A CRITICAL ASSESSMENT OF INTRACORPORATE LOSS SHIFTING AFTER PROSECUTIONS BASED ON CORPORATE WRONGDOING

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I. INTRODUCTION

Historically, there have been few efforts by corporate managements to shift the losses flowing from criminal activities conducted by or on behalf of the corporation to culpable individuals. The paucity of these actions has varied roots, but includes many of the same policies and incentives that cause corporations to indemnify directors and officers.[1] But actions seeking what in substance amounts to indemnification from corporate fiduciaries have recently become common, propelled by the mechanism of the shareholder derivative suit.[2]

Shareholders suing derivatively, or perhaps more accurately, lawyers representing such shareholders,[3] have different incentive

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1. Some of these policies and incentives include: the fear that liability "will either thin the ranks of corporate executives or induce institutional paralysis," Kathleen Brickey, *Rethinking Corporate Liability Under the Model Penal Code*, 19 RUTGERS L.J. 593, 622 (1988); the view that "it is sometimes in the best interests of the corporation, from a financial point of view, to walk as close to the line as possible," *id.* at 623; the recognition that it is "'entirely conceivable that a director or officer can be in violation of a criminal statute in the furtherance of corporate activity and yet still be fulfilling his obligations to the corporation in all good faith,'" *id.* (quoting Note, *Indemnification of the Corporate Official for Fines and Expenses Resulting from Criminal Antitrust Litigation*, 50 GEO. L.J. 566, 570 (1962)); the desire to "benefit good corporate soldiers," *id.*; and, undoubtedly, personal loyalties. *Id. See, e.g.*, Mooney v. Willys-Overland Motors, Inc., 204 F.2d 888, 898 (3d Cir. 1953) (holding that the purpose of indemnification of directors is to encourage qualified persons to serve as corporate directors, secure in the knowledge that expenses incurred by them in defending their actions as directors will be borne by the corporation that they serve); Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 1993-94 (1978).

2. *See* FED. R. CIV. P. 23.1.

3. *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, 677-84 (1986) (stating that the attorney, and not the client, often defines the objectives of a derivative litigation); 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) (examining the financial incentives for plaintiffs' attorneys in derivative suits

structures and operate under different sets of constraints than corporate managements.[4] Acting on their authority to step into the corporation's shoes and to bring corporate claims when management will not, shareholders have pursued intracorporate loss-shifting remedies from corporate fiduciaries with increasing vigor. As a result, directors, officers, and employees are often finding themselves named as defendants in subsequent civil actions brought by or on behalf of the corporation itself and not by the victim of the corporation's crime.[5]

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and proposing reform measures); 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, 424 & n.29 (1991) (suggesting that fiduciary liability for illegal acts could be windfall for the plaintiff's corporate bar).

4. *See* Macey & Miller, *supra* note 3, at 34-41.

5. Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988-90*, 71 B.U. L. REV. 247, 269 (1991) ("Derivative lawsuits by shareholders seeking to recoup fines and other costs related to criminal prosecutions are relatively common."). *See, e.g.*, Stern v. General Elec. Co., 924 F.2d 472 (2d Cir. 1991) (where a plaintiff shareholder attempted to institute a derivative action alleging that the directors' actions exposed the company to criminal liability under the Federal Regulation of Lobbying Act and an anti-bribery statute even though there was never a criminal prosecution); Nathan v. Rowan, 651 F.2d 1223 (6th Cir. 1981) (barring a shareholder from instituting a derivative action against directors and officers who allegedly caused corporation to violate federal excise tax and securities laws because the claims were *res judicata*); *In re* Crazy Eddie Sec. Litig., 714 F. Supp. 1285 (E.D.N.Y. 1989) (where a corporation brought an action against its former directors and officers who allegedly caused the corporation to defraud shareholders and investors); *In re* E.F. Hutton Banking Practices Litig., 634 F. Supp. 265 (S.D.N.Y. 1986) (attempted derivative claim against directors and officers who allegedly caused the corporation to engage in a check kiting scheme); Lewis v. Sporck, 612 F. Supp. 1316 (N.D. Cal. 1985) (derivative claim against directors, officers, and employees who allegedly caused the corporation to defraud the government by falsifying testing data and steal trade secrets from a competitor).

Derivative actions by shareholders alleging that directors and officers have caused a defense contractor corporation to defraud the government have been particularly prevalent. *See, e.g.*, Burt *ex rel.* McDonnell Douglas v. Danforth, 742 F. Supp. 1043 (E.D. Mo. 1990); Shields v. Erickson, 710 F. Supp. 686 (N.D. Ill. 1989) (where shareholders instituted a derivative claim against the directors and officers of a defense contractor alleging that they caused the corporation to defraud the government); Mozes v. Welch, 638 F. Supp. 215 (D. Conn. 1986) (where a shareholder attempted to file a derivative action against corporate directors alleging that they submitted false claims to the government in defense contracts, thereby subjecting the corporation to criminal charges); Goldberg v. Jones, No. CV88-7332KN (C.D. Cal. complaint filed Dec. 12, 1988); Shields v. Mettler, No. 1:89CV0422 (N.D. Ohio complaint filed Mar. 7, 1989); Cummings v. Mettler, No. 1:89CV0176 (N.D. Ohio complaint filed Jan. 27, 1989); Weinberger v. Gardner, No. 89-1179 (E.D. Pa. complaint filed June 28, 1989).

Loss-shifting claims of this kind present several difficult issues.[6] Although these claims are grounded in hornbook law regarding fiduciary duty, their underlying rationale is hard to reconcile with current notions of corporate or organizational criminal responsibility. This article reexamines these issues by addressing the theoretical and practical difficulties posed by efforts to shift the losses that attend corporate criminality to fiduciaries whose actions on behalf of the corporation constituted, caused, or contributed to the criminal activity for which the corporation has been punished.

Attempts to shift losses from the corporation to its directors and officers can be regarded as actions seeking indemnification rather than actions involving a straightforward application of fiduciary duty principles.[7] This has not typically been the case. Instead, indemnity claims and claims for breach of fiduciary duty seeking the same result have been pleaded and analyzed separately.[8] A loss-shifting action does not arise under any criminal statute when it is based on a claim of breach of fiduciary duty. Nevertheless, compensation to the corporation from its officers and directors can be fruitfully analyzed as the functional equivalent of traditional indemnification

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6. Intracorporate loss shifting following prosecutions based on corporate wrongdoing has most frequently occurred in the context of indemnification of directors and officers. As a result, an extensive body of literature addresses the propriety and mechanics of indemnification "when we lay blame for wrongdoing at the feet of individual corporate officers and agents." Brickey, *supra* note 1, at 621. *See, e.g.*, JOSEPH WARREN BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE (1991).

Less attention has been paid to corporate efforts to secure compensation from fiduciaries who had some level of personal involvement in an activity that gave rise to a corporate criminal prosecution. Notable exceptions are Ryan, *supra* note 3, and Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980). There is, of course, a large body of literature addressing the mechanism of the derivative suit in general, and its particular application as a tool for enforcing the fiduciary duty of care. Much of that literature bears on the questions addressed here.

7. *See generally* David M. Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653, 690-91 (1984) (proposing that an action against a corporation's officers for a breach of the duty of care merely shifts the risk of penalty to the officers and fails to create any deterrent effect); Stone, *supra* note 6, at 56-65 (noting that a derivative action for indemnity can be initiated by shareholders as a result of a director or manager's breach of the fiduciary duty of due care).

8. *See, e.g.*, Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 984 (S.D.N.Y. 1988), *vacated in part by In re* Crazy Eddie Sec. Litig., 714 F. Supp. 1285 (E.D.N.Y. 1989).

running in the opposite direction.[9] Since an action for breach of fiduciary duty has the same effect as an indemnity action, the same policy considerations should logically bear on the availability of both causes of actions.

Given the similarity between the two types of actions, public policy considerations will have the same bearing on an action for breach of fiduciary duty as they do on an action for corporate indemnity.[10] In particular, a corporate criminal conviction may take on more than just evidentiary significance in a subsequent loss-shifting action for breach of fiduciary duty. Its existence, and the rationale for punishing the corporation in the first place, may instead form a policy-based argument that some or all intracorporate loss-shifting actions should be dismissed for failure to state a claim on which relief may be granted.

The thesis of this article is that, absent a specific legislative or contractual justification for a loss-shifting action, courts should leave undisturbed the allocation of blame and penalties established by the prosecutors and courts in criminal proceedings.[11] This is true whether

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9. It might also be thought of as the functional equivalent of contribution to the extent the plaintiff seeks to shift some, but not all, of the loss associated with corporate criminality. But cases are not typically structured this way.

10. Stone, *supra* note 6, at 48-49. *See, e.g.*, MODEL BUSINESS CORP. ACT ch. 8, subch. E, introductory comment § 8.44 (1991) (discussing the policy considerations that may be violated by indemnification); 5D ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5 § 264.02[b] (2d ed. 1992) ("Federal public policy plays a significant role in determining which persons who violated 10b-5 can obtain indemnity."); Johnston, *supra* note 1, at 2006-07, 2011 (noting the common law principle "that contracts indemnifying a party for his own . . . misconduct are not enforceable as a matter of public policy"); Tucker v. Arthur Anderson & Co., 646 F.2d 721, 724 (2d Cir. 1981) (noting that it would be contrary to public policy to allow a violator of the securities laws to be compensated for damages); *Bernstein*, 702 F. Supp. at 984 (emphasizing the importance of promoting "the policies of judicial economy, convenience, and fairness to litigants"); *In re* Olympia Brewing Co. Sec. Litig., 674 F. Supp. 597, 610-11 (N.D. Ill. 1987) (noting that some courts have rejected indemnity claims on the grounds that granting indemnity might run counter to the legislative purpose of deterring fraud); Seiler v. E.F. Hutton & Co., 102 F.R.D. 880, 885 (D.N.J. 1984) (holding that securities laws do not grant a defendant the right to indemnity for losses incurred).

11. *See* Stone, *supra* note 6, at 62-64.

A discussion of the nature of the duties imposed on corporate fiduciaries, and the role those duties play "as one of the social controls on corporate deviance," Ryan, *supra* note 3, at 417, is beyond the scope of this article. These duties arguably should include obligations for management itself to obey general legal standards and to "supervis[e] . . . corporate activities to insure general law compliance by all corporate actors, including employees." *Id.* at 418 & n.14. *See* AMERICAN LAW

the issue is approached from the perspective of either criminal or corporate law.

Our judicial system has not come to rely on intracorporate loss-shifting actions to further criminal law objectives, as it has with other types of actions by "private attorneys general."[12] It is not at all clear that loss-shifting actions can achieve this goal. In fact, they may have just the opposite effect. Nor is it obvious that, all things considered, loss-shifting actions promote the objectives of corporate law. The actions drain corporate resources and typically produce settlements of questionable value to corporations involved.[13] To the extent an additional shareholder enforcement mechanism is desired, actions seeking only equitable relief, rather than intracorporate loss shifting, are better designed to promote the ends of both criminal and corporate law.

II. AN OVERVIEW OF CURRENT LAW

It is hornbook law that the shareholders of a corporation that is guilty of criminal wrongdoing may seek, through the vehicle of a derivative action, to make the corporation whole by holding those fiduciaries who caused the corporation to violate the law liable for the resulting injury. Corporate directors and officers have a fiduciary duty to promote their corporation's best interests and protect it against loss. "Upon accepting the office of director or officer of a corporation, a person assumes a duty of loyalty to the company and its shareholders, and a duty to act with care in fulfilling his responsibilities."[14] These duties, in particular the duty of care, require corporate fiduciaries to refrain from engaging in, or causing their corporation to engage in, illegal activities in the conduct of the corporation's

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INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (Tentative Draft No. 2, 1984). This article is instead concerned with the appropriate enforcement of those duties through derivative actions within the context of "the traditional corporate governance framework." Ryan, *supra* note 3, at 418. Wholly apart from how it is enforced, a general law compliance obligation may have considerable significance as an aspirational standard. *See, e.g.*, John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 792, 796-99 (1984).

12. *See* Stone, *supra* note 6, at 61.

13. *See* Milt Policzer, *They've Cornered the Market*, Nat'l L.J., Apr. 27, 1992, at 1, 34.

14. EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS § 2:01 (1984).

business.[15] Failure to properly discharge these fiduciary duties can render the fiduciary liable to the corporation.[16] Liability may arise even if the resulting illegality was directed at a third party and not the corporation and was intended to benefit the corporation. This article examines fiduciary liability in such situations and explores its justification and impact.[17]

In *Wilshire Oil Co. v. Riffe*,[18] a corporation sued several former officers to recover damages—including fines, penalties, civil damages, settlements, attorneys' fees, and other expenditures—incurred by the company due to antitrust violations committed on its behalf. The corporation argued that the officers breached their fiduciary duties by violating the antitrust laws. In reversing the dismissal of the action

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15. *See, e.g.*, Wilshire Oil Co. v. Riffe, 409 F.2d 1277, 1285-86 (10th Cir. 1969); Clayton v. Farish, 73 N.Y.S.2d 727, 744-45 (Sup. Ct. 1947); Simon v. Socony-Vacuum Oil Co., 38 N.Y.S.2d 270, 274 (Sup. Ct. 1942), *aff'd mem.*, 47 N.Y.S.2d 589 (App. Div. 1st Dept. 1944); DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE 34 (3d ed. 1989); WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS §§ 1.14, 4.15 (4th ed. 1988); 18B AM. JUR. 2d, *Corporations* § 1687, 1688 (1985).

16. Liability also may arise under the rule that an "agent who subjects his principal to liability because of a negligent or other wrongful act is subject to liability to the principal for the loss which results therefrom." RESTATEMENT (SECOND) OF AGENCY § 401, cmt. d (1958). "This includes the payment of damages by the principal to the third person, or of a fine to the state in case of a crime." *Id.*

17. There are at least two different situations in which such liability may arise. In one, the fiduciary is directly involved in the corporate wrongdoing. In the other, the fiduciary's involvement is limited to a failure to prevent wrongdoing by others within the corporation. The imposition of liability in the latter situation has been more controversial and finds less support in the case law. *Compare* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. Ch. 1963) (rejecting a claim against corporate directors because plaintiffs failed to show that directors had actual knowledge of other employees' wrongdoing) *with* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: AN ANALYSIS AND RECOMMENDATIONS § 4.01 (Tentative Draft No. 1, 1985) [hereinafter ANALYSIS AND RECOMMENDATIONS] (proposing to expand the scope of corporate directors' violations of their duty of care). *See generally* William J. Carney, *The Monitoring Board, Duties of Care, and the Business Judgment Rule*, *in* AMERICAN LAW INSTITUTE AND CORPORATE GOVERNANCE: AN ANALYSIS AND CRITIQUE 111 (1987) [hereinafter ANALYSIS AND CRITIQUE] (suggesting that an initiative making directors responsible for monitoring potential violators of the law would make the duty of care for directors too strict); Nicholas Wolfson, *The Theoretical and Empirical Failings of the American Law Institute's Principles of Corporate Governance in* ANALYSIS AND CRITIQUE, *supra*, at 69, 96-99 (criticizing stricter duty of care standards for directors); William F. Kennedy, *The Standard of Responsibility for Directors*, 52 GEO. WASH. L. REV. 624, 639-40 (1984) (explaining that it is impractical to make corporate directors responsible for discovering their employees' wrongdoing). The distinction between these two situations is not central to the thesis of this article.

18. 409 F.2d 1277 (10th Cir. 1969).

by the lower court, the court of appeals held that the corporation could "invoke the law of fiduciary duty in order to affix liability upon employees whose antitrust violations have subjected the corporation to civil and criminal liability."[19]

Wilshire Oil and similar cases indicate that illegal corporate activity directed at a third party does not automatically result in fiduciaries being liable to the corporation. Any follow-on liability implicates the corporation's internal affairs and requires both a violation of law and a breach of the fiduciary duty owed to the corporation. The statutes and case law governing fiduciary liability vary,[20] but often reflect a deeply ingrained desire to shield corporate fiduciaries from liability, affording considerable protection even in the face of potentially serious error.[21]

This protection, however, has not prevented a recent proliferation of shareholder actions seeking to shift the financial consequences of corporate criminality to directors and officers.[22] Many of these actions involve fiduciaries of corporations that have been convicted of, or have pleaded guilty to, fraud in defense contracting activities, but there are also other examples.[23] As criminal prosecutions of corporations become more common,[24] the number of actions of this kind is likely to increase. This trend is likely to intensify with the implementation of the Sentencing Guidelines developed by the United

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19. *Id.* at 1285. *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 182 A.2d 328 (Del. Ch. 1962), *aff'd*, 188 A.2d 125 (Del. 1963); Clayton v. Farish, 73 N.Y.S.2d 727 (Sup. Ct. 1947); Simon v. Socony-Vacuum Oil Co., 38 N.Y.S.2d 270 (Sup. Ct. 1942), *aff'd mem.*, 47 N.Y.S.2d 589 (App. Div. 1st Dept. 1944); BLOCK ET AL., *supra* note 15, at 34; Elizabeth T. Tsai, Annotation, *Right of Corporation to Indemnity for Civil or Criminal Liability Incurred By Employees' Violations of Antitrust Laws*, 37 A.L.R.3d 1355 (1971). *See generally* Harlan M. Blake, *The Shareholders' Role in Antitrust Enforcement*, 110 U. PA. L. REV. 143, 157-78 (1961) (discussing derivative actions against directors for expenses resulting from antitrust violations); Note, *Corporate Indemnification for Rule 10b-5 Violations*, 70 COLUM. L. REV. 504 (1970) (proposing corporate indemnity actions for liability resulting from violations by employees of Rule 10b-5).

20. *See* D. BLOCK ET AL., *supra* note 15, at 40-48, 673-88; KNEPPER & BAILEY, *supra* note 15, §§ 7.01-.08.

21. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991); OHIO REV. CODE ANN. § 1701.59(D) (Anderson Supp. 1991).

22. *See* Coffee, *supra* note 11, at 811-12.

23. *See supra* note 5.

24. *See* Alan J. Chaset & Benson B. Weintraub, *New Guidelines for Sentencing Corporations*, Trial, Apr. 1992, at 41; Cohen, *supra* note 5, at 252.

States Sentencing Commission.[25] It is anticipated that these sentencing guidelines will result in substantial increases in the penalties associated with corporate criminal convictions.[26]

III. CHALLENGING THE RATIONALE FOR INTRACORPORATE LOSS SHIFTING

As yet, the increasing number of these loss-shifting cases has not prompted a reevaluation of their underlying legal theory. Directors and officers faced with such actions have most often defended themselves within the statutory and common law framework of fiduciary duty. Recent case law is, therefore, not instructive, except to the extent that it accepts the legal theories supporting intracorporate loss shifting.[27] In contrast to the large body of literature on derivative actions in general, there is little recent commentary addressing the question of whether it makes sense to allow corporations, or shareholders acting on behalf of corporations, to shift losses associated with corporate criminality to fiduciaries.

An unqualified affirmative answer to this question is not inevitable. The fiduciary duty principles that compel an affirmative answer are long standing and well entrenched—at least when the fiduciary is directly involved in the wrongdoing.[28] It is not clear, however, that these principles can bear close scrutiny in all cases, either standing on their own or considered in relation to the legal and policy justifications for increased criminal prosecutions of corporations, instead of exclusive reliance on prosecutions of responsible fiduciaries.

The question must first be approached by examining the impact of modern theories of corporate criminal responsibility on those theories customarily used to justify intracorporate loss shifting. It is then necessary to review the relationship between loss shifting and the objectives of criminal and corporate law, and between loss shifting

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25. UNITED STATES SENTENCING COMMISSION GUIDELINES MANUAL ch. 8 (Nov. 1991); UNITED STATES SENTENCING COMMISSION, SUPPLEMENTARY REPORT ON SENTENCING GUIDELINES FOR ORGANIZATIONS (Aug. 1991).

26. *See* Chaset & Weintraub, *supra* note 24, at 41; Harvey L. Pitt & Karl A. Groskaufmanis, *Mischief Afoot: The Need for Incentives to Control Corporate Criminal Conduct*, 71 B.U. L. REV. 447, 448-49 (1991); L. Gordon Crovitz, *Vindictive Corporate Punishments Toss Stockholders Into Stockades*, Wall St. J., Nov. 13, 1991, at A17.

27. *See, e.g.*, Burt *ex rel.* McDonnell Douglas v. Danforth, 742 F. Supp. 1043 (E.D. Mo. 1990); Shields v. Erickson, 710 F. Supp. 686 (N.D. Ill. 1989).

28. *See supra* note 17.

and the general principles of tort and contract law regarding compensation for damages. At each level of analysis, there are serious questions regarding the rationale for allowing losses resulting from corporate criminality to be shifted to fiduciaries.

A. Collective Responsibility Theories and Intracorporate Loss Shifting

Intracorporate loss-shifting claims against responsible fiduciaries are rooted in agency principles and the view that, since a corporation can commit crimes only through individuals acting on its behalf, the corporation itself cannot be a blameworthy agent. In an era when the theoretical justification for criminal prosecutions of corporations rested largely, if not exclusively, on the doctrine of *respondeat superior*, intracorporate loss shifting under agency principles was not subject to significant challenge. As a result, seminal cases authorizing intracorporate loss shifting are largely unreasoned and are based on the proposition that it is preferable that the "guilty" individual bear the adverse consequences of criminal conduct perpetrated on the "innocent" corporation's behalf, and that the corporation be made whole.[29]

This view of the proper source of corporate criminal liability still has its defenders,[30] and it may represent the better view. But corporate criminal liability has attracted much scholarly attention in recent years, and considerable effort has been expended on developing and evaluating new justifications for both imposing such liability and expanding its scope.[31] Much of this effort has focused on shifting attention and blame from the individual corporate actor to the collective responsibility of the organization as a whole, or at least adding

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29. *See, e.g.*, *Wilshire Oil*, 409 F.2d at 1283-84; Note, *supra* note 19, at 504-05.

30. *See, e.g.*, Milton Eisenberg, *Corporate Criminal Liability: Is It Time for a New Look?*, (NLCPI White Paper Feb. 1991).

31. *See, e.g.*, Barry D. Baysinger, *Organization Theory and the Criminal Liability of Corporations*, 71 B.U. L. REV. 341 (1991); Michael K. Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 B.U. L. REV. 395 (1991); John Braithwaite & Gilbert Geis, *On Theory and Action for Corporate Crime Control*, 28 CRIME & DELINQ. 292 (1982); Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095 (1991); Simeon M. Kriesberg, *Decisionmaking Models and the Control of Corporate Crime*, 85 YALE L.J. 1091 (1976); Stephen A. Saltzburg, *The Control of Criminal Conduct in Organizations*, 71 B.U. L. REV. 421 (1991); Note, *Developments in the Law—Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227 (1979).

the concept of collective responsibility to the traditional law enforcement arsenal, which focuses largely on the individual.[32]

This more modern approach implicates corporate as well as individual criminal responsibility, since the corporation may be more than the sum of its parts, and corporate wrongdoing may not always be fairly traceable to a single individual or group of individuals.[33] Drawing on organizational theory and some empirical evidence, scholars have identified a variety of reasons why corporate prosecutions might be regarded as desirable, or even necessary, and why it might be insufficient to simply prosecute the individuals involved in corporate wrongdoing.[34] These reasons flow in part from the view that "the corporate system itself sometimes helps produce criminal behavior" because "the organizational incentive structure causes, or at least contributes to, the individual misconduct."[35] As a result, "the law should attach blame to the corporation as well as to the individual,"[36] both to deter corporate wrongdoing and "to identify the need for reform at the corporate level."[37]

The debate over this modern theory and the propriety of corporate prosecutions based on it will not be resolved here. The very existence of debate, however, suggests a need to reexamine intracorporate loss shifting in the context of corporate criminality.

To the extent a prosecution rests, in whole or in part, on an assessment of collective responsibility rather than on a simple application of the doctrine of *respondeat superior*, the theoretical basis for intracorporate loss shifting becomes problematic.[38] In cases where criminal penalties rest on collective responsibility and not simply on

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32. *See, e.g.*, MARSHALL B. CLINARD, CORPORATE ETHICS AND CRIME (1983); DIANE VAUGHAN, CONTROLLING UNLAWFUL ORGANIZATIONAL BEHAVIOR (1983); Brent Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault and Sanctions*, 56 S. CAL. L. REV. 1141 (1983); Diane Vaughan, *Toward Understanding Unlawful Organizational Behavior*, 80 MICH. L. REV. 1377 (1982).

33. *See, e.g.*, VAUGHAN, *supra* note 32, at 68-77; Bucy, *supra* note 31, at 1099, 1127-47; Stone, *supra* note 6, at 31.

34. Ann Foerschler, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CALIF. L. REV. 1287 (1990).

35. *Id.* at 1289-90. *See* Bucy, *supra* note 31, at 1099, 1127-47.

36. Foerschler, *supra* note 34, at 1289.

37. *Id.* at 1290. *See* Saltzburg, *supra* note 31, at 429-32.

38. *Cf.* Maryville Academy v. Loeb Rhodes & Co., 530 F. Supp. 1061, 1071 (N.D. Ill. 1981) (indemnification available where corporate liability rests solely on doctrine of *respondeat superior*); JACOBS, *supra* note 10, § 264.02[b], at 11-435 & n.39 (where principal's liability rests solely on agency principles, principal can obtain indemnity from agent).

the doctrine of *respondeat superior*, the distinction between the "innocent" corporation and the "guilty" individual is blurred. As a result, it may become difficult to determine not only whether the loss is being shifted to the right persons, but whether it should be shifted at all; and, if so, the extent to which loss shifting should be allowed. Causation principles might adequately limit loss shifting in these circumstances,[39] as might common law and statutory limitations on the liability of fiduciaries. Acceptance of the collective responsibility approach to justifying corporate criminal prosecutions, however, may either give rise to broader limitations, or give support to more stringent enforcement of existing limitations, on efforts to shift the consequences of corporate criminality to fiduciaries.

B. Criminal Law Objectives and Intracorporate Loss Shifting

Intracorporate loss-shifting actions can have one of three effects on the attainment of the objectives of criminal law. First, they can undermine criminal law objectives by diluting the government's effort to assign blame and penalties to the corporation either in addition to or instead of particular individuals acting on the corporation's behalf. Second, they can promote these objectives either by encouraging "private attorneys general" to ferret out and punish wrongdoing or by adding an additional level of punishment and deterrence. Finally, loss-shifting actions can have no meaningful effect for a variety of reasons, such as their unpredictability and insignificance in relation to the impact of criminal sanctions.

Loss shifting from corporations to their fiduciaries has developed as a creature of corporate law with no apparent regard for its impact on the ends of criminal law. Many decisions authorize loss shifting without considering whether it promotes, undermines, or has no effect on the objectives of corporate criminal prosecutions such as deterrence and retribution. The law governing the right of fiduciaries to indemnity from their corporations has not developed in such a

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39. *See generally* Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 52 GEO. WASH. L. REV. 609, 617 (1984) (discussing the importance of proximate cause in the determination of whether conduct that violates an officer's duty of care will give rise to financial accountability); Phillips, *supra* note 7, at 668-72 (discussing the appropriateness of proximate cause as an element in a cause of action for breach of an officer's duty of care).

vacuum.[40] The law governing the functional equivalent of indemnification flowing in the opposite direction should also not develop in a vacuum, particularly if the idea of some form of collective responsibility for corporate criminality is accepted.

In the context of indemnification of individuals, "the trend . . . has been to liberalize and expand the scope of indemnification."[41] Even so, while "[m]ost observers . . . see nothing improper in the indemnification of corporate officers and directors when they are successful in their defenses,"[42] indemnification for criminal fines and penalties "presents a more difficult problem."[43] The standards vary from state to state but, as a general rule,

> [t]he person indemnified must have acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation with respect to the claim against him. As to any criminal action or proceeding, such person must have had no reasonable cause to believe his conduct was unlawful. Public policy prohibits indemnification of corporate officers for intentional illegal conduct. And one who deliberately violates federal criminal law cannot be acting "in good faith."[44]

The existence of a conviction, guilty plea, or plea of *nolo contendere* does not end the matter under this standard.[45] The standard indicates, however, that in striking a balance between "the need to punish

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40. *But see* Pamela H. Bucy, *Indemnification of Corporate Executives Who Have Been Convicted of Crimes: An Assessment and Proposal*, 24 IND. L. REV. 279, 280 (1991) ("[I]ndemnification developed in the context of civil liability and was extended to the criminal arena simply by tacking a few words about criminal liability onto existing indemnification statutes."); James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1231-34 (1988) (proposing that holding directors liable for indemnification of the corporation may serve to retard corporate efficiency and productivity).

41. KNEPPER & BAILEY, *supra* note 15, § 20.02. *See* Bucy, *supra* note 40, at 283-84; Thomas L. Hazen, *Corporate Directors' Accountability: The Race to the Bottom—The Second Lap*, 66 N.C. L. REV. 171, 177 (1987); Johnston, *supra* note 1, at 1995-96.

42. KNEPPER & BAILEY, *supra* note 15, § 20.02.

43. *Id.*

44. *Id.* § 20.08 (footnotes omitted). *See, e.g.*, Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Associated Milk Producers, Inc. v. Parr, 528 F. Supp. 7, 7-8 (E.D. Ark. 1979); Odette v. Shearson, Hammill & Co., 394 F. Supp. 946, 957 (S.D.N.Y. 1975).

45. KNEPPER & BAILEY, *supra* note 15, § 20.08. *See* Green v. Westcap Corp., 492 A.2d 260, 264 (Del. Super. 1985).

unfaithful fiduciaries and, at the same time, provide protection for aggressive corporate managers willing to undertake good faith risks in the search for profits,"[46] public policy considerations are considered relevant, and the objectives of criminal law are not ignored.[47]

The link between criminal law objectives and the denial of indemnification to fiduciaries who have been successfully prosecuted is relatively direct. The law has required a considerable degree of individual participation and culpability in order to sustain convictions of fiduciaries based on their involvement in most corporate wrongdoing.[48] The indemnification of persons satisfying this higher standard of culpability could inappropriately weaken deterrence, retribution, and other ends sought to be promoted by prosecuting corporate directors and officers in the first place.[49] As a matter of corporate governance, indemnification in such circumstances could send an inappropriate signal to fiduciaries, promoting unwarranted risk taking on the corporation's behalf.[50] These propositions are difficult to test empirically, but are appealing intuitively and seem to be generally accepted.[51]

The link between the rejection of a loss-shifting or indemnification action and the ends of the criminal law may be more attenuated in the context of corporate efforts to shift the losses associated with corporate criminality to their fiduciaries. That, however, is not a

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46. KNEPPER & BAILEY, *supra* note 15, § 20.02. *See* Johnston, *supra* note 1, at 1993-94.

47. *See* Johnston, *supra* note 1, at 2006-07. *But see* Brickey, *supra* note 1, at 622. This is not to say, however, that indemnification of corporate executives convicted of crimes does not occur "routinely, and quietly." Bucy, *supra* note 40, at 279, 281 & n.7, 315-16. *See* Bucy, *supra* note 31, at 1141.

48. Except in the case of a few federal statutes that "have been interpreted to create a strict liability standard for the criminal conduct of corporate officers," some degree of "[m]oral culpability must usually be proved before criminal liability is imposed." Paul F. Schaaff, Jr., Note, *Indirect Criminal Conduct of Corporate Officers—Law in Search of a Fair and Effective Standard of Liability*, 13 DEL. J. CORP. L. 137, 138 (1988). But, as the government has been given "increasingly wide latitude" in proving *mens rea*, its burden of proving criminal intent in white collar criminal prosecutions has been diluted. *See* Bucy, *supra* note 40, at 294, 296-304. Strict liability prosecutions, moreover, have been increasing in number. *Id.* at 295-96.

49. Bucy, *supra* note 40, at 342.

50. *Id.*

51. *See, e.g.*, Gould v. American-Hawaiian S.S., 387 F. Supp. 163 (D. Del. 1974), *vacated on other grounds*, 535 F.2d 751 (3d Cir. 1976); Bucy, *supra* note 40, at 312; John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry Into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 407-11 (1981); Dale A. Oesterle, *Limits on a Corporation's Protection of its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513, 514, 523, 532, 582.

reason to ignore the goals of criminal law in formulating rules governing intracorporate loss shifting. If these goals are promoted by imposing criminal penalties on corporations as well as on responsible corporate agents, they may be frustrated by allowing a corporation to shift its resulting losses to its fiduciaries or the insurers of its fiduciaries.[52] Even if the corporation does not regain its lost goodwill or reputation, a loss-shifting action may deflect "corporate" blame to a particular individual, undermining the policies supporting the initial assignment of blame to the corporation.[53] In these senses, intracorporate loss-shifting actions could frustrate the objectives of the criminal law.[54]

It is unlikely that loss-shifting actions will materially promote criminal law objectives such as deterrence and retribution. Loss-shifting actions do create additional costs and inconvenience for corporations involved in criminal conduct. In this sense, they may be regarded as imposing a penalty supplementary to that imposed by criminal law. But there is little reason to think that the prospect of additional costs and inconvenience adds materially to the incentives for lawful corporate behavior created both by criminal penalties and by civil liability to victims of the corporation's crime. Defense and settlement costs may be large, but they typically pale in comparison to the other consequences of criminal corporate conduct.[55]

Nor can loss-shifting actions be expected to promote compliance with the law by ferreting out wrongdoers within the corporation. The stated purpose of a loss-shifting action is to recover compensation

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52. *See* Stone, *supra* note 6, at 62. *Cf.* MODEL BUSINESS CORP. ACT ch. 8, subch. E, introductory comment (1984). Among other things, intracorporate loss-shifting actions may reduce the incentive for shareholders to select and supervise managers for law compliance and may "create incentives for shareholders to hire managers willing to commit crimes on the corporation's behalf." Ryan, *supra* note 3, at 437.

53. *But see* Saltzburg, *supra* note 31, at 431-32.

54. This problem is particularly pronounced where the substantive criminal statute at issue is a federal statute. In some circumstances, state law indemnification claims relating to certain federal statutes are preempted by federal law. *See, e.g.*, Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101, 1108 (4th Cir. 1989) ("[I]t would run counter to the basic policy of the federal securities laws to allow a securities wrongdoer such as Baker, Watts to shift its entire responsibility for federal violations on the basis of a collateral state action for indemnification."); BRODSKY & ADAMSKI, *supra* note 14, § 19:07. A detailed analysis of the preemption issue is beyond the scope of this article.

55. Other consequences of criminal corporate conduct may include adverse impacts on revenue generation, loss of good will, and debarment from governmental contracts.

for corporations that have been damaged by their involvement with the criminal justice system. These actions arise in situations where the government has already detected the illegality and penalized the corporation (and perhaps the responsible individuals as well). Accordingly, these actions cannot be expected to identify criminal conduct of which the government was previously unaware.

A follow-on civil lawsuit on the corporation's behalf may potentially identify responsible fiduciaries that a previous criminal law prosecution may have overlooked or rejected as insufficiently involved to support individual criminal liability.[56] But loss-shifting actions are not likely to expose fiduciaries to criminal prosecution or increase the sum total of the criminal and civil penalties associated with the particular corporate misconduct. Aside from potentially significant litigation costs, a civil damages action following a criminal conviction will not effectively increase the overall adverse financial consequences of the wrongdoing. Instead, the effect of a successful loss-shifting action is simply to reallocate those consequences of the wrongdoing from the corporation to its fiduciaries or the fiduciaries' insurers. In terms of their direct financial impact, therefore, these actions are thus best viewed as private actions with private consequences, without significant potential to promote the objectives of criminal law.[57]

The possibility that settlements in loss-shifting actions will promote the objectives of criminal law may be somewhat greater. Many cases have been settled through the implementation of "corporate prophylactics"—corrective measures ostensibly designed to ensure that the wrongdoing that led to the corporate criminal conviction does not recur.[58] It is debatable, however, whether these settlements add materially to measures that the government has already required or that the corporation itself would voluntarily put in place, following disclosure of corporate criminality. Whether these measures ultimately serve their intended purpose of preventing future corporate wrong-

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56. *See* Stone, *supra* note 6, at 29 ("[I]t is ordinarily less costly to identify and convict whatever enterprise was responsible than to go further and fix responsibility on one of the enterprise's agents.").

57. *See* Phillips, *supra* note 7, at 689.

58. *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 24, 26-33 (Summer 1985); Bryant G. Garth et al., *Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate*, 48 LAW & CONTEMP. PROBS. 137, 146-47 (Summer 1985); Kennedy, *supra* note 17, at 644.

doing remains to be seen.[59] But, even if these threshold questions are answered affirmatively, shareholders could still seek these prophylactic measures without attempting to shift the financial consequences of corporate wrongdoing.[60]

Whether the objectives of criminal law are promoted, hindered, or unaffected by actions seeking intracorporate loss shifting is ultimately an empirical question. Given the complexity of the issue, however, an empirical answer may never be available.[61] In light of this uncertainty, a case can be made, based on criminal law objectives, for not disturbing the allocation of blame and penalties established by the legislatures, prosecutors, and courts in criminal proceedings. Such a rule has three primary advantages in relation to criminal law. First, it avoids disruption of the presumptively correct societal allocation of criminal penalties.[62] Second, this rule removes the potential for imposition of "draconian" penalties on corporate fiduciaries[63] and eliminates the possibility that those fiduciaries will bear two criminal penalties—their own and their corporation's. Third,

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59. *See, e.g.*, Garth et al., *supra* note 58, at 146-47; Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, *in* 7 J.L. ECON. & ORGANIZATION 55, 84 (1991); Policzer, *supra* note 13, at 34.

60. *See infra* Part IV.

61. A significant money judgment or settlement in favor of a corporation may reduce the impact of a criminal fine or penalty in a particular case, but the corporation itself may ultimately foot the bill due to factors such as increased insurance costs. *See* Kennedy, *supra* note 17, at 644. A settlement incorporating strong "corporate prophylactics" may reduce the likelihood of future criminal activity by the corporation without shifting the costs or blame associated with criminal penalties to fiduciaries. But such settlements may amount to no more than a ratification of pre-existing corporate controls or ones implemented to satisfy the government in connection with the criminal prosecution. *See* Dean James F. Hogg, *Tinkering with Successive Drafts Will Not Change the Reporters' Philosophy*, *in* ANALYSIS AND CRITIQUE, *supra* note 17, at 23, 44-45 (1987). The litigation itself will impose significant direct and indirect costs on the corporation itself, which costs should be considered in evaluating settlements. These may be found to operate as a form of tax or additional penalty on corporations involved in criminal conduct. *See id.* at 67-68; Kennedy, *supra* note 17, at 644; Donald V. Seibert, *The Dynamics of Corporate Governance*, *in* ANALYSIS AND CRITIQUE, *supra* note 17, at 15, 21. The possible impact of other potential outcomes is equally uncertain.

62. *See* Stone, *supra* note 6, at 35 ("In order to make society's selection stick, it may be necessary to limit indemnification . . . ."). *Cf.* MODEL BUSINESS CORP. ACT, *supra* note 10, § 8.22 ("A shift of these liabilities from the individual director or officer to the corporation by way of indemnification may in some instances be viewed as frustrating the public policy of those statutes which expressly impose the sanctions on the director or officer.").

63. Stone, *supra* note 6, at 63.

it ensures that the effects of criminal sanctions will fall only on those fiduciaries who have received the benefits of "the procedural advantages they would have enjoyed as defendants in a criminal suit,"[64] when shown to have personally violated the criminal law.

This approach is primarily subject to three criminal law objections: (1) it may overpenalize innocent corporations and their shareholders; (2) it may underpenalize and, therefore, under deter responsible fiduciaries to whom some or all of the blame and penalties associated with corporate criminality should be directed; and (3) it may encourage fiduciaries to trade off corporate convictions or pleas to avoid individual conviction or pleas, thereby reducing their own liability.[65]

The argument that a rule barring intracorporate loss shifting would overpenalize corporations involved in criminal conduct and their innocent shareholders encounters two major obstacles in addition to the collective responsibility theories described above.[66] First, this argument ignores the benefits that the corporation and the shareholders derived from both the criminal conduct and from the procedures and policies (or lack thereof) that allowed the criminal conduct to occur. These benefits include not only the direct return on criminal conduct, but the avoidance of monitoring costs, as well as the increased flexibility, creativity, and productivity that may have flowed from "looser" procedures and policies.

Second, and more important, the overpenalization argument is ultimately a challenge to the imposition of corporate punishments in general. This argument makes the large—and untested—assumption that a derivative action of this kind financially benefits the corporation or allows it to regain, at least in part, the goodwill or reputation that the corporation lost through its contact with the criminal justice system. This assumption is debatable.[67] Even if this assumption is

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64. *Id.* at 64.

65. *See id.* at 54. The incentive to do so could be exacerbated if the corporation's ability to obtain indemnification were made to turn on whether the responsible fiduciary had also been convicted or pleaded guilty in connection with the activity that led to the imposition of criminal sanctions on the corporation.

66. *See supra* Part III(A).

67. *See supra* notes 58-59. Such actions may increase, not decrease, the financial consequences to the corporation of criminal activity carried out on its behalf. This is particularly true when a derivative action is filed during the pendency of a corporation's dispute with the government, resulting in a situation where shareholder plaintiffs seek to prove or even exaggerate the consequences of the corporation's criminal conduct. As a general provision, moreover, the corporation, and not the

accepted at face value, the overpenalization argument is viable only if the criminal punishment imposed on the corporation is perceived to be too severe. This result could only be realized if those designing the punishment assumed that it would be partially mitigated by subsequent intracorporate loss shifting and increased the level of punishment in order to compensate for this anticipated mitigation. There is no evidence to this effect, and the proposition seems highly implausible. Any other argument resting on the severity of corporate criminal sanctions (there are many and they have some force) is no more than an attack on the judgment of the legislatures, prosecutors, courts, and juries. If the judgment of any of these entities is suspect, the problem should be dealt with directly, through revision of the criminal law.

The second and third potential objections—that a rule barring intracorporate loss shifting will underpenalize fiduciaries and encourage them to trade off corporate convictions to reduce their own exposure to liability—can be considered together. As to the latter, a rule precluding intracorporate loss shifting would have only a minor effect on this managerial incentive to trade off a conviction. Even assuming that the responsible managers were in a position to act on this incentive while handling the corporation's dealings with the government, the desire to avoid personal criminal convictions (and possible jail terms) supplies all the necessary motivation to conduct a proper legal defense. Any such incentive, moreover, is counterbalanced by the prosecutors' desire to either convict or obtain guilty pleas from any responsible individuals, in addition to the corporation itself.

As to the former argument, there is little reason to think that responsible fiduciaries will go unpunished absent intracorporate loss-shifting actions, at least where they are directly involved in the wrongdoing.[68] The government has a strong incentive to identify responsible individuals and ensure that they are subjected to prosecution.[69] There is no evidence that shareholder plaintiffs are more efficient or effective than the government in identifying those re-

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individual defendants, typically bears the lion's share of the cost of defending and settling derivative actions.

68. *See* Cohen, *supra* note 5, at 268; Ryan, *supra* note 3, at 426 ("Direct involvement carries the risk of independent criminal liability for the fiduciary, so the threat of criminal liability might provide sufficient deterrence in direct involvement situations.").

69. *But see* Saltzburg, *supra* note 31, at 425-29.

sponsible for corporate criminality. Shareholder plaintiffs may be considerably less effective, since their natural inclination will be to focus their attention on individuals who have insurance or deep pockets and are running the corporation, rather than those directly involved in the corporate wrongdoing. As a result, a rule precluding intracorporate loss shifting will not materially increase the likelihood that fiduciaries directly responsible for corporate wrongdoing will go unpunished.[70] Even if it did allow fiduciaries to go unpunished, the problem would best be remedied through the criminal law since reliance on follow-on civil litigation is inefficient.

The situation is somewhat different when a loss-shifting claim is based on a fiduciary's failure to adequately supervise corporate employees and not on his direct involvement in corporate wrongdoing.[71] Since the likelihood of criminal liability for the fiduciary is greatly reduced in such cases, it can be argued that failure to adequately supervise may deserve greater fiduciary liability than direct involvement, if other social controls are considered.[72] In other words, a perceived deterrence gap in the criminal law should be plugged by allowing an entity that is subject to criminal sanctions under applicable law to shift some or all of the costs associated with those sanctions to a fiduciary who is not subject to criminal sanctions.

This can be done, however, only by changing the allocation of blame and penalties established by the legislatures, prosecutors, and courts. Actions of this kind, simply seeking to shift the deterrent fines and penalties from the corporation to the fiduciaries, do not result in the levying of any additional criminal penalties. If imposing those fines and penalties on the fiduciaries, rather than on the corporation, provides a more effective deterrent, that result should be sought through revision of the standards of criminal liability applicable to fiduciaries and corporations.

Moreover, even if it is conceded that a direct link occasionally exists between inadequate supervision by corporate management and the resulting corporate crime, the inadequate supervision is not solely responsible for the corporation's crime. Cases of this kind are based on the theory that the crime could have been prevented if the board of directors had acted differently. But, it is not, in most instances, the directors' conduct that has subjected the corporation to criminal

70. *See* Stone, *supra* note 6, at 63.
71. *See supra* note 17.
72. Ryan, *supra* note 3, at 426, 462-65.

liability. Instead, other individuals within the corporation have acted on its behalf in ways that the criminal law deems adequate to attribute criminal liability to the corporation (and in all likelihood to those actors as well). Loss shifting in such circumstances is, therefore, difficult to reconcile with the principles of indemnification law.[73]

C. Corporate Law Objectives and Intracorporate Loss Shifting

Assessing the impact of intracorporate loss-shifting actions on the objectives of corporate law is more difficult. On one hand, intracorporate loss-shifting actions may constitute a form of shareholder control over the actions of fiduciaries, representing a means by which fiduciaries can be called to account for damages caused by their action or inaction. On the other hand, such actions may undermine a corporation's defense against government and third-party claims,[74] producing negative value for the corporation and operating as a further penalty for criminal conduct.[75] Loss-shifting actions may also cause management problems similar to those that have led legislatures and corporations to conclude that indemnification of fiduciaries is consistent with the goals that the law established for corporate entities.[76]

Here, again, empirical data would obviously be helpful. But absent such data, it is fair to conclude that a rule precluding intracorporate loss-shifting actions following a corporate criminal prosecution would not undermine the objectives of corporate law. From a corporate law perspective, the proposed rule is subject to two additional objections. First, a rule precluding intracorporate loss shifting may involve too much deference by corporate law to criminal law, allowing criminal law to intrude too deeply into matters of internal corporate governance. Second, elimination of intracorporate loss shifting may give rise to an anomalous situation where fiduciaries are entitled to indemnification for criminal proceedings brought against them as directors or officers of the corporation, but are not held similarly accountable when their actions embroil the corporation in criminal proceedings. Neither objection is compelling.

Fiduciaries may, within limits, be indemnified for the consequences of their criminal activities on behalf of the corporation.

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73. *See, e.g.*, *Baker, Watts*, 876 F.2d at 1108; JACOBS, *supra* note 10, § 264.02[b], at 11-433 to -435.

74. *See In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. at 269-70.

75. *See supra* notes 61 and 67.

76. *See supra* note 1; Stone, *supra* note 6, at 63-64.

When the fiduciary has acted in good faith and has not intentionally violated a criminal statute on the corporation's behalf, the indemnification of a fiduciary is a defensible action that balances the objectives of both criminal and corporate law.[77]

Indemnification under a standard requiring a fiduciary to act in good faith is necessary to promote valid corporate objectives.[78] Loss shifting (indemnification flowing in the opposite direction) may also promote corporate objectives, including the desire to punish unfaithful fiduciaries and induce their compliance with the law. But the risk of personal criminal convictions and the denial of personal indemnification may provide fiduciaries with all the punishment and incentive that is necessary to promote these corporate objectives. The additional risk of loss-shifting actions might lead to the sort of institutional problems that indemnification statutes and bylaws are designed to mitigate.[79] In this respect, loss-shifting actions by corporations might conflict with the salutary corporate policies underlying such statutes and bylaws.

Equally important, the theory of indemnification of fiduciaries is firmly grounded in the language of both corporate statutes and the particular corporate articles or bylaws.[80] It is significant that the operative statutory and contractual language is addressed directly to the issue of indemnification, which reflects a conscious decision by both the legislature and contracting parties to promote effective corporate management by allowing indemnification in criminal cases under certain specified circumstances.

When loss shifting or indemnification is to flow in the opposite direction—from fiduciary to corporation—the corporate law justification is much less specific. The statutory authorization typically lies in the general fiduciary duty statute, and does not reflect any specific legislative balancing of criminal and corporate law objectives. While it is possible that "indemnification" rights of this kind could be specifically provided for in a corporation's articles, bylaws, or employment contracts,[81] this has typically not been done.

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77. *See supra* note 44.

78. *See supra* note 1 and text accompanying *supra* notes 45-47.

79. *See supra* note 1. *See also* Hazen, *supra* note 41, at 171-72.

80. A corporation's articles or bylaws are the particular contract that governs rights and liabilities within a corporation. *See, e.g.*, DEL. GEN. CORP. L. § 145 (1991); MODEL BUSINESS CORP. ACT, *supra* note 10.

81. *But see In re* Olympia Brewing Co. Sec. Litig., 674 F. Supp. at 622-23 (discussing circumstances under which contractual indemnification agreements may be found unenforceable as violative of public policy).

Actions seeking to shift to fiduciaries losses associated with corporate criminality have, therefore, been grounded in general principles not precisely tailored to the issue involved. In addition, these actions are not based upon statutes or contracts that reflect the specific judgment that these actions are necessary to promote either the goals of corporate law or the objectives of a particular corporation. Absent more specific statutory or contractual authorization, intracorporate deference to the allocation of blame and penalties established in criminal proceedings is appropriate, and a rule barring intracorporate loss shifting should not intrude too deeply into matters of corporate governance.[82]

Nor is there any reason to regard the resulting allocation of rights and liabilities within the corporation as anomalous. A system barring intracorporate loss shifting in one direction but allowing it in the other would stem from the greater specificity with which corporate law objectives have manifested themselves in relation to the indemnification of fiduciaries. If the objectives justifying intracorporate loss shifting were manifested with similar specificity in a corporation statute or a corporation's operative documents, such a system allowing disparate treatments of loss-shifting actions in each direction would be more difficult to condone. But that has not been done and, as a result, that system of disparate treatment need not be regarded as anomalous as a matter of corporate law. In fact, by eliminating the possibility that indemnification claims might flow in both directions at once, as is the situation when fiduciaries are indemnified against loss-shifting claims brought on their corporation's behalf,[83] the rule could well be regarded as restoring an element of rationality to a system that in all likelihood is not serving the interests of corporations or their shareholders.

D. Damages Principles and Intracorporate Loss Shifting

Loss-shifting actions by a corporation that has been the intended beneficiary of criminal activity may create a windfall for the cor-

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82. Such a rule precluding intracorporate loss shifting could well have salutary effects on corporate governance by prompting further discussion and delineation, by both legislatures and corporations themselves, of the circumstances in which a corporation should be allowed to seek indemnification from its fiduciaries for the consequences of criminal activities conducted on its behalf.

83. *See* Johnston, *supra* note 1, at 2009-10.

poration.[84] In some situations, the costs associated with the detection of corporate criminal activity (e.g., legal fees, fines, penalties, etc.) may exceed the benefits that the corporation derived from the activity before it was discovered. This, however, will not always be true since "corporate deviance can be profitable to the corporation."[85] Allowing recoveries against fiduciaries may unjustly enrich the corporation when the corporation does realize a net benefit from the criminal behavior.[86]

This concern can be mitigated, at least in part, by application of appropriate damage theories. Under traditional tort and contract law principles, damages and benefits to a single plaintiff causally resulting from the same conduct must be netted out in determining the plaintiff's actual damages.[87] This principle led to the dismissal of a complaint in *Smiles v. Elfred*,[88] a derivative action brought against, among others, the corporation's officers. In *Smiles*, the plaintiffs alleged that the defendants' violations of antitrust law caused the corporation to be convicted, fined, and exposed to civil liability. The complaint was dismissed on the ground that damages

> may not be presumed from the mere imposition of a fine, the expenditure of specified substantial sums of money in

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84. It also may tend to overpenalize the fiduciaries. The possibility of follow-on civil liability has not been regarded as a reason to temper criminal sanctions in order to avoid excessive penalties. Such a situation could nevertheless be objectionable if it alters an allocation of total responsibility between the corporation and the individual, ultimately causing the individual to bear more than his proportionate share of both the blame and penalty.

85. Ryan, *supra* note 3, at 452. This does not mean, of course, that "[a]chieving profits outside the bounds of the law" should be regarded as a valid corporate purpose. Donald E. Schwartz, *Defining the Corporate Objective: Section 201 of the ALI's Principles*, 52 GEO. WASH. L. REV. 511, 513 (1984).

86. *See, e.g.*, Wesley E. Forte, *Liabilities of Corporate Officers for Violations of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313, 336-39 (1965); Ryan, *supra* note 3, at 424-25, 452-58; *Recent Developments, Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 174, 178 (1964).

87. *E.g.*, Minpeco, S.A. v. Conticommodity Servs., 676 F. Supp. 486, 488-89 (S.D.N.Y. 1987) (holding that a plaintiff who was both enriched and injured by the wrongful activity can recover only if and to the extent that it discharges its burden of proving net injury, after accounting for both positive and negative effects of the conduct charged); Grossman, Faber & Miller, P.A. v. Cable Funding Corp., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,913, at 97,120, 97,120-21 (D. Del. Dec. 16, 1974). *See* RESTATEMENT (SECOND) OF TORTS § 920 (1979); CHARLES T. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 40, at 146 (1935); 1 CHARLES L. KNAPP, COMMERCIAL DAMAGES ¶¶ 2.06[3][c], 4.02[3], 4.05 (1987).

88. 149 N.Y. L.J., Feb. 20, 1963, at 14, col. 6 (N.Y. Sup. Ct. 1963).

> defending criminal contempt proceedings or the exposure to [civil] antitrust suits . . . , in the absence of allegations in the complaint excluding the possibility that [the corporation] may have gained more from the price-fixing conspiracy than the amounts of the fine paid and the expenditures said to have been incurred or risked.[89]

It is unclear, however, whether shareholder plaintiffs will be required to plead and prove net loss as a precondition to recovery. The American Law Institute (ALI), for example, would permit a plaintiff to plead corporate loss generally.[90] If the court decides to allow any offset at all, the burden of proving corporate gain from the illegal activity would then shift to the defendants.[91] Such a rule, of course, would "make it much harder to obtain quick dismissals in corporate deviance cases" by precluding defendants from obtaining "an immediate dismissal on the pleadings merely by pointing to the plaintiff's inability to establish net corporate losses from the illegal conduct."[92]

The primary justifications for an ALI-type rule are that it makes it easier for plaintiffs to bring these type of cases, allocates the burden of proof to the better-informed defendants, and changes the "settlement dynamics . . . because the defendant fiduciaries would face embarrassment from having to plead and prove that they should escape individual liability because their corporation's crimes did pay."[93] All this is true, and such a rule could be justified if these loss-shifting actions demonstrably served the interests of corporate and criminal law. But these points, particularly the settlement leverage point, all become disadvantages if such actions have the potential to undermine the objectives of criminal law.

Regardless of how the net injury principle is applied and how corporate loss must be pleaded, the direct and indirect benefits associated with corporate criminality (including those benefits asso-

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89. *Id. See* Forte, *supra* note 85, at 336-39 (stating that a derivative plaintiff must plead facts showing that the corporation suffered a net loss from the antitrust violation committed by an officer or director); *Recent Developments*, *supra* note 86, at 178 (approving the result in *Smiles* because "[n]o justification exists for permitting a windfall to the unharmed corporation or for additionally penalizing the director").

90. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.16(c) (Tentative Draft No. 9, 1989).

91. *Id.*

92. Ryan, *supra* note 3, at 473.

93. *Id.* at 456.

ciated with the policies and procedures that allowed the criminality to occur) may be difficult to quantify. In addition, it may be in the corporation's best interests to not have these benefits fully enumerated, since doing so could expose the corporation to further liability to the victim of the wrongdoing. As a result, loss-shifting actions theoretically create considerable potential for unjust enrichment of the corporation, regardless of the damages principles applied.

In the absence of evidence that loss-shifting actions promote the ends of the criminal law, this potential windfall for the corporation should not be accepted. There is, to be sure, an argument that "[an] absolute prohibition of shareholder litigation when corporate deviance has been profitable might tend to give the impression that corporate law is willing to tolerate crime, as long as it pays."[94] But this position assumes that a general law compliance requirement would be construed as "condon[ing] criminal activity"[95] unless there is a shareholder action to enforce it. This is not an acceptable assumption since the duty of a fiduciary would still have precatory value,[96] and its importance could be impressed upon fiduciaries and employees in other ways, such as inclusion in the provisions of employment contracts or retrospectively through the electoral process.[97] Even if the assumption that the preclusion of a shareholder action condones criminal activity is valid, shareholder actions seeking relief other than money damages through intracorporate loss shifting[98] would seem adequate to enforce the duty without creating the potential for corporate windfalls.

IV. AN EQUITABLE REMEDY AS AN ALTERNATIVE TO INTRACORPORATE LOSS SHIFTING

This analysis suggests that there is little justification for allowing corporations to shift the financial consequences of corporate criminality to their fiduciaries. While actions seeking such relief have increased recently, the remedy of money damages is seldom obtained.[99] Most cases are settled and, while there are exceptions, most

94. *Id.* at 425.
95. *Id.*
96. *See supra* note 11.
97. *See* Ryan, *supra* note 3, at 426 n.35; Stone, *supra* note 6, at 62.
98. *See* Ryan, *supra* note 3, at 426 n.35.
99. *See generally* Romano, *supra* note 59, at 61-65 (providing statistics on various shareholder suits).

settlements result in no actual loss shifting.[100] Instead, the nominal defendant corporation adopts measures ostensibly designed to ensure that the wrongdoing that led to the corporation's involvement with criminal law does not recur.[101]

Nevertheless, even the remote potential for a loss-shifting remedy has considerable impact on both plaintiffs and defendants. The availability of that remedy may well encourage the pursuit of shareholder litigation in the aftermath of an episode of corporate criminality, because it greatly increases the plaintiffs' ultimate settlement leverage. The availability of a loss-shifting remedy increases the corporation's ultimate cost of defending and settling cases such as these by significantly increasing the stakes in the litigation.

The remedy of loss shifting may also have the perverse effect of creating an incentive to delay the implementation of corporate prophylactics. By delaying remedial measures, the corporation can avoid creating a discovery road map for plaintiffs by not revealing evidence that the existing levels of oversight and control at the time of the wrongdoing were inadequate. A delay of the implementation of prophylactic measures also allows the corporation to retain bargaining chips for the eventual settlement of a loss-shifting action. The availability of a loss-shifting remedy may also heighten the incentive for collusive settlements in which little real attention is paid to the adequacy and value to the corporation of the remedial measures adopted under a settlement agreement.

A preferable cause of action would be one in which the available relief is limited to the enforced adoption of remedial measures designed to prevent a recurrence of the prior corporate wrongdoing. The elements of such an action would include:

(a) the existence of prior corporate criminal activity that has led to a conviction, guilty plea, or plea of *nolo contendere*, and the passage of a reasonable period of time following the conclusion of the criminal proceeding;

(b) the availability of particular prophylactic measures that—if in place at the relevant time—could have prevented or reduced in scope and impact the prior criminal activity, or made the criminal activity substantially less likely to occur;

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100. *Id.*

101. *Id. See supra* text accompanying notes 58-59.

(c) the likelihood that the prior criminal activity or a comparable violation involving the same aspect of the corporation's business will recur absent the adoption of particular prophylactic measures;

(d) the failure of the corporation's board of directors, following a demand and the passage of a reasonable period of time, to adopt particular prophylactic or alternative measures reasonably calculated to achieve the same objective of preventing recurrence; and

(e) a departure by the board of directors from the applicable standard of conduct in its decision making process on the adoption of prophylactic measures.

Limiting the corporation's cause of action in this way should have a number of beneficial effects when examined in conjunction with the demand requirement of Federal Rule of Civil Procedure 23.1. *First*, demand should rarely, if ever, be excused in an action of this kind, which will eliminate costly and wasteful diversions from the merits of many loss-shifting actions.[102] *Second*, the discovery burdens associated with a typical loss-shifting action should be greatly reduced by eliminating the requirement that the shareholder plaintiff sufficiently tie particular directors or officers to the corporate wrongdoing in order to justify a damages award. *Third*, by reducing or eliminating the need to prove injury to the corporation, the prophylactic cause of action should further reduce the need for discovery and expert testimony and should diminish the possibility that issues uncovered by efforts to prove damages might injure the corporation.[103] *Fourth*, the prophylactic cause of action should significantly reduce the time, expense, and distraction of management attention typically associated with loss-shifting litigation by reducing the range of issues involved in shareholder litigation growing out of corporate criminality. *Fifth*, by removing the threat of personal financial liability and reducing the premium that loss-shifting actions place on accusations of serious misconduct by high-level fiduciaries, the prophylactic cause of action should produce greater objectivity and critical self-evaluation by boards of directors as well as more measured and less costly defensive postures. And, *sixth*, the prophylactic cause of action has the potential to create an environment more conducive to the implementation of measures that may meaningfully decrease the likelihood of future criminal activity by emphasizing the remedial

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102. *See, e.g.*, Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343-44 (7th Cir. 1990), *rev'd*, 111 S. Ct. 1711 (1991).

103. *See supra* notes 58-59, 67 and accompanying text.

actions taken by the corporation in response to a prior criminal violation and the costs and benefits of additional steps that might be taken.

This cause of action would arise in a situation where a corporation commits a criminal violation and, either acting on its own or at the prodding of the government, adopts measures to prevent a recurrence. A shareholder, who may or may not be fully apprised of the remedial steps already taken by the corporation, would submit a demand letter requesting particular remedial action. If the remedial measures or their functional equivalent have already been adopted, the corporation could so inform the shareholder, and that should end the matter. If the proposal is addressed to a gap in the corporation's internal controls and otherwise has merit, the corporation might well adopt it and, thus, eliminate any basis for shareholder litigation.[104] If the demand is rejected, however, a prophylactic cause of action will lie, and attention will be focused on the directors' business judgment regarding prophylactic measures, the remedial measures already in place (if any), the need for additional remedial measures, and the costs, benefits, and value to the corporation of the particular remedial measures proposed by the shareholder plaintiff.

In such an environment, shareholder plaintiffs will have an incentive to carefully evaluate the adequacy of the corporation's internal controls and the steps it has taken to prevent recurrence of the corporate criminality. At the same time, corporate management can avoid shareholder litigation by adopting reasonable prophylactic measures and yet maintain an ability to resist meaningless, duplicative, or counterproductive measures without fear of exposing their corporation to protracted and costly litigation, continued publicity concerning the episode of corporate wrongdoing or fear of exposing themselves to potentially ruinous personal financial liability.

This leaves only the questions of whether entrepreneurial shareholder lawyers will have an adequate incentive to pursue the prophylactic cause of action and, if not, should we care. In light of the utility of loss-shifting actions, I tend to believe that the answer to the second question is no. The prophylactic cause of action should, however, hold sufficient attraction for shareholder lawyers in situa-

104. Doing so would not constitute an admission for purposes of a damages action that the prior procedures were inadequate, nor would it deprive potential defendants in an action for money damages of a means to settle such litigation.

tions where corporate management rejects demonstrably beneficial prophylactic measures. Pursuing an action on this theory should be far less costly than litigating a loss-shifting action. The business judgment rule will pose a considerable, yet not insurmountable, obstacle to such actions. But there is no reason why plaintiffs cannot receive fee awards for successfully pursuing a prophylactic cause of action just as they can for successfully concluding a loss-shifting action or for settling a loss-shifting action for purely nonmonetary consideration.[105]

V. CONCLUSION

The criminal and corporate law justifications for loss-shifting actions in the aftermath of corporate criminal prosecutions are weak. In certain circumstances, these actions may frustrate the goals of criminal law by upsetting the legislatively and judicially established allocation of penalties and blame to the corporation. In such cases, public policy may demand that actions seeking indemnification or its functional equivalent for corporations from their fiduciaries be dismissed. That result should be attainable within the existing statutory and common law framework of indemnification and fiduciary duty. Motions to dismiss on public policy grounds should be considered when assessing defensive strategies in loss-shifting actions. If, however, legislative action is required, legislation barring loss shifting by corporations that have been convicted of or pleaded guilty to a criminal offense in some or all circumstances—including those in which the corporation's criminal liability did not arise solely out of attribution of the fiduciary's conduct to it through the doctrine of *respondeat superior*—and establishing a prophylactic cause of action would strike an appropriate balance between the objectives of the criminal law and those of the corporate law.

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105. *See, e.g.*, *In re* M.D.C. Holdings Sec. Litig., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,474 (S.D. Cal. Aug. 30, 1990); Carolyn Berger, *Settlements and Awards of Attorneys' Fees in Delaware State Courts*, *in* AMERICAN BAR ASSOCIATION, DYNAMICS OF CORPORATE CONTROL § J (1991); Romano, *supra* note 59, at 63; Policzer, *supra* note 13, at 34.