salomon, Inc., No. 91 Civ. 5442, 1994 U.S. Dist. LEXIS 8038, at *3 (S.D.N.Y. June 16, 1994).

freund, Strauss, Meriwether, Mozer and Murphy.[218] The plaintiffs were all purchasers of Salomon, Inc. common stock and all other publicly issued or traded securities of Salomon (including some purchasers of call options for Salomon common stock) during the period March 27 through August 14, 1991.[219] Count I of the complaint charged the defendants with failure to disclose the unlawful activities, misleading statements in the Salomon Annual Report dated March 27, 1991 concerning the company's "ethical business conduct," and inadequate disclosure in the August 9, 1991, press release in violation of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder.[220] Count II charged that Salomon, Gutfreund, and Strauss violated section 11 of the Securities Act of 1933 by failing to disclose the unlawful activities in the prospectus for a registered offering of Salomon debt securities.[221]

A proposal to settle the Securities Litigation was approved by District Court Judge Patterson on June 16, 1994.[222] Under the terms of the settlement, a total of $54.5 million would be paid to the plaintiffs from the $100 million Civil Claims Fund established in the May 29, 1992 settlement agreement with the government.[223] The court also approved $9.6 million in attorneys fees, to be paid by Salomon in addition to the $54.5 million.[224]

(ii) *The Treasury Litigation.* The first suit by purchasers of U.S. Treasury notes who were allegedly damaged by Salomon's actions was brought on August 13, 1991, in federal court in New York City.[225] Ultimately, ten class actions were consolidated, and in addition, six individuals filed separate actions.[226] The class actions charged that plaintiffs were injured by defendants' conduct in rigging bids in the April, May, and June 1991 auctions of U.S. Treasury notes and engag-

218. *Id.* at *1-2.

219. *Id.*

220. *Id.* at *10.

221. *Id.* Count III charged that Gutfreund and Strauss were liable for the violations charged in Counts I and II in their capacity as controlling persons of Salomon under section 15 of the 1933 Act and Section 20(a) of the 1934 Act. *Id.*

222. *Id.* at *1-2.

223. *Id.* at *3; *see also* SALOMON, INC., JUNE 30, 1994 QUARTERLY REPORT on Form 10-Q 19 (explaining the company's legal proceedings).

224. *In re Salomon, Inc.*, 1994 U.S. Dist. LEXIS 8038, at *48.

225. This action was captioned Katz v. Salomon, Inc., 91 Civ. 5471, filed August 13, 1991, in the U.S. District Court for the Southern District of New York. *See* SALOMON, INC., JUNE 30, 1991 QUARTERLY REPORT on Form 10-Q 15 (summarizing the legal actions relevant to Salomon, Inc.).

226. SALOMON, INC., 1993 ANNUAL REPORT on Form 10-K 4. The consolidated actions were captioned *In re* Salomon Bros. Treasury Litig., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,119 (S.D.N.Y. Feb. 22, 1994).

ing in a "squeeze" on the market for those securities in violation of the Securities Exchange Act of 1934, the Sherman Act, the Commodities Exchange Act and the Racketeer Influenced and Corrupt Organizations Act.[227] The defendants included parties other than Salomon.

The consolidated actions were settled on July 26, 1994, with court approval for a total payment by Salomon of $66 million, including plaintiffs' attorneys fees and expenses, almost two-thirds of which will be paid from the $100 million Civil Claims Fund established in May of 1992.[228] Defendants Steinhardt Management Co. and related entities agreed to pay $22 million, and Caxton Corporation agreed to pay $12 million; the only defendant who failed to settle was Paul Mozer.[229] The court also approved plaintiffs' counsel fees of $25 million and $3.5 million in expenses.[230] Steinhardt and Caxton later paid an additional $76 million to settle charges of violations of the securities and antitrust laws by the SEC and the Justice Department.[231]

(iii) *The Derivative Litigation.* Sixteen shareholders' derivative suits, initially filed in August of 1991, were consolidated in federal court in New York City.[232] The complaint asserted claims in a derivative capacity on behalf of Salomon, Inc., and in a double derivative capacity on behalf of its wholly-owned subsidiary, Salomon Brothers, Inc.[233] The individual defendants included Gutfreund, Strauss, Meriwether and Mozer.[234] The complaint alleged a violation of section 10(b) of the Securities Exchange Act of 1934 and breach of fiduciary duty under state law.[235] The damages sought exceeded $326 million, including $290 million paid to the government, an additional $32.1

227. *See* In re *Salomon Bros. Treasury Litig.* at 98,927 (ordering Federal Reserve Bank of New York to produce documents).

228. SALOMON, INC., JUNE 30, 1994 QUARTERLY REPORT on Form 10-Q 19. One suit by a plaintiff who opted out of the settlement remains pending. *See* Three Crown Limited Partnership v. Caxton Corp., 817 F. Supp. 1033 (S.D.N.Y. 1993) (complaint states cause of action under the Sherman Act); SALOMON, INC., 1994 ANNUAL REPORT on Form 10-K 3-4 (discussing the sanctions resulting from the Treasury Litigation).

229. Frances A. McMorris, *Salomon Settlement*, WALL ST. J., July 27, 1994, at B2.

230. *Id.*; *see also* John Connor, *Settlement of Suit Over Treasury Notes Considers $24 Million in Legal Fees*, WALL ST. J., July 25, 1994, at A9 (discussing the proposed settlement of action against Salomon, Inc.).

231. SEC v. Steinhardt Management Co., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,483 (Dec. 16, 1994); John Connor, *Steinhardt, Caxton to Pay $76 Million to Settle U.S. Charges of Manipulation*, WALL ST. J., Dec. 19, 1994, at B10; Laura Jereski, *Steinhardt to Shutter His Hedge Funds*, WALL ST. J., Oct. 12, 1995, at C1.

232. *In re* Salomon, Inc. Shareholders' Derivative Litig., [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,454 (Sept. 28, 1994).

233. *In re* Salomon, Inc., No. 91 Civ. 5442, 1994 U.S. Dist. LEXIS 8038 at *4 (S.D.N.Y. June 16, 1994).

234. *Id.*

235. *Id.*

million paid pursuant to settlement of the Securities Litigation and the Treasury Litigation, and $4.1 million paid in settlement of state regulatory claims.[236] The U.S. District Court granted a motion by the individual defendants to compel arbitration of the issues raised in the Derivative Litigation under the rules of the New York Stock Exchange.[237] However, the New York Stock Exchange declined to exercise jurisdiction and the federal courts refused to appoint a substitute arbitrator.[238] In October 1995, the case was settled pending court approval of $40 million in cash and noncash consideration, of which Salomon will retain $22.5 million after payment of attorneys fees and expenses.[239]

With regard to this case, one could not argue that the Board of Directors overprotected guilty members of management, or otherwise failed to act in the best interests of the shareholders to preserve and protect the corporation. Indeed, with respect to disciplinary action against responsible members of management, if anything, the Board erred on the side of severity in order to placate the federal government. Of course, whether or not the company will return to its former profitability remains an open question.[240]

1. The Board Acted Swiftly to Make Changes in Top Management

The Board concluded that half-measures would not be enough to prevent disaster. The corporation was threatened with the loss of its designation as a primary dealer in U.S. Treasury securities. Not only did the company face a blizzard of private suits and administrative proceedings, but it remained in great danger of facing criminal charges. Consequently, the Board terminated the two managing directors believed to have participated in the criminal conduct, and it accepted the resignations of the three top corporate officers who had knowledge of the situation.

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236. *Id.* at *5.

237. *Id.* at *1.

238. *In re* Salomon, Inc. Shareholders' Derivative Litig., 68 F.3d 554 (2d Cir. 1995) (affirming the District Court's decisions to deny arbitration).

239. *See* Michael Siconolfi, *Former Salomon Officers Are Settling Suit Over '91 Scandal for $40 Million*, WALL ST. J., Oct. 20, 1995, at C15. Reportedly, Gutfreund, Strauss and Meriwether together paid a total of $12 million in cash, the insurers paid $21 million in cash and the remaining $7 million noncash consideration included a surrender of indemnification claims. *Id.*

240. *See* Michael Siconolfi, *Salomon Brothers Expects Defections with New Pay Plan*, WALL ST. J., March 27, 1995, at A3 (noting that the Salomon Brothers Chairman Maughan referred to the company's 1994 loss as "appalling"); Leah Nathans Spiro, *Turmoil at Salomon*, BUS. WK., May 1, 1995, at 144 (reporting that "huge losses and a talent drain have [the company] reeling"); Suzanne Woolley, *A Sleeper Named Solly*, BUS. WK., Oct. 16, 1995, at 104 (noting that Salomon, Inc. ranked among the Council of Institutional Investors' list of 20 worst performing public companies).

Under the circumstances, one could object that Warren Buffet, a controlling shareholder, was in a position to force drastic changes in management. But normally a major shareholder or independent members of the Board will have the motivation and authority to take corrective action.[241] Even if such motivation or authority does not exist, the company can be sold to a new owner who could act;[242] if the situation continues to deteriorate, the company may be forced into bankruptcy.[243]

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241. *See* Rhonda L. Rundle, *National Medical Sees Fraud Settlement Ultimately Costing About $375 Million*, WALL ST. J., April 15, 1994, at A3 (indicating that National Medical Chairman Jeffry C. Barbakow assumed control of management and quickly moved to settle outstanding civil and criminal charges); *see also* SEC v. National Medical Enters., Litigation Release No. 14,156, 1994 SEC LEXIS 2098 (July 12, 1994) (stating that on June 29, 1994, National Medical pled guilty to six counts of criminal charges and paid a total of $362.7 million to the United States government, as well as an additional $16.3 million to private hospitals).

Eddie Antar, the founder of Crazy Eddie, Inc., lost control of the company in 1987 in a tender offer made by a group of private investors who later claimed that the company overstated its inventory by $65 million. *See In re* Crazy Eddie Sec. Litig., 824 F. Supp. 320 (E.D.N.Y. 1993) (related fraud on the market and RICO litigation settled for $42 million); *see also* United States v. Antar, 53 F.3d 568 (2d Cir. 1995) (holding that trial judge should have disqualified himself for bias); SEC v. Antar, 71 F.3d 97 (3d Cir. 1995) (removing trial judge for bias in related cases); Wade Lambert, *Crazy Eddie Founder's Conviction In Stock Fraud Case Is Reversed*, WALL ST. J., April 13, 1995, at B4.

The chief executive officer and a director of Orange & Rockland Utilities, Inc., indicted for grand larceny for misappropriation of company funds, was removed from his office as CEO for cause and then removed as a director for cause. *See* PROXY STATEMENT OF ORANGE & ROCKLAND UTILS. 2, 7-12 (April 6, 1994). The New York Supreme Court upheld his removal. Smith v. Orange & Rockland Utils., 617 N.Y.S.2d 278 (Sup. Ct. 1994). He was found not guilty of income tax evasion in a related case, although the prosecutor himself resigned from office in a bizarre turn of events and pled guilty himself to tax evasion. *See Expenses: Fiction, Maybe, but a Crime?*, FORTUNE, Oct. 16, 1995, at 42 (discussing the acquittal of Orange & Rockland Utilities' CEO and the conviction of his prosecutor).

242. *See* Nicholas Bray & Glenn Whitney, *Baring's Collapse Tied to Wide Cast in Special Report*, WALL ST. J., July 19, 1995, at A8 (finding broad responsibility for collapse). Following the disastrous losses in derivatives futures of about $1.5 billion, allegedly due to unauthorized trading at the Singapore office of Barings PLC by Nicholas Leeson, the company was taken over by Internationale Nederlanden Groep NV, a Dutch financial group. Changes in top management were made immediately. *See* JUDITH H. RAWNSLEY, TOTAL RISK (1995) (providing an account of the scandal).

243. In February of 1990, pressured by its lenders, the Federal Reserve Bank of New York, the New York Stock Exchange, the SEC and the U.S. Treasury Department, the board of the powerful firm of Drexel Burnham Lambert, Inc. voted to file for bankruptcy. *See* JAMES B. STEWART, DEN OF THIEVES 506-507 (1992) (providing an historical account of the investigations and convictions of Michael Milken and Ivan Boesky); *see also In re* Joseph, Exchange Act Release No. 32,340, 1993 SEC LEXIS 1239 (May 20, 1993) (barring former Drexel chief executive officer Joseph from employment in a supervisory capacity in the securities industry for three years for failure to supervise Michael Milken); *In re* Drexel Burnham Lambert Group, 995 F.2d 1138 (2d Cir. 1993) (settling Drexel's claims against Milken and others for $1.3 billion).

2 *The Board Adopted a Neutral Position in the Derivative Litigation*

The corporation originally moved to dismiss the shareholders' derivative suits for failure to make pre-suit demand on the Board of Directors, but then withdrew that motion when the uninvolved directors were dismissed as individual defendants.[244] The corporation also did not seize control of the litigation by forming a special litigation committee of the board for the purpose of making recommendations concerning prosecution of the suits.[245] In addition, although the terminated executives made claims for indemnification against the pending litigation, the Board on September 5, 1991, determined that it would not advance any further legal fees or expenses in defense of the terminated employees, including Gutfreund and Strauss.[246] It cannot be said that the Board itself should have brought suit against the departing executives. While the individual defendants in the derivative suit might eventually be found liable to the corporations, few individuals are capable of paying damages of $350 million,[247] and the firm's directors' and officers' liability insurance policy would undoubtedly

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244. SALOMON, INC., 1994 ANNUAL REPORT on Form 10-K 4. The company's motion to dismiss for failure to make demand on the Board probably stood a good chance of being granted. *See generally* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE §§ 5:12-13 (1994) (showing that suits are frequently dismissed if plaintiffs do not make a pre-suit demand).

In a derivative suit brought by E.F. Hutton shareholders, the court held that demand on the Board cannot be avoided simply by alleging that the directors condoned and acquiesced in illegal conduct. *In re* E.F. Hutton Banking Practices Litig., 634 F. Supp. 265, 272 (S.D.N.Y. 1986); *see also* Shields v. Singleton, 19 Cal. Rptr. 2d 459, 466 (Cal. Ct. App. 1993) (refusing to excuse demand by general allegations that Teledyne directors aided and abetted criminal fraud and corruption in the procurement of defense contracts); *In re* Baxter Int'l, Inc. Shareholder Litig., 654 A.2d 1268, 1270-71 (Del. Ch. 1995) (allegations of director failure to prevent violations of criminal law do not excuse demand); Cohan v. Loucks, No. 12,323, 1993 Del. Ch. LEXIS 99, at *7 (Del. Ch. June 11, 1993) (approving settlement of derivative suit charging damages due to Baxter International's criminal violations of the Israeli boycott regulations; demand on board would probably be required and the decision of the board not to sue would probably be entitled to protection under the business judgment rule).

245. *See supra* notes 49-60 and accompanying text (discussing special litigation committees).

246. SALOMON, INC., PROXY STATEMENT 14 (March 25, 1992); SALOMON, INC., 1991 ANNUAL REPORT on Form 10-K 10.

247. *See* Lawrence J. Fox, *The Special Litigation Committee Investigation: No Undertaking for the Faint of Heart in* SECTION OF LITIGATION, ABA, CORPORATE INVESTIGATIONS: CONDUCTING THEM, PROTECTING THEM 202, 208 (1992) (stating that the committee must avoid developing a fine case against directors or officers with little or no assets, while establishing a multi-million dollar liability for the corporation vis a vis class action plaintiffs); Michael P. Kenny & William R. Mitchelson, Jr., *Corporate Benefits of Properly Conducted Internal Investigations*, 11 GA. ST. U. L. REV. 657, 679 (1995) (maximizing the corporation's ability to obtain a favorable resolution while limiting potential liability).

not respond in a suit by the company itself as opposed to a *bona fide* derivative suit.[248]

B. The Securities Fraud Scandal at Cooper Companies, Inc.

The SEC recently issued a Report of Investigation into Cooper Companies, Inc. (Cooper) which criticizes the actions of the Cooper Board of Directors when faced with civil and criminal charges stemming from securities law violations by the corporation and its co-chairman of the board, Gary A. Singer.[249] Cooper's common stock is listed on the New York Stock Exchange. Cooper consented to the issuance of the SEC report without admitting or denying any of the statements contained therein. The Commission stated:

> The Commission is issuing this Report to emphasize that corporate directors have a significant responsibility and play a critical role in safeguarding the integrity of the company's public statements and the interests of investors when evidence of fraudulent conduct by corporate management comes to their attention. In this case, Cooper's Board of Directors did not fulfill its obligations under the federal securities laws when confronted with evidence of serious wrongdoing by persons it continued to entrust with the day-to-day management of the company and the making of public statements on the company's behalf. That evidence called into question the accuracy of Cooper's outstanding reports and made it incumbent on the Board to ensure the candor and completeness of the company's public statements to investors.[250]

The following account is derived from the SEC report and has not been independently verified other than, where indicated, by reference to Cooper documents filed with the Commission. On January 15, 1992, the SEC issued an order directing an investigation into charges of securities law violations by Cooper, Gary Singer and Steven Singer, Gary's brother and a Cooper director as well as its chief administrative officer and chief operating officer.[251] On February 7, 1992, Gary and Steven Singer asserted their Fifth Amendment privilege against self-incrimination and refused to testify before the Commission staff into charges that: (1) Cooper and the Singer brothers participated in a "frontrunning" scheme in the market for high yield bonds; and (2) Gary Singer caused high yield bonds to be fraudulently traded be-

248. *See* 2 KNEPPER & BAILEY, *supra* note 105, § 25-7 (noting that the purpose of the "insured v. insured" exclusion is to prevent collusive litigation by the company against its officers and directors).

249. Report of Investigation in *In re Cooper Cos.* As It Relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 35,082, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,472 (Dec. 12, 1994) [hereinafter Report of Investigation].

250. *Id.* at 86,062.

251. *Id.* at 86,063.

tween Cooper's account and accounts in the names of his wife and aunt, to the detriment of Cooper.[252] At the same time, the Commission investigated charges of a third scheme involving Gary Singer and Cooper concerning the manipulation of the price of Cooper's debentures to avoid an interest rate reset obligation imposed by the debenture.[253]

On March 12, 1992, Cooper's counsel was informed that the U.S. Attorney's Office in New York was conducting an investigation into charges of market manipulation, and bribery of a mutual fund manager and securities trader by key employees.[254] The Cooper Board promptly authorized an internal investigation by independent counsel, but Gary and Steven Singer refused to be interviewed by the independent counsel.[255] By April 9, the investigation had allegedly disclosed that in 1991, Gary Singer caused bond trades in excess of $6 million at below-market prices between Cooper and his wife and aunt, depriving Cooper of profits of more than $560,000.[256]

On May 21, the Commission and the U.S. Attorney filed both civil and criminal charges against Albert Griggs, a former analyst/assistant portfolio manager with The Keystone Group, Inc., and John Collins, the principal of Back Bay Capital, Inc., in connection with the Cooper frontrunning scheme.[257] The Commission's complaint charged that Griggs engaged in a fraudulent kickback scheme with an unnamed senior Cooper officer in which Griggs gave that officer advance knowledge of the high-yield bonds Griggs had recommended for purchase by a group of mutual funds.[258] The officer then allegedly caused Cooper and related persons and entities to buy the bonds and resell them to the funds at profits of nearly $3 million, in addition to paying over $700,000 in Cooper corporate funds to Griggs and Collins for "consulting services" through Back Bay Capital.[259]

At a May 21, 1992, plea hearing in the criminal proceeding, Griggs publicly identified Gary Singer as the senior officer at Cooper with whom he ran the frontrunning scheme.[260] According to the Commission, Steven Singer then caused Cooper to issue a press release stat-

252. *Id.*
253. *Id.* at 86,062.
254. *Id.* at 86,063.
255. *Id.*
256. *Id.*
257. *Id.* at 86,062-63; SEC v. Griggs, Litigation Release No. 13,247, 1992 SEC LEXIS 1193 (May 21, 1992); COOPER PROXY STATEMENT 9 (June 30, 1992).
258. Report of Investigation, *supra* note 249, at 86,062; COOPER 1992 ANNUAL REPORT on Form 10-K 12.
259. Report of Investigation, *supra* note 249, at 86,062.
260. *Id.* at 86,063.

ing, "The Company denies any wrongdoing and is unaware of any wrongdoing on the part of its officers or employees."[261] Griggs and Collins consented to a permanent bar from association with any securities firm and agreed to cooperate in the SEC investigation.[262] Collins agreed to disgorge about $225,000 plus certain related tax refunds, which was apparently all that remained of the alleged $700,000 payments by Cooper.[263] Griggs and Collins also pleaded guilty in the related criminal proceedings.[264]

On May 28, 1992, Cooper held a meeting of its board of directors at which Gary Singer agreed to take a temporary, paid leave of absence.[265] On May 26, Cooper's other co-chairman of the Board, Bruce D. Sturman, commenced a derivative suit in New York Supreme Court against Gary and Steven Singer, their brother Brad Singer and father Martin Singer based on the alleged frontrunning scheme with Griggs and Collins; the Cooper Board promptly suspended Sturman with pay as co-chairman.[266] Cooper appointed a search committee to find a new chief executive officer for the company.[267] On May 27, 1992, a second shareholders' derivative suit was filed against the company and its directors in Delaware Chancery Court, once again based on the Keystone frontrunning scheme and the board's alleged failure to investigate the charges.[268] Both actions have been settled on undisclosed terms, subject to court approval.[269]

In April 1992, a proxy contest was initiated by Frederick Adler, a partner in the law firm of Fulbright & Jaworski and a major Cooper shareholder and former director who left the Board in October of 1991; this contest was settled on June 15, 1992.[270] Under the terms of the settlement, Adler and Louis Craco, a partner in the law firm of Wilkie Farr & Gallagher, agreed to be nominated to the Cooper Board of Directors.[271] Five sitting directors were not nominated for

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261. *Id.* at 86,063-64.

262. SEC v. Griggs, Litigation Release No. 13,297, 1992 SEC LEXIS 1193, at *3-4 (May 21, 1992).

263. *Id.*

264. COOPER PROXY STATEMENT 9 (June 30, 1992).

265. *Id.* at 3.

266. *Id.* at 3, 10. The *Sturman* action was dismissed in August 1993 on the grounds of *forum non conveniens*, and the dismissal was affirmed by the Supreme Court, Appellate Division in March 1995. The suit was refiled in Delaware in June 1995. COOPER 1995 ANNUAL REPORT on Form 10-K 44-45.

267. COOPER PROXY STATEMENT 3 (June 30, 1992).

268. COOPER, APRIL 30, 1992 QUARTERLY REPORT on Form 10-Q 15 (reporting the suit, Lewis v. Singer, Civ. Action No. 12584).

269. COOPER 1995 ANNUAL REPORT on Form 10-K 44-45.

270. COOPER PROXY STATEMENT 3-5, 10 (June 30, 1992).

271. *Id.*

re-election: Gary, Steven, and Brad Singer, Bruce Sturman, and Warren Keegan, a Pace University Professor and business consultant.[272] The nine nominees for the Cooper Board included Messrs. Adler and Craco, four incumbent directors and three new appointees.[273]

On July 27, 1992, the SEC advised Cooper that it would recommend enforcement action against the company and Gary and Steven Singer.[274] Gary Singer was then placed on an unpaid leave of absence, but continued to receive benefits and payment of his legal fees.[275] The Board also terminated Bruce Sturman allegedly for cause, following Sturman's initiation of a suit in California against Cooper on July 24 for anticipatory breach of his employment contract.[276] The Board re-elected Steven Singer as executive vice president and chief operating officer of Cooper on July 28, 1992.[277]

Finally, on November 10, 1992, the SEC filed a civil action against Cooper and Gary and Steven Singer, and indictments were returned against Cooper and Gary Singer based upon the frontrunning scheme.[278] Cooper promptly retained the law firm of Gibson, Dunn & Crutcher as outside counsel for corporate governance advice.[279] On November 16, acting on the advice of counsel at Gibson, Dunn & Crutcher, the Cooper Board formed a management committee to oversee the company's operations in the absence of a chief executive officer and to provide guidance to Steven Singer, the chief operating officer.[280]

The civil action, initiated on November 10, named as defendants Cooper and Gary and Steven Singer, Gary Singer's aunt, wife and two alleged Singer family businesses. The SEC sought disgorgement of profits from the frontrunning scheme and from the transactions in which Cooper portfolio bonds were allegedly sold at below-market prices to Singer family members.[281]

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272. *Id.* at 4; COOPER PROXY STATEMENT 3 (February 27, 1991).

273. COOPER PROXY STATEMENT 4 (June 30, 1992).

274. Report of Investigation, *supra* note 249, at 86,064-65.

275. *Id.* at 86,064.

276. COOPER PROXY STATEMENT 8 (August 12, 1993); *see* Sturman v. Cooper Cos., No. C-93-02227-VRW, 1993 WL 356893 (N.D. Cal. Sept. 3, 1993) (remanding the case to state court in the absence of any federal question).

277. Report of Investigation, *supra* note 249, at 86,065.

278. *Id.*

279. Letter from John F. Olson, Esq., Gibson, Dunn & Crutcher to Richard Wulf, Chief of the Commission Division of Corporation Finance, SEC No-Action Letter, 1994 SEC WL 731843 (Dec. 19, 1994).

280. *Id.* at *4.

281. SEC v. Cooper Cos., Litigation Release No. 13,432, 1992 SEC LEXIS 2933 (Nov. 10, 1992).

The November 10 action also charged that Cooper and Gary Singer had illegally manipulated the trading price of Cooper's 10 5/8 percent Convertible Subordinated Reset Debentures due 2005 to avoid a June 15, 1991, interest rate reset.[282] Under the related indenture, if the market price of the debentures on that date was not at least 75 percent of face value, Cooper would adjust the interest rate to a level that would cause the debentures to have such a market value.[283] According to the complaint, on June 13 and 14, 1991, Gary Singer purchased for Cooper's account 98 percent of all of the debentures traded on the New York Stock Exchange, causing the price to rise to the required 75 percent of face value.[284] The complaint further charged that Gary Singer obtained fraudulent opinion letters from two little-known brokerage firms purporting to establish that the interest rate of the debentures was not required to be reset.[285] The two alleged brokerage firms, and the principals of each, were later charged with complicity in the scheme.[286]

On January 13, 1994, Cooper and Gary Singer were both convicted of fraud in the frontrunning scheme.[287] The court ordered Cooper to pay a criminal fine of $1.8 million, and restitution and interest of $1.3 million.[288] In August 1995 Gary Singer was sentenced to twenty-eight months in prison, $50,000 in fines, three years of supervised release and 1,000 hours of community service.[289]

In the related civil proceedings on December 12, 1994, Cooper consented to entry of an injunction against further violations of the securities laws; in addition, Cooper agreed not to employ Gary or Steven Singer or any relative of either, and to disgorgement of $1.6 million and a civil penalty of $1.1 million, each net of the criminal fine and

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282. *Id.* at *4.

283. *Id.*

284. *Id.* at *5.

285. *Id.*

286. SEC v. Russo, Litigation Release No. 13,632, 1993 LEXIS 1050 (May 11, 1993); SEC Admin. Proceeding File No. 3-8573, Exchange Act Release No. 35,081, 1994 SEC LEXIS 3962 (Dec. 12, 1994). The SEC entered into a settlement agreement with one of the brokerage firms which provided for censure, suspensions and fines without any admission or denial by the respondent. Admin. Proceedings Against Lawrence Mascera and Mascera & Co., SEC News Release SEC 95-136, 1995 SEC WL 420707 (July 18, 1995).

287. Report of Investigation, *supra* note 249, at 86,065; *see* United States v. Singer, No. 92 Cr. 964 (RJW), 1994 U.S. Dist. LEXIS 9773 (S.D.N.Y. July 18, 1994) (denying new trial and motion for judgment of acquittal).

288. SEC v. Cooper Cos., Litigation Release No. 14,351, 1994 SEC LEXIS 3963, at *1-2 (S.D.N.Y. December 12, 1994); *see Federal Judge Orders Cooper Companies to Pay $3.1 Million Penalty*, WALL ST. J., July 18, 1994, at B6 (reporting criminal fine and restitution to Keystone Funds).

289. *See Ex-Cooper Official Given 28-Month Term In Junk-Bond Scheme*, WALL ST. J., Aug. 10, 1995, at B10 (noting that the sentence imposed on Singer was harsher than he had expected).

restitution.[290] Steven Singer agreed to settle the action on the basis of a $200,000 civil penalty and over $2.5 million to be paid by him and the other defendants.[291]

The Commission concluded that the Board failed in its duties in two respects: (1) after the Board learned that a member of senior management concealed fraudulent self-dealing transactions, thereby causing the company's outstanding reports to be inaccurate, the Board failed to take immediate and effective action to protect the interest of the company's investors; and (2) the Board's failure to act allowed a second corporate officer, also allegedly involved in the fraudulent frontrunning scheme, to direct the issuance of a press release on behalf of the company which falsely denied any knowledge of wrongdoing.[292]

1. The Fraudulent Self-Dealing Transactions

A majority of the Cooper Board was closely linked by family and personal connections, which generally is not a sound practice for a public company and a particularly unfortunate circumstance in this case. The Board majority included Gary Singer, his brother Steven, a third brother Brad, Steven Singer's father-in-law Joseph Feghali, and Bruce Sturman, a high school friend and business ally of the Singers.[293] The remaining directors were Michael Kalkstein, a lawyer; Robert Weiss, Cooper's treasurer and chief financial officer; Warren Keegan, a Pace University professor and business consultant; and Arthur Bass, a former Cooper president and chief executive officer.[294] Steven Singer was a lawyer,[295] and the Singer family, together with the Sturman family, had just taken control of Cooper and fought off two proxy contests in 1988 and 1989.[296] These same individuals were named co-defendants in a fraud on the market suit arising out of activities subsequent to May 1988 when they joining Cooper.[297]

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290. COOPER, 1994 ANNUAL REPORT on Form 10-K 44-45.

291. Civil Action Against the Cooper Companies et al., SEC News Digest 95-152, 1995 SEC NEWS LEXIS 1757 (Aug. 8, 1995); *Ex-Official of Cooper Settles SEC Charges of "Front-Running"*, WALL ST. J., Aug. 9, 1995, at B5 (outlining Steven Singer's civil penalty agreement).

292. Report of Investigation, *supra* note 249, at 86,065.

293. Terence P. Pare, *All in the Families*, FORTUNE, August 15, 1988, at 83.

294. COOPER PROXY STATEMENT 4-6 (June 30, 1992); COOPER PROXY STATEMENT 3 (February 27, 1991).

295. He was associated with Paul, Weiss, Rifkind, Wharton & Garrison from 1985 to 1986, and was deputy general counsel for Cooper from 1988 to 1989. COOPER PROXY STATEMENT 2 (Feb. 27, 1991).

296. *See* Kaufman v. Cooper Cos., 719 F. Supp. 174, 176-78 (S.D.N.Y. 1989) (recounting the history of the battle for control of Cooper).

297. Frank H. Cobb, Inc. v. Cooper Cos., [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,576, at 92,667 (Mar. 20, 1992).

While the SEC had ordered an investigation into charges of securities law violations, the existence of an investigation, particularly a civil one, does not prove anything.[298] The fact that both Singers allegedly claimed their Fifth Amendment privilege and refused to testify before the Commission, presumably on the advice of counsel, may well have been consistent with the corporation's best interests since the company faced possible criminal charges.[299]

According to the SEC, when Cooper was informed of an investigation by the New York U.S. Attorney's Office on March 12, 1992, the Board authorized an internal investigation by independent counsel.[300] That action was quite appropriate. When the Singers allegedly refused to be interviewed by the independent counsel, such refusal would have been cause for concern if this is what happened. Ordinarily, a private employer is entitled to the cooperation of employees in an internal investigation and may terminate an employee who refuses to answer questions about the performance of his duties.[301]

According to the SEC, Cooper's internal investigation disclosed that Gary Singer had engaged in self-dealing transactions with members of his family and family businesses by causing Cooper portfolio bonds to be sold at less than market prices, thereby depriving Cooper of profits totalling over $560,000.[302] If improper self-dealing by an

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298. *See, e.g.*, United States v. Matthews, 787 F.2d 38, 49-50 (2d Cir. 1986) (rejecting criminal charges under the proxy rules of the Securities Exchange Act of 1934 for company's failure to disclose in its proxy statement that the defendant was the subject of a grand jury investigation into alleged bribery of state officials); *accord In re* Browning-Ferris Indus., Shareholder Derivative Litig., 830 F. Supp. 361, 370 (S.D. Tex. 1993), *aff'd sub nom.*, Cohen v. Ruckelshaus, 20 F.3d 465 (5th Cir. 1994) (finding no violation of proxy rules for failure to disclose that a board nominee had been the target of a grand jury investigation for federal antitrust violations to which the corporation later pled guilty and paid a $1 million fine).

299. Seymour Glanzer et al., *The Use of the Fifth Amendment in SEC Investigations*, 41 WASH. & LEE L. REV. 895, 920 (1984) (claiming privilege may be best course of action); *see generally* William R. McLucas et al., *An Overview of Various Procedural Considerations Associated With the Securities and Exchange Commission's Investigative Process*, 45 BUS. LAW. 625 (1990) (discussing the "do's and don'ts" associated with SEC investigations); *cf.* SEC v. Dresser Indus., 628 F.2d 1368 (2d Cir.), *cert. denied*, 449 U.S. 993 (1980) (holding that a corporation must respond to an SEC investigative subpoena even though the evidence obtained may be used by the government in contemplated parallel criminal proceedings).

300. Report of Investigation, *supra* note 249, at 86,063.

301. *See* Marvin F. Hill, Jr. & James A. Wright, *Employee Refusals to Cooperate in Internal Investigations: "Into the Woods" with Employers, Courts, and Labor Arbitrators*, 56 MO. L. REV. 869, 906-08 (1991) (asserting that employees must provide management with information); *cf.* TRW, Inc. v. Superior Ct., 31 Cal. Rptr. 2d 460, 472 (Cal. App. 1994), *cert. denied*, 115 S. Ct. 1102 (1995) (holding that employee of government contractor has no right to have counsel present or remain silent in the face of an internal investigation and may be discharged for failure to cooperate; the employee's Fifth Amendment rights are adequately protected by disallowing use of compelled testimony in any subsequent criminal proceeding).

302. Report of Investigation, *supra* note 249, at 86,063.

executive is discovered, such conduct presumably would be proper cause for discharge. In this situation, Cooper had reason to act cautiously, not necessarily because of Mr. Singer's employment contract, but because Cooper itself faced serious criminal charges and Mr. Singer was the only person with personal knowledge of the facts.[303]

2. *The False Press Release*

The SEC's second claim alleged that the Board, while in the possession of knowledge of improper self-dealing by the company's chief executive officer, allowed the CEO's brother to issue a false press release denying any knowledge of wrongdoing.[304] The fact that an executive may have engaged in wrongdoing does not constitute grounds for discharging his brother, although a conflict of interest clearly arises under such circumstances. Note that Steven Singer was not himself indicted. The press release was issued when Griggs and Collins entered guilty pleas, and they publicly identified Gary Singer as their confederate in the frontrunning scheme; however, he was not identified as a participant in the alleged self-dealings, of which Cooper itself was the only victim, although such transactions must be reported in filings with the SEC and the stock exchange.[305]

In any event, no systemic breakdown is apparent under the factual circumstances described above. The Cooper Board has since been completely replaced, together with its management team, and corporate governance changes have been made with the advice of independent outside counsel. The SEC Division of Corporation Finance noted these factors in finding good cause to grant Cooper relief from the disqualifying provisions which would otherwise, based upon the criminal convictions, bar the company from using exemptions from registration under the Securities Act of 1933.[306] If the Cooper Board in fact acted inappropriately, any wrongdoing will presumably be dealt with in the pending derivative suits.

VIII. CONCLUSION

Principles of Corporate Governance has a vision of the corporate world that is a vision of uniform compliance with law, although al-

303. *See In re* E.F. Hutton Banking Practices Litig., 634 F. Supp. 265, 269-70 (S.D.N.Y. 1986) (stating that an independent board, faced with wrongdoing by individual officers and directors which threatens the viability of the company, may well wish to defer litigation against such individuals).

304. Report of Investigation, *supra* note 249, at 86,065.

305. *Id.* at 86,063-64.

306. *See* Letter from Gibson, Dunn & Crutcher, *supra* note 279 (granting application for relief pursuant to Rule 505(b)(2)(iii) of Regulation D).

lowances are made for instances where laws are unenforced, ambiguous or invalid, or rightly regarded as a cost of doing business. This is not a vision of the real world, where the norm of general compliance with law is an aspirational one rather than a realistic one.[307] The United States is a nation with a superabundance of laws: laws that have been forgotten, laws that are rarely or selectively enforced, laws that no one understands, and laws that are regarded by everyone as more of a nuisance than a moral command.[308] We are constantly reminded of this state of affairs when our moral, political, business, professional, religious, educational, judicial and other leaders are found to have the same weaknesses as society at large with respect to income tax compliance, use of controlled substances, employment of undocumented aliens or unconventional sexual preferences. The situation is exacerbated by the contention of law enforcement personnel that criminal conviction should not require proof of intent to violate the law, a very problematic notion that greatly confuses the moral and legal issues.[309]

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307. *See* Michael Siconolfi, *Wall Street Gurus Are Hitting the Books Again*, WALL ST. J., Feb. 21, 1995, at C1 (noting a dirty little secret on Wall Street, namely that many brokerage employees who are required to have a broker's license don't have them).

308. For example, the U.S. Supreme Court has not yet found anyone in violation of the court-created laws against insider trading. *See* Carpenter v. United States, 484 U.S. 19 (1987) (affirming conviction of Wall Street Journal employee by an equally divided court); Dirks v. SEC, 463 U.S. 646 (1983) (reversing censure of broker); Chiarella v. United States, 445 U.S. 222 (1980) (reversing conviction of a financial document printing employee). A stock broker was convicted and imprisoned for violating insider trading laws by trading on inside information of a tender offer by A & P for Waldbaum, Inc. in United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992). It was probably small consolation to him that he could have kept the money if it had been inside information about a merger instead of a tender offer, since breach of fiduciary duty is required to violate Section 10(b), but not Section 14(e), of the Securities Exchange Act of 1934. *See* SEC v. Switzer, 590 F. Supp. 756, 765-66 (W.D. Okla. 1984) (holding that University of Oklahoma football coach did not violate law by trading on inside information of bank merger overheard by him at a track meet); *see also* United States v. Rebrook, 58 F.3d 961, 965-66 (4th Cir.), *cert. denied*, 116 S. Ct. 431 (1995) (reversing conviction of lawyer for securities fraud but affirming conviction for wire fraud); United States v. Bryan, 58 F.3d 933, 952 (4th Cir. 1995) (rejecting misappropriation theory of insider trading). The Government prudently decided not to seek Supreme Court review of the question in *Bryan*. Milo Geyelin, *Insider Ruling Will Stand*, WALL ST. J., Oct. 6, 1995, at B5.

309. In some recent cases, the Supreme Court has applied a presumption, as a matter of statutory construction, that actual knowledge of prohibited conduct is required for criminal conviction. *See, e.g.*, Staples v. United States, 114 S. Ct. 1793, 1804 (1994) (interpreting the National Firearms Act to require proof of actual knowledge that weapon meets statutory definition of a machine gun); Ratzlaf v. United States, 114 S. Ct. 655, 663 (1994) (interpreting a "willful violation" of the Bank Secrecy Act to require actual knowledge that structuring the transaction to evade the reporting requirement was unlawful); United States v. X-Citement Video, Inc., 115 S. Ct. 464, 472 (1994) (interpreting a "knowing" violation of the Protection of Children Against Sexual Exploitation Act to require proof of actual knowledge that actress is a minor and the material is sexually explicit); Posters 'N' Things, Ltd. v. United States, 114 S. Ct. 1747, 1754 (1994) (interpreting the Mail Order Drug Paraphernalia Control Act to require proof of the use

While corporate directors should certainly not be able to break the law with impunity, lawbreaking is not a uniquely corporate law concern. If directors break the law, they should be, and are, subject to the same criminal, civil and administrative penalties as any other individual, business person or not. If they cause damage to the corporation in the process, they should be held accountable for their actions, subject to the authority of other disinterested directors to decide whether or not to file suit. The idea that directors are routinely hiding behind permissive standards for director conduct and lenient provisions for director indemnification and insurance is not supported by the facts.

With respect to the suggestion that the derivative shareholder attorney's hand should be strengthened by abolishing the "net loss" rule and weakening the power of disinterested directors to control derivative litigation, the wisdom of relying upon professional plaintiff's counsel under present conditions has been more than adequately questioned elsewhere.[310] In a recent case, a hastily considered diversification program by Pacific Enterprises caused over $750 million in losses to the corporation.[311] A leading plaintiff's law firm brought a derivative action in California state court on behalf of the corporation against the directors, and simultaneously brought a "fraud on the market" class action in federal court against the corporation on behalf of the company's common stockholders.[312] The state court action was

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of interstate commerce to sell items which the defendant knew were likely to be used with illegal drugs); Cheek v. United States, 498 U.S. 192, 203-04 (1991) (interpreting a "willful" violation of the Internal Revenue Code to require proof of actual intent to evade income tax laws).

310. In BZT, Inc. v. Great N. Nekoosa Corp., 47 F.3d 463 (1st Cir. 1995), the court disallowed any attorneys' fees for plaintiff's counsel for what it viewed as "phantom legal services" in a shareholders' derivative suit against directors which challenged their opposition to a hostile takeover. *Id.* at 466. Although the directors ultimately agreed to the takeover, and the acquiring corporation agreed not to object to fees for plaintiff's counsel of up to $2 million, the court found that the plaintiff's attorneys had not contributed to the ultimate success of the takeover. *Id.*; *see generally* John C. Coffee, Jr. *Understanding the Plaintiff's Attorney: The Implications of Economic Theory For Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 677 (1986) (concluding that such actions "are uniquely vulnerable to collusive settlements that benefit plaintiff's attorneys rather than their clients"); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (proposing changes to compensate for the fact that plaintiff's counsel is not accountable to his "client").

311. *In re* Pacific Enter. Sec. Litig., 47 F.3d 373 (9th Cir. 1995).

312. *Id.* at 378. The court stated that it was "concerned about the potential conflicts created by the linked settlement and by . . . dual representation of derivative and securities plaintiffs." *Id.* However, the court did not rule on the issue because no objection had been made in the trial court. Plaintiff's counsel indicated that no conflict arose and stated that representation by one firm in both cases had "tremendous advantages" in terms of coordination. Jill Abramson & Amy Stevens, *Class-Action Clash: King of "Strike Suits" Finds Style Cramped by Legal-Overhaul Bill*, WALL ST. J., March 30, 1995, at A1, A6.

refiled in federal court, and both suits were settled simultaneously.[313] Under the terms of the settlement agreement, the corporation paid $21 million and its officers' and directors' insurers paid $12 million to settle the securities suit and the insurers and the company's auditors paid $12 million to the corporation to settle the derivative suit. Plaintiff's counsel requested $8 million of the latter $12 million but received $4 million.[314] As the court noted, the corporation arguably received no financial benefit from the settlement because all of the money went to the securities plaintiffs,[315] despite the fact that both suits were of doubtful merit.[316]

The tonic for poor corporate governance practices prescribed in recent decades has been the presence of independent directors on the corporation's board.[317] Institutional investors, who have become a powerful force in corporate governance, have endorsed the concept of having a majority of independent directors on the board, a recommendation contained in the recently adopted GM Guidelines.[318] The definition of "independent director" endorsed by the National Association of Corporate Directors excludes: (1) any employee or former employee or relative of an employee; (2) service providers to the

313. *In re Pacific Enters.*, 47 F.3d at 375.

314. *Id.* at 375-76.

315. *Id.* at 378.

316. *See id.* ("[T]he odds of winning the derivative lawsuit were extremely small."); *id.* at 375 (noting a statement by the federal trial judge in the securities case that "many defendants were 'probably going to win' on summary judgment"); *see also* Kahn v. Sullivan, 594 A.2d 48, 62-63 (Del. 1991) (affirming a settlement agreement in a derivative action in which plaintiff's counsel received legal fees of $800,000 despite a benefit to the corporation which the Court of Chancery described as "meager," and despite the trial court's view that plaintiff's "potential for ultimate success on the merits [was] realistically, very poor").

317. *See* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 673-675 (1992) (analyzing the disinterested director requirement). On November 30, 1995, Delaware Supreme Court Chief Justice E. Norman Veasey declared, "[h]aving a majority of independent directors makes a big difference." Shelene Clark, *Independent Board that Can "Just Say No" to Management Makes "A Big Difference" if Corporation Ends Up in Court*, BNA CORP. COUNSEL WEEKLY, December 6, 1995, at 8.

318. *See GM Board Guidelines On Significant Corporate Governance Issues*, Guideline 15, "Mix of Inside And Outside Directors" ("The Board believes that as a matter of policy there should be a majority of independent Directors on the GM Board."); *see also A Message From Our Chairman, in* GENERAL MOTORS 1993 ANNUAL REPORT (1994) (noting that the GM Guidelines embrace the idea of lead directors, and that the concept of outside directors' meetings has received praise from investor representatives). In a letter dated May 12, 1994, CALPERS (the $80 billion California Public Employees' Retirement System) sent a copy of the GM guidelines to the largest corporations in America; according to CALPERS, more than half of the 300 companies surveyed submitted responses rated by CALPERS as good to exceptional. *CALPERS Pleased with Final Results of Year-Long Survey on Governance*, BNA CORP. COUNSEL WEEKLY, June 7, 1995, at 2.

corporation or employees of major service providers; and (3) anyone who receives corporate compensation other than director fees.[319]

It is generally agreed that the example set by top corporate managers is key in setting the tone for corporate compliance with the law.[320] The 1992 report of the Committee of Sponsoring Organizations of the Treadway Commission on internal control stresses that, more than any other individual, the chief executive officer sets the tone for integrity and ethics in the corporation.[321] The presence of independent directors on the board and their support for corporate compliance with law reinforces the determination of corporate management not to tolerate lawbreaking.

319. REPORT OF THE NACD BLUE RIBBON COMMISSION ON PERFORMANCE EVALUATION OF CHIEF EXECUTIVE OFFICERS, BOARDS, AND DIRECTORS 34 (1994). Strengthening the independent review of internal controls at insured depository institutions was a major goal of the Federal Deposit Insurance Corporation Improvement Act of 1991, which requires independent directors on the audit committee. 12 U.S.C. § 1831m(g)(1) (1994); Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317 (1993). The SEC has announced its support for the Investment Company Act Amendments of 1995, H.R. 1495, which among other things would increase the statutory requirement of independent directors on the boards of regulated investment companies from forty percent to a majority. *Barbash Details SEC's Stand on Proposed Investment Company Act Overhaul*, Fed. Sec. L. Rep. (CCH) No. 1692, at 1697 (Dec. 13, 1995).

320. RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING 29 (1994).

321. EXECUTIVE SUMMARY, INTERNAL CONTROL—INTEGRATED FRAMEWORK 1, 4 (1992); *see generally* Catherine Collins McCoy & John A. Galotto, *The COSO Report on Internal Control: Implications for Public Companies and Executives*, 7 INSIGHTS No. 8, at 29 (Aug. 1993).