# TWENTY-EIGHT WORDS: ENFORCING CORPORATE FIDUCIARY DUTIES THROUGH CRIMINAL PROSECUTION OF HONEST SERVICES FRAUD

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## ABSTRACT

*This article examines the federal government's growing use of 18 U.S.C. § 1346 to prosecute public company executives for breaching their fiduciary duties. Section 1346 is a controversial but under-examined statute making it a felony to engage in a scheme "to deprive another of the intangible right of honest services." Although enacted by Congress over twenty years ago, the Supreme Court repeatedly declined to review the statute, until now. In 2009, Justice Antonin Scalia pointed to the numerous interpretive questions dividing the federal appellate courts and proclaimed that it was "quite irresponsible" to let the "current chaos prevail." Since then, the Court has granted certiorari in no fewer than three separate cases construing the honest services law.*

*The questions before the Supreme Court are of particular interest to public company executives and their professional advisors. Following revelations of massive fraud and management wrongdoing at Enron and other public companies, the Justice Department employed § 1346 to indict executives accused of breaching their fiduciary duties. Former Enron CEO Jeffrey Skilling and former Hollinger CEO Conrad Black are just two of the corporate fiduciaries found guilty of breaching their duties and convicted under the statute. Traditionally, Delaware law has governed the content and enforcement of executives' legal duties, largely protecting public company fiduciaries from civil liability. Now, with the emergence of honest services fraud as a weapon against corporate wrongdoing, and pressure from Congress for more prosecutions, civil and criminal law are trending in opposite directions. Corporate fiduciaries may become criminally liable for conduct that would not subject them to civil sanctions. Furthermore,*

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*because these fiduciaries look to state law for the standards governing their conduct, this anomalous development has profound implications for public company governance.*

*This article analyzes the issues before the Supreme Court in light of these contradictory enforcement trends. Spill-over from federal criminal jurisprudence to state fiduciary duty doctrine is one concern, but over-criminalization and prosecutorial abuse also must be considered. I conclude this article by proposing a statutory amendment that may advance Congress's interest in prosecuting public company executives for serious fraud while limiting federal interference with potentially conflicting fiduciary obligations arising under state law.*

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## I. INTRODUCTION

If lawyers for the notorious corporate kleptocrat[1] Lord Conrad Black can persuade the United States Supreme Court to reverse their client's convictions for honest services mail fraud, the former media executive may have Justice Antonin Scalia to thank for his good fortune. Over the past two decades, the Court refused persistent appeals imploring the Justices to invalidate the federal honest services statute—§ 1346—which criminalizes fraudulent schemes "to deprive another of the intangible right of honest services."[2] Notwithstanding sharp disagreements among the circuit courts over its proper scope, the Supreme Court had declined every opportunity to construe the twenty-eight-word statute. Indeed, just one month after Black filed his petition, the Court denied certiorari in *Sorich v. United States*,[3] an honest services challenge from the Seventh Circuit (the same appellate court that had affirmed Black's convictions) raising very similar questions about the statute's reach. The Court's denial in *Sorich*, however, prompted a surprising dissent from Justice Scalia. Adding his voice to a chorus of other jurists and scholars, Justice Scalia complained that honest services fraud had become a "potent federal prosecutorial tool," "invoked to impose criminal penalties upon a staggeringly broad swath of behavior, including misconduct not only by public officials and employees but also by private employees and corporate fiduciaries."[4] After all, what is the "intangible right of honest services"? Read literally, § 1346 criminalizes conduct ranging from a mayor using his influence to get a restaurant table without a reservation to a public servant recommending an unqualified friend for a public contract. In the private sphere, the statute could prohibit "any self-dealing by a corporate officer" as well as "a salaried employee's phoning in sick to go to a ball

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[1]A special committee of the board of directors of Hollinger International determined that under Black's leadership as chairman and CEO, the firm was a "corporate kleptocracy." *See* Hollinger Int'l, Inc., Report of Investigation by the Special Committee of the Board of Directors of Hollinger International Inc. (Form 8-K), at 4 (2004) [hereinafter Breeden Report], *available at* http://www.sec.gov/edgar/searchedgar/webusers.htm; *see also* Posting of Jonathan Kay to Full Comment, http://network.nationalpost.com/np/blogs/fullcomment/archive/2007/07/13/jonathan-kay-on-conrad-black-his-crimes-do-not-fit-him.aspx (July 13, 2007, 13:28 EST) (describing Black as a corporate kleptocrat).

[2]18 U.S.C. § 1346 (2006). Section 1346 provides that the "scheme[s] or artifice[s] to defraud" proscribed by the mail fraud and wire fraud statutes, *id.* §§ 1341, 1343, include schemes or artifices "to deprive another of the intangible right of honest services." In full, the statute reads: "For the purposes of this chapter, the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services." *Id.* § 1346.

[3]129 S. Ct. 1308 (2009).

[4]*Id.* at 1309 (Scalia, J., dissenting from denial of certiorari).

game."[5] Justice Scalia urged the Court to review both the meaning of the statute and its constitutionality, admonishing his colleagues that it was "quite irresponsible to let the current chaos prevail."[6] Still, legal prognosticators anticipated that the Court would reject Black's petition as it had rejected every other challenge to § 1346,[7] leaving Black, a sixty-five-year-old British baron, to complete the remaining five and a half years of his prison sentence at a Florida minimum security camp located not far from his former Palm Beach mansion.[8]

The pundits were wrong. Apparently persuaded by Justice Scalia's entreaty, the Supreme Court granted Black's petition[9] and then, just a month later, also accepted a second petition to construe the scope of § 1346.[10] In the latter case, the Court agreed to review a Ninth Circuit decision applying the statute to prosecute an elected state legislator. The petitioner, former Alaska Representative Bruce Weyhrauch, allegedly deprived the state of his honest services by voting on legislation while concealing a material conflict of interest.[11] Although neither Black nor Weyhrauch attacked the honest services statute on constitutional grounds, the Court waited just a week after beginning the new Term before granting yet a third petition—this one filed by former Enron CEO Jeffrey Skilling—directly challenging the constitutionality of § 1346.[12] In an unexpected about-face, then, the Supreme Court now is likely to resolve not only long-standing controversies about the government's application of § 1346 to convict public and private officials, but the Court also will hear arguments that the compact law lacks the specificity necessary to survive constitutional scrutiny.

The Supreme Court's decision to examine the honest services statute for the first time comes as criticism of the law—and, more broadly, criticism of the discretion the statute gives federal prosecutors—is mounting. Over

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[5] *Id.*

[6] *Id.* at 1311.

[7] *See, e.g.*, Romina Maurino, *In Last-Ditch Appeal, Conrad Black Asks High Court to Reverse Fraud Conviction*, LAW.COM, Jan. 12, 2009, http://www.law.com/jsp/article.jsp?id=1202427355542.

[8] Theresa Tedesco, *Black Rolls up to Prison in Cadillac; "Not a Scary Place"; Ex-media Baron Expects "Boring" Time Behind Bars*, NAT'L POST (Ontario), Mar. 4, 2008, at A3.

[9] United States v. Black, 530 F.3d 596 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 2379 (U.S. May 18, 2009) (No. 08-876).

[10] *See* United States v. Weyhrauch, 548 F.3d 1237 (9th Cir. 2008), *cert. granted*, 129 S. Ct. 2863 (U.S. June 29, 2009) (No. 08-1196).

[11] *Id.* at 1239.

[12] United States v. Skilling, 554 F.3d 529 (5th Cir. 2009), *cert. granted*, 130 S. Ct. 393 (U.S. Oct. 13, 2009) (No. 08-1394). Skilling also argues that the Court must reverse his convictions for honest services fraud because the government failed to prove that his conduct was intended to achieve private gain rather than to advance Enron's interests. *See infra* Parts V.B.3.c., V.C.

the past several years, judges and scholars have expressed growing concern that the ambiguous language in § 1346 has enabled the Department of Justice (DOJ) to prosecute public corruption cases for political purposes.[13] Although Congress may not have intended to "grant carte blanche" to federal prosecutors to define "'honest services' from case to case for themselves,"[14] the federal courts of appeals have allowed precisely that result. Commentators recognize, too, that the Supreme Court's decisions in *Black*, *Weyhrauch*, and *Skilling* could defuse or even eliminate a powerful weapon often employed by the DOJ to attack public corruption.[15]

Less studied, but also significant, is how the outcomes of these appeals might weaken the federal government's reinvigorated war on corporate corruption.[16] In the past decade, Justice Department prosecutors have employed the honest services statute increasingly to charge, convict, and sentence corporate fraudsters, including not only notorious CEOs like Conrad Black, Enron's Skilling and Kenneth Lay, and Adelphia's John Rigas, but also scores of other lesser-known senior executives and their professional advisors.[17] In many cases, § 1346 has been a stealth count, operating as a backup charge that won guilty verdicts and jailed corporate executives when proof of other allegations fell short. Each conviction for honest services fraud carries a maximum sentence of twenty years in prison.

If the Supreme Court upholds the convictions of Black and Skilling, honest services fraud charges are certain to appear in forthcoming indictments of corporate executives for wrongdoing connected to last year's financial crisis. The Obama Administration has made prosecuting corporate fraud a top priority for the DOJ under new Attorney General Eric Holder.[18] Federal law enforcement authorities already have devoted vast resources to investigating allegations of senior management's deception and self-dealing

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[13]*See, e.g.*, Rachel E. Barkow, *Institutional Design and the Policing of Prosecutors: Lessons from Administrative Law*, 61 STAN. L. REV. 869 (2009); Bruce A. Green & Fred C. Zacharias, *"The U.S. Attorneys Scandal" and the Allocation of Prosecutorial Power*, 69 OHIO ST. L.J. 187, 188 (2008).

[14]United States v. Rybicki (*Rybicki II*), 354 F.3d 124, 138 (2d Cir. 2003) (en banc).

[15]*See, e.g.*, Lynne Marek, *Fitzgerald and "Honest Services,"* NAT'L L.J., June 15, 2009, at 1.

[16]I refer to officers and directors collectively as "executives," "managers," or "management."

[17]*See* Marek, *supra* note 15, at 1 (noting that § 1346 was the "lead charge" asserted against 79 defendants in 2007, up from 63 in 2005, and 28 in 2000); *infra* Part IV.A.

[18]In recent testimony before Congress, the DOJ committed to "prosecute the wrongdoers, seek to put them in jail, work tirelessly to recover assets and criminally derived proceeds, and strive to make whole the victims of such crimes." *Federal and State Enforcement of Financial Consumer and Investor Protection Laws: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 2 (2009) (statement of Rita Glavin, Acting Assistant Att'y Gen., Criminal Division, United States Department of Justice).

at some of the nation's largest (or formerly largest) financial institutions. Government lawyers also have launched criminal investigations to determine whether representations by CEOs about their firms' financial condition were deceptive in light of the companies' subsequent failures or near failures.[19] Understandably focused on restoring public confidence in the capital markets, Congress, too, has demanded prosecution of corporate officers and directors for any crimes that contributed to the economic downfall. But will the honest services fraud statute still be available to prosecute corporate executives for fraud and related wrongdoing?

Assuming that the Court dispenses with Skilling's constitutional challenge, the answer will depend on how the Justices interpret the twenty-eight seemingly unobjectionable words that Congress added to the mail fraud statute in 1988. Paradoxically, the potency of § 1346 derives from its innocuous language. The statute simply defines a "scheme to defraud" under the mail and wire fraud statutes to include conduct that "deprive[s] another of the intangible right of honest services."[20] The government, then, may prosecute mail and wire frauds without proof that victims lost money or property. Yet, read literally, § 1346 reaches most dishonesty, as Justice Scalia illustrated in his dissent.

Courts have attempted to cabin the reach of honest services fraud by construing the statute more restrictively. In order to "deprive another of the intangible right of honest services," the courts reason, the defendant must owe some duty to provide honest services to some person who has the intangible right to receive the honest services.[21] Such rights and duties generally obtain from special relations, such as those between fiduciaries and their beneficiaries.[22] Whether the requisite rights and duties arise under state law, federal law, or both is just one of the many questions that have divided the federal circuit courts.[23] By linking criminal liability to proof of a

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[19] *See* Gretchen Morgenson, *Ex-Chief Accused of Stock Fraud at a Big Lender*, N.Y. TIMES, June 5, 2009, at A1; Linda Sandler & Christopher Scinta, *Lehman Collapse Probed by Three Federal Grand Juries*, BLOOMBERG.COM, Oct. 17, 2008, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a5oUolV5pBTk.

[20] 18 U.S.C. § 1346 (2006); *see infra* Part V.

[21] *See* United States v. Williams, 441 F.3d 716, 723 (9th Cir. 2006) ("The undifferentiated term 'another' has led a number of circuits to question whether Congress really meant to give § 1346 unlimited breadth.").

[22] *Id.* ("At a minimum, we and other circuits have recognized the viability of the 'intangible rights' theory when the private defendant stands in a fiduciary or trust relationship with the victim of the fraud.").

[23] *See* Lisa L. Casey, *Class Action Criminality*, 34 J. CORP. L. 153, 189-90 (2008) (raising numerous questions regarding interpretation and application of § 1346, including "[f]rom what sources do such rights arise? State law? Federal law?").

fiduciary breach—a finding that, in and of itself, requires fact-sensitive boundary drawing—the analysis becomes more complex and less reliable. The courts, *ex post*, must define and interpret fiduciary principles; in some cases, federal courts have gone so far as to recognize original duties, creating novel fiduciary theories. The variation and even contradiction evident in the case law also exposes the considerable discretion vested in federal prosecutors to determine the line between unethical behavior and criminal conduct.

Prosecutors' reliance on, and possible expansion of, fiduciary duties as the basis for honest services fraud has potentially far-reaching consequences for persons already recognized as fiduciaries under state law, particularly for corporate executives facing prospective liability in the wake of the economic crisis. My thesis is that the government's increased use of § 1346 to criminalize fiduciary breaches contrasts sharply with the decline in fiduciaries' accountability under civil law for the same conduct. The threshold for indicting corporate executives for honest services fraud seems at least as low, if not lower, than either the threshold for enforcing breach of fiduciary duty claims under Delaware law or the threshold for pursuing civil securities fraud claims. In fact, civil law and criminal law are trending in opposite directions: as it has become more difficult to hold a corporate executive civilly liable for breaching her fiduciary duties, it has become easier to hold her criminally liable for the same conduct. Fiduciary betrayals—which, before Enron, likely would have exposed corporate managers to a slight risk of civil liability—have become the foundation upon which the government prosecutes the same individuals criminally, charging them with the felony of honest services fraud. This developing anomaly, while largely unrecognized in the literature, upsets our traditional expectation that criminal charges are more serious, and more difficult to prove, than civil claims.

I also contend that greater use of criminal sanctions is driven, at least in part, by the growing perception that civil law does not adequately deter, let alone punish, wrongdoing by corporate executives. Criminal enforcement responds to the perceived need for greater punishment and deterrence of corporate malfeasance. Disloyal and dishonest behavior by corporate fiduciaries injures not only the company that employed the corrupt executive, damaging its shareholders and employees, but these breaches harm the economy more broadly. As we have repeatedly witnessed this decade, executives may engage in deceitful conduct of such a magnitude that its revelation not only destroys their firms but also jeopardizes investors' confidence in public companies, financial institutions, and the securities markets. This fallout leads to even greater demand for effective law enforcement. That demand, however, cannot be met by civil law because as the

civil doctrine has developed over the past several decades, corporate executives have become increasingly insulated from liability.

Since the Supreme Court's forthcoming decisions likely will limit the continuing availability of honest services fraud as a weapon to deter executives, this article also examines the questions before the Court and how the Court's rulings might impact directors and officers of public companies. While the Supreme Court's construction may provide some order to prosecutions under § 1346, the decision also could create further chaos.

My analysis, then, is organized as follows. Part II briefly considers why directors and officers are fiduciaries and describes their duties as fiduciaries.[24] The next two sections compare and contrast civil enforcement of executives' fiduciary duties with their criminal enforcement under § 1346. Part III examines private enforcement of executives' fiduciary duties. This part identifies the significant legal obstacles preventing shareholders from enforcing management's fiduciary duties in state court or federal court, whether shareholders bring their claims derivatively or as class actions. As verified empirically, public company executives rarely incur liability for breaching their fiduciary duties.[25]

Part IV chronicles the government's use of § 1346 to prosecute corporate executives and provides original evidence of the Justice Department's increasing use of the statute as a weapon against corporate crime. As this account shows, Congress and the White House strongly encouraged criminal prosecutions of culpable executives following the collapses of Enron and WorldCom. Part IV concludes by explaining how federal criminal law empowers prosecutors to indict and convict corporate executives using § 1346.

Part V analyzes the questions raised by the honest services fraud cases before the Supreme Court in the October 2009 Term. As background for this analysis, the section begins by examining the evolution of the intangible rights doctrine and Congress's enactment of § 1346.[26] Most of Part V

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[24]Executives of most public companies look to Delaware law for the content and enforcement of their fiduciary duties. Since this article examines civil and criminal enforcement actions brought against executives of large public companies, it will review and analyze Delaware corporate and fiduciary law. Other states also rely on Delaware decisions because of the large number of companies incorporated there and the special expertise of Delaware courts.

[25]Indeed, even academics who favor state competition for charters concede that public companies incorporate in Delaware to minimize directors' and officers' exposure to personal liability for breaching their fiduciary obligations. *See, e.g.*, Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

[26]*See* United States v. Brown, 459 F.3d 509, 519 (5th Cir. 2006) ("[Section 1346] can be understood only in the light of the long history of the mail- and wire-fraud statutes, which were intentionally written broadly to protect the mail and, later, the wires from being used to initiate fraudulent schemes.").

considers the important interpretive problems that have bedeviled the appellate courts, focusing particular attention on those issues that the Supreme Court may resolve presently.

Part VI explores how the Supreme Court's decisions in *Black*, *Weyhrauch*, and *Skilling* could impact the government's reinvigorated efforts to fight corporate fraud following the recent financial crisis. I conclude by offering a specific suggestion as to how Congress might promote the federal interest in prosecuting dishonest public company fiduciaries while curbing the threats of overcriminalization, prosecutorial abuse, and spill-over from federal criminal jurisprudence to Delaware's corporate doctrine.

## II. CORPORATE EXECUTIVES' FIDUCIARY DUTIES, ACCORDING TO DELAWARE

Executives who engage in serious misconduct are subject to discipline under multiple, overlapping liability regimes[27]—civil and criminal, private and public, state and federal. Because these legal rules apply simultaneously, the same misconduct exposes accused managers to concurrent enforcement actions, and adjudicated wrongdoers face a range of potential sanctions, from monetary damages to regulatory penalties such as debarment to imprisonment. For example, opportunistic misconduct by corporate executives may give rise to liability for breach of a fiduciary duty, fraud (both statutory and common law), other intentional torts, and violations of various criminal laws. Effective disciplinary rules not only punish past wrongdoing but also provide appropriate incentives to deter future wrongdoing.

Fiduciary law, the "most mandatory inner core" of corporate doctrine,[28] regulates the conduct of corporate directors and officers. Yet, the fusion of substantive tenets deferential to public company management with procedural rules devised to dispose of shareholder lawsuits as cheaply as possible has produced a system of fiduciary duties practically incapable of civil enforcement. Shareholder litigation, once the principal judicial device for addressing fiduciary corruption, no longer disciplines most directors and officers who have breached their fiduciary duties to the corporation. As the

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[27]Of course, non-legal mechanisms also serve disciplinary functions. For example, the firm may terminate the wrongdoer (or request that she resign her position) rather than pursue the company's rights in litigation; and the firm's stockholders may choose to sell their shares rather than initiate litigation.

[28]John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1621 (1989).

civil law has developed over time, private enforcement has become exceptionally expensive, and the resulting benefits are questionable. Public enforcement of fiduciary duties[29]—specifically, criminal prosecutions charging honest services fraud—may better punish serious infidelity while providing superior deterrence.

Before analyzing criminal liability, however, it is important to review the fiduciary duties of corporate executives and the predominant legal reasons that public company managers rarely incur civil liability for breaching those obligations. Part II synopsizes managers' fiduciary duties under state law. Then, Part III identifies the important procedural rules and substantive doctrines that make civil enforcement so complicated, burdensome, and ineffective, regardless of whether the action is brought in state or federal court. Part III concludes by briefly surveying empirical evidence on corporate executives' civil liability for fiduciary breach.

It is well-settled that corporate executives are bound by fiduciary principles.[30] Classic fiduciary law regulates self-serving behavior in relationships where one party undertakes to serve another party's interests and requires access or control over the other party's assets in order to perform the undertaking.[31] Like trustees of trusts (the archetypal fiduciary), corporate executives are entrusted by statute with power over assets to be used in the interest of others; specifically, general corporation laws enacted by state legislatures invest corporate directors and their officer-delegees with full discretion to manage their company's business.[32] Recognizing that managers may divert company assets or take firm benefits for themselves without authorization, the law seeks to deter such opportunism. For seventy years, the Delaware Supreme Court has stated that

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[29]The public enforcement actions considered in this article are criminal proceedings instituted by the DOJ. The Securities and Exchange Commission (SEC) institutes civil enforcement actions against public company managers which also discipline executives in important ways. However, because the SEC's authority is limited to the securities laws, and it cannot directly enforce state fiduciary law, SEC enforcement actions are not considered here.

[30]*See* Koehler v. Black River Falls Iron Co., 67 U.S. 715, 720-21 (1862) ("[Directors] hold a place of trust, and by accepting the trust are obliged to execute it with fidelity, not for their own benefit, but for the common benefit of the stockholders of the corporation.").

[31]*See* Robert Flannigan, *The Economics of Fiduciary Accountability*, 32 DEL. J. CORP. L. 393, 393-95, 399 (2007) (explaining conventional fiduciary accountability as a general form of default civil liability concerned with opportunism, the specific mischief that arises in limited access arrangements).

[32]*See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.").

> [w]hile technically not trustees, [directors and officers] stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . [in order] to protect the interests of the corporation committed to his charge. . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[33]

Universally, as in Delaware, directors and officers owe fiduciary duties to their firms in order to discipline managers' self-interested conduct.[34]

Corporate law further delineates that executives bear two principal duties as fiduciaries: loyalty and care.[35] The duty of loyalty, described as "the most important fiduciary duty of corporate officers and directors"[36] and "the one accepted constant in the various corporate law debates,"[37] functions especially to control managers' opportunism. Loyal executives may not use their positions to further their private interests, and they must refrain from doing anything to benefit themselves that would injure their firm.[38] Furthermore, executives may not stand on both sides of a company transaction nor

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[33]Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939), *quoted in* Schoon v. Smith, 953 A.2d 196, 206 (Del. 2008).

[34]*Black's Law Dictionary* defines the phrase "fiduciary duty" as:

> A duty of utmost good faith, trust, confidence, and candor owed by a fiduciary (such as a lawyer or corporate officer) to the beneficiary (such as a lawyer's client or a shareholder); a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person (such as the duty that one partner owes to another).

BLACK'S LAW DICTIONARY 581 (9th ed. 2009).

[35]Gantler v. Stephens, 965 A.2d 695, 708-09 (Del. 2009) (holding explicitly, for the first time, that "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and . . . the fiduciary duties of officers are the same as those of directors."). Few Delaware decisions distinguish between directors and non-director officers.

[36]Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 3 (1993).

[37]Flannigan, *supra* note 31, at 428 ("We have made a *choice* to reduce the costs of opportunism by incurring the costs of fiduciary regulation. . . . [T]he universal assumption appears to be that the conventional duty of loyalty is an efficient mechanism to control opportunism in limited access arrangements.").

[38]*Guth*, 5 A.2d at 510 (explaining, in prose regularly quoted, that "undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest"); *see also Schoon*, 953 A.2d at 206 (quoting *Guth* for the enduring proposition that "corporate executives cannot use their positions of trust and confidence to further their private interests").

derive any personal benefit through self-dealing.[39] Simply put, managers may not engage their self-interest without consent from the corporation.[40] In contrast to the duty of loyalty, the duty of care requires corporate executives to make lawful decisions, employing well-informed, deliberate processes.[41] The duty of care compels executives to be adequately informed and diligent when making corporate decisions and to protect the interests of the firm.[42] In order to exercise informed business judgment, each director must devote adequate time to board activities, review materials prepared for board meetings in advance of those meetings, and, with due consideration, candidly and deliberately decide matters brought before the board.[43]

Although the fiduciary duties of corporate executives generally organize into two broad classes, loyalty and care, Delaware courts have identified another duty as well, a duty of good faith.[44] In the controversial 1996 decision in *In re Caremark International Inc. Derivative Litigation*,[45] Chancellor William Allen instructed that corporate directors could incur liability if they failed to exercise appropriate attention to the firm's on-going operations and employees in good faith.[46] However, Chancellor Allen also noted in dicta that

> [g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.[47]

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[39]Anadarko Petrol. Corp. v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988).

[40]Non-director officers, as agents of the corporation, are obligated by agency law and corporate law to act loyally for the benefit of the firm in matters connected with their agency. *See* RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).

[41]*See* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

[42]*See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1994).

[43]*See* Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

[44]In 1993, the Delaware Supreme Court stated, in dictum, that corporate directors incur a "triad[]" of fiduciary duties, including the traditional duties of loyalty and care as well as a third duty of "good faith." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[45]698 A.2d 959 (Del. Ch. 1996).

[46]*Id.* at 967-70.

[47]*Id.* at 971. For over a decade, the corporate law academy parsed *Caremark* and other relevant judicial opinions and debated the potential boundaries of this good faith duty to monitor. *See, e.g.*, Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1

Relying on this dicta, courts came to recognize so-called "*Caremark* claims," actions addressed to directors' "utter failure" and "systematic failure" to take minimal steps to monitor legal compliance.[48] Chancellor Chandler's 2003 decision denying the Walt Disney directors' motion to dismiss suggested that Delaware courts might advance management's duty of good faith as a discrete fiduciary obligation, potentially exposing outside directors to greater risk of liability for oversight failures.[49] This development generated considerable commentary,[50] especially in light of revelations in 2002 that the directors managing Enron and WorldCom may "have willfully shut their eyes" to executives' wrongdoing until it was too late and the firms failed.[51]

Then, in 2006, the Delaware Supreme Court in *Stone v. Ritter* clarified that the duty of good faith is an aspect of the duty of loyalty rather than a distinct fiduciary duty or an obligation arising under the duty of care.[52] As Professor Bainbridge and his co-authors recently argued, "Acknowledging good faith to be an independent fiduciary duty risked tipping that balance too far toward director accountability."[53] Nonetheless, the court in *Stone* did acknowledge that corporate executives may incur liability for failing to exercise oversight, and it established the elements of such claims. As Justice Holland explained:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to

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(2006); Hilary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004).

[48]*See, e.g.*, In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 n.111 (Del. 2006); Globis Partners, L.P. v. Plumtree Software, Inc., No. 1577-VCP, 2007 WL 4292024, at *7 n.50 (Del. Ch. Nov. 30, 2007).

[49]*See In re* Walt Disney Co. Deriv. Litig., 825 A.2d 275, 278 (Del. Ch. 2003) (holding that facts as alleged raised sufficient doubt that directors' actions were taken in good faith).

[50]*See, e.g.*, Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005); Sale, *supra* note 47.

[51]JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 15-16 (2006).

[52]Stone v. Ritter, 911 A.2d 362, 369-70 (Del. 2006). Thus, corporations cannot exonerate their directors from liability for *Caremark* claims pursuant to Delaware's exculpation statute. *See infra* Part III.A.4.

[53]Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 562 (2008).

> act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[54]

Although the obligation to act in good faith is not an independent fiduciary duty, a director could be liable for bad faith conduct nonetheless, because failure to act in good faith would breach the director's duty of loyalty. *Stone* also clarified that a corporate fiduciary acts in bad faith when she:

> "intentionally acts with a purpose other than that of advancing the best interests of the corporation, where . . . [she] acts with the intent to violate applicable positive law, or where . . . [she] intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."[55]

Furthermore, executives breach their duty of loyalty by knowingly causing the corporation to use illegal means in the pursuit of profit, by exposing the corporation to penalties from criminal and civil regulators, or by consciously causing the corporation to act unlawfully.[56]

Candor is closely associated with good faith and the duty of loyalty as well. The obligation of candor applies to communications among the firm's executives.[57] As agents of the corporation, officers must use their reasonable efforts to provide the board of directors with information relevant to affairs entrusted to them and which the officers have notice that the directors would want.[58] Without receipt of truthful and complete information material to its decisions, the board cannot manage the firm profitably. As fiduciaries of the firm, all executives also have an "unremitting obligation" to deal candidly with the corporation and their fellow executives when advancing their own

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[54]*Stone*, 911 A.2d at 370 (footnotes omitted).

[55]*Id.* at 369 (quoting In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006)).

[56]Desimone v. Barrows, 924 A.2d 908, 934-35 (Del. Ch. 2007).

[57]Some Delaware decisions use the term "duty of candor" to describe the obligation of corporate executives to provide full and fair disclosure to shareholders (the duty of disclosure), although the Delaware Supreme Court has urged the Court of Chancery to avoid such imprecision. *See* Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992).

[58]*See* RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

> Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

*Id.*

interests (i.e., self-dealing transactions).[59] While classic doctrine strictly prohibits fiduciaries from acting in conflict with their beneficiaries and proscribes the receipt of personal benefits, traditional principles do provide a defense: opportunism is not actionable as breach if the fiduciary obtained consent to enjoy the benefit or act despite the conflict. To be effective, however, consent must be fully informed.[60] The inquiry, then, is whether the company—typically acting through fully informed and disinterested independent directors—validly approved the executive's conflict or benefit. To obtain operative consent, the conflicted executive must fully disclose (1) the existence of a conflict of interest, and (2) material facts concerning the subject transaction that may not be known to the company (i.e., the directors qualified to make the decision).[61]

The duty of candor should not be confused with managers' duty of disclosure. The latter obligation requires corporate executives to disclose all material information when communicating publicly or directly with shareholders about the firm's affairs.[62] Regardless of whether the communication seeks shareholders' approval or ratification of some action, "'[c]orporate fiduciaries can breach their duty of disclosure . . . by making a materially false statement, by omitting a material fact, or by making a partial disclosure that is materially misleading.'"[63] The Delaware Supreme Court recently clarified that the duty of disclosure also is not an independent duty; rather, it is part of the duty of loyalty owed by directors to the corporation.[64]

Having summarized the fiduciary duties of corporate executives under state law,[65] I turn to the legal rules impeding effective enforcement of those duties in civil proceedings.

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[59]*See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1283 (Del. 1989) (explaining how CEO deceived disinterested directors).

[60]*See* 1 AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02, at 215 (1994) (stating that an interested director must "affirmatively . . . disclose the material facts known to the director" and "explain the implications of a transaction"); *see also* RESTATEMENT (THIRD) OF AGENCY § 8.06(1)(a) (2006) (stating that an agent's conduct does not constitute breach if principal consents to conduct and, in obtaining consent, agent acts in good faith and discloses all material facts, and otherwise deals fairly with principal).

[61]*See infra* Part III.B.6; *see also* STEPHEN B. PRESSER, AN INTRODUCTION TO THE LAW OF BUSINESS ORGANIZATIONS 242 (2005) (quoting IOWA CODE § 496A.34 (2005)).

[62]*See* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) ("Whenever directors communicate publicly or directly with shareholders about the corporation's affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty.").

[63]Pfeffer v. Redstone, 965 A.2d 676, 684 (Del. 2009) (quoting O'Reilly v. Transworld Healthcare, Inc., 745 A.2d 902, 916 (Del. Ch. 1999)).

[64]*Id.* at 690.

[65]This high-level account of Delaware's corporate fiduciary doctrine necessarily glosses over

## III. OBSTACLES TO ENFORCING EXECUTIVES' FIDUCIARY DUTIES UNDER CIVIL LAW

In theory, the threat of personal liability for a fiduciary breach has two important functions. First, the threat deters managers from exploiting their position through, among other disloyal acts, insider transactions and diversion of corporate profits, property, and opportunities. Second, the risk of personal liability encourages outside directors to exercise their authority and oversight capabilities to detect, and even prevent, self-interested misconduct by inside executives.

In practice, however, directors and officers seldom face civil liability for breaching their fiduciary duties, regardless of the forum in which shareholders bring suit and despite corporate law rhetoric emphasizing the importance of executives' fiduciary responsibilities. For one thing, corporate boards seldom choose to pursue the firms' claims against executive malefactors for breaches of fiduciary duty, at least not publicly.[66] Professors Johnson and Millon have focused attention on the relative paucity of private litigation claiming that public company officers (as opposed to directors) breached their fiduciary duties.[67] When shareholders sue corporate fiduciaries for breach, the defendants usually win early dismissal of the litigation, and the defendants very rarely are adjudicated liable, much less pay monies to resolve the lawsuits. The following sections identify the legal obstacles that thwart shareholders' efforts to hold executives accountable as fiduciaries.

### A. *Obstacles to Civil Enforcement in State Court*

A fiduciary's dereliction of her duties generally gives rise to one or more causes of action.[68] Although the board of directors must authorize any

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areas of confusion and continuing development.

[66]One explanation for non-enforcement is structural bias. Another is directors' concern about negative publicity and risk that the corporation's public pursuit of claims against the executive will give rise to shareholder litigation. A third possibility, however, is that the board disciplines the executive by demanding her resignation or by terminating her. If the board cannot reach agreement with the executive on the appropriate severance arrangement, the parties likely will arbitrate the dispute—including, perhaps, the firm's claims that the executive breached her fiduciary duties—in the confidential forum agreed to under the executive's employment contract.

[67]*See* Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1611 (2005) ("[A]lthough officers and directors occupy distinctive roles in corporate governance, most corporate law authority uncritically obliterates that distinction when it comes to fiduciary duties.").

[68]*See* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1035 (Del. 2004) (explaining that the distinction between derivative and direct claims rests solely on who suffered alleged harm and who would receive benefit of the recovery).

claim filed on behalf of the corporation, courts of equity recognize that directors would not vote to sue themselves. Nor, in the main, would directors sue their own colleagues or even non-director members of the senior management team. Therefore, corporate law allows one or more of the corporation's shareholders to assume "the legal managerial power to maintain a derivative action to enforce the corporation's claim."[69] Still, Delaware's legislature and its courts have installed significant procedural and substantive obstacles, derailing shareholders' efforts to enforce executives' fiduciary duties through derivative litigation. A large literature examines these legal rules. For our purposes, a brief summary suffices to explain why civil actions holding corporate executives liable are so uncommon.

### 1. Standing to Enforce

Although an executive's fiduciary breach may affect the corporation's employees, bondholders, and other creditors, only shareholders have standing in most cases to assert derivative claims on the company's behalf.[70] Plaintiffs not only must own stock when they initiate their derivative complaint, but their complaint also must aver that they owned stock in the corporation at the time of the subject transaction.[71] Additionally, plaintiffs must hold their shares throughout the litigation.[72] Even involuntary dispositions of shares, such as through a merger, can deprive the plaintiff of standing to continue prosecuting the lawsuit.[73]

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[69]Levine v. Smith, 1987 WL 28885, at *2 (Del. Ch. Dec. 22, 1987); *see also* Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) (holding that derivative suits allow shareholders to sue on behalf of the corporation when "'it is apparent that material corporate rights would not otherwise be protected'" (quoting Sohland v. Baker, 141 A. 277, 282 (Del. 1927))).

[70]The principal exception to this rule is that creditors of insolvent corporations may assert derivative claims, though not direct claims, on behalf of the corporation for breach of fiduciary duty. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101, 103 (Del. 2007) ("When a corporation is insolvent . . . creditors take the place of shareholders as the residual beneficiaries of any increase in value." (emphasis omitted)).

[71]DEL. CODE ANN. tit. 8, § 327 (2006). For criticism of the contemporaneous ownership requirement, see generally J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673 (2008) (arguing that the rule is unnecessary and incoherent, and proposing that an alternative standard be adopted).

[72]Lewis v. Anderson, 477 A.2d 1040, 1046 (Del. 1984) ("[A] derivative shareholder must not only be a stockholder at the time of the alleged wrong and at time [sic] of commencement of suit but he must also maintain shareholder status throughout the litigation.").

[73]*See id.*

### 2. The Demand Rule and Pleading Demand Futility

According to Delaware law, before shareholders can initiate a derivative action, they either must make a demand on the board that the corporation pursue its claims against the executives,[74] or they must plead facts sufficient to demonstrate that demand on the board would have been futile.[75] Whether demand is made or not, derivative suit pleadings must comply with "stringent requirements" and allege "particularized factual statements that are essential to the claim."[76] In practice, plaintiffs plead demand futility rather than make a demand on the company's board.[77] The corporation, acting through a special litigation committee (SLC) of disinterested directors, if necessary, will respond by moving to dismiss the plaintiff's complaint for its failure to make a demand.[78] In most cases, defendants will prevail. Not only are Delaware courts loath to excuse demand, but plaintiffs must satisfy an onerous pleading standard. To establish demand futility, plaintiffs must allege particularized factual allegations which raise reasonable doubt that: "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."[79] In practice, Delaware courts rarely find that plaintiffs have

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[74]Although shareholders are plaintiffs, they prosecute derivative claims on behalf of the corporation. *Zapata*, 430 A.2d at 784-86. Disinterested directors—non-defendant directors who are not otherwise disabled from exercising independent business judgment—maintain their authority to control the litigation. *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

[75]Stone v. Ritter, 911 A.2d 362, 366-67 (Del. 2006). If the reviewing court determines that demand would have been futile, the court will excuse demand. *Zapata*, 430 A.2d at 784.

[76]Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).

[77]Plaintiffs who make demand on the board are deemed to have conceded the directors' independence and disinterestedness for purposes of the lawsuit. *E.g.*, Levine v. Smith, 591 A.2d 194, 212 (Del. 1991), *overruled on other grounds by Brehm*, 746 A.2d at 253.

[78]*See* ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 465 (2d ed. 2004) ("[N]o SLC has ever recommended that derivative litigation continue against sitting officers, as opposed to former directors or senior executive officers."); *see also* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1776, 1783 (2004) (reviewing all corporate litigation filed in Delaware in 1999 and 2000, authors found that courts dismissed 60% of derivative actions against public corporations and plaintiffs obtained no relief; further, the courts excused demand in only one of eight cases where the parties litigated demand futility). "The limited data that has been collected on [SLC behavior] supports the view that the appointment of a special litigation committee almost always leads to dismissal of the case." *Id.* at 1791 n.147.

[79]*Aronson*, 473 A.2d at 814. This requirement "exists to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation." *In re* Am. Int'l Group, Inc. Deriv. Litig., 965 A.2d 763, 808 (Del. Ch. 2009). When the case involves the board's failure to take action, the second prong is inapplicable and the court only asks whether the plaintiff has alleged with particularity facts which "create a reasonable doubt that . . . the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."

satisfied this heightened pleading standard,[80] and the courts' published decisions sometimes display an aversion toward shareholder litigation.[81] The upshot is that the board's decision not to sue is protected by the business judgment rule and "will be respected unless it is wrongful."[82]

### 3. The Business Judgment Rule

Claims for breach of the duty of care generally are subject to the business judgment rule. This central corporate law doctrine establishes "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[83] To promote risk taking, the business judgment rule protects directors from civil liability for their decisions in all but the most extreme circumstances.[84] Furthermore, the rule, when applicable,[85] also creates a presumption against judicial review of most claims that executives breached their duty of care.[86] Simply put, courts

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Rales v. Blasband, 634 A.2d 927, 934 (Del. 1993).

[80]Delaware presumes that directors are independent and disinterested until shown otherwise, and "[i]ndependence is a fact-specific determination made in the context of a particular case." Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004). Specifically, the court considers not only "whether the director is disinterested in the underlying transaction" but also, "even if disinterested, whether the director is otherwise independent." *Id.* Commentators have criticized this presumption and the limited nature of judicial inquiries testing it. *See, e.g.*, Antony Page, *Unconscious Bias and the Limits of Director Independence*, 2009 U. ILL. L. REV. 237, 242-46.

[81]*See, e.g.*, *Brehm*, 746 A.2d at 255 (holding that higher pleading standards are needed to prevent shareholders from causing "the corporation to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation").

[82]Zapata Corp. v. Maldonado, 430 A.2d 779, 784 & n.10 (Del. 1981).

[83]*Aronson*, 473 A.2d at 812; *see also id.* at 815-16 (holding that despite chairman's ownership of controlling interest in corporation and his selection of each director, the presumption of independence will stand unless plaintiffs allege facts demonstrating "that through personal or other relationships the directors are beholden to the controlling person").

[84]*See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors."); *see also* Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) ("Whereas an automobile driver who makes a mistake in judgment . . . injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment . . . will rarely, if ever, be found liable for damages suffered by the corporation.").

[85]The business judgment rule does not apply if the directors have not exercised judgment (i.e., made no decision). *See, e.g.*, *Van Gorkom*, 488 A.2d at 873. Nor will the business judgment rule protect decisions by conflicted directors. *See, e.g.*, Lewis v. S.L. & E., Inc., 629 F.2d 764, 769 (2d Cir. 1980) ("[T]he business judgment rule presupposes that the directors have no conflict of interest.").

[86]*See generally* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

will not hear complaints challenging management's business decisions provided that the decisions are based on any rational business purpose.[87] The business judgment rule imposes a nearly insurmountable barrier to executives' liability in order to "prevent[] judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available—a standard measured by concepts of gross negligence."[88] But even if plaintiffs somehow rebut the business judgment rule with facts sufficient to demonstrate gross negligence,[89] courts nonetheless dismiss duty of care claims without reviewing their merits, provided that the directors did not act in bad faith and that the corporation's charter includes an exculpatory provision.[90]

### 4. Exculpatory Charter Provisions

Public corporations generally agree to indemnify their executives to the fullest extent permitted by law. Usually, indemnity agreements cover the directors' litigation expenses and attorneys' fees, as well as judgments, fines, and settlement amounts.[91] Delaware companies also may have charter

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[87] *See* Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.") (footnote omitted); *see also In re* Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996) ("[W]hether a . . . decision [is] substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance the corporate interests." (emphasis omitted)).

[88] *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 122 (Del. Ch. 2009). The *Citigroup* court reasoned that the fiduciary duty of care and business judgment rule "properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision." *Id.* at 124.

[89] The Delaware Supreme Court has described gross negligence as reckless indifference to or a deliberate disregard for stockholders, or actions outside the bounds of reason. *Van Gorkom*, 488 A.2d at 873 & n.B.

[90] Even without an exculpatory provision, proof of gross negligence is not necessarily determinative of liability. Although defendants will not be shielded from liability by the business judgment rule, they will not be liable for breaching their duty of care if they can demonstrate the entire fairness of their decision. *See* McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000).

[91] State indemnification statutes, such as section 145 of the Delaware General Corporation Law, typically permit corporations to indemnify their executives for expenses, judgments, and the like that are reasonably incurred in actions against them because they are executives, but only if the executives act in "good faith" and in a manner they reasonably believe to be "in or not opposed to the best interests of the corporation." DEL. CODE ANN. tit. 8, § 145 (2006). These statutes also authorize corporations to advance the litigation expenses their directors and officers (D&Os) incur in such actions. *Id.* In practice, corporations routinely advance such expenses. Companies also routinely purchase D&O liability insurance to cover the corporation's obligation to indemnify its

provisions exculpating their directors from personal liability for monetary damages arising from a breach of the duty of care.[92] Importantly, section 102(b)(7) does not permit corporations to absolve directors for breaches of their duty of loyalty.[93] Nor may corporations release directors from liability for breaching their fiduciary duties intentionally, knowingly, or in bad faith. Nevertheless, because most public companies have adopted exculpatory provisions in their certificates of incorporation,[94] directors are protected from claims for monetary damages based solely on their lack of care.[95]

Accordingly, even if plaintiffs rebut the business judgment rule and successfully allege a duty of care violation, the director defendants need not prove entire fairness provided that the company's charter exculpates its directors.[96] Instead, plaintiffs must establish that the director defendants wasted corporate assets—an extremely rare claim that is nearly impossible to prove.[97] For executives to incur liability, then, plaintiffs must state a claim that, by law, cannot be exculpated, i.e., a duty of loyalty breach or a claim of bad faith oversight. However, public company executives do not risk substantial personal liability for even non-exculpated claims.

### 5. Pleading Non-exculpated Claims with Particularity

To plead a cognizable, non-exculpated claim against corporate executives—for example, a *Caremark*-type claim for bad faith failure of oversight—shareholders must allege particularized facts giving rise to a serious

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executives and to cover losses that cannot be indemnified. However, D&O policies exempt losses for adjudicated dishonesty, disloyalty, or criminal acts.

[92] *See, e.g., id.* § 102(b)(7); Malpiede v. Townson, 780 A.2d 1075, 1095-96 (Del. 2001) (affirming dismissal of duty of care claims where corporation's charter included exculpatory provision). Notably, the statute does not permit corporations to insulate their directors from liabilities under other laws, such as the federal securities statutes.

[93] *See, e.g., McMullin*, 765 A.2d at 926.

[94] Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done About It*, 85 OR. L. REV. 993, 1022 & n.131 (2006) (detailing a study of firms making SEC filings between July 2001 and July 2002, finding that "virtually every firm" had an exculpation clause in its charter). All fifty states have enacted laws limiting directors' liability for breach of the duty of care or allowing corporations to adopt exculpatory charter provisions. *Id.* at 1022.

[95] Emerald Partners v. Berlin, 787 A.2d 85, 94 (Del. 2001).

[96] *Id.* at 92.

[97] *See In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 748-49 (Del. Ch. 2005) ("Corporate waste is very rarely found in Delaware courts because the applicable test imposes such an onerous burden upon a plaintiff—proving 'an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'" (quoting Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000))), *aff'd*, 906 A.2d 27 (Del. 2006). Waste occurs only in the "rare, 'unconscionable case[ ] where directors irrationally squander or give away corporate assets.'" *Id.* at 749 (quoting *Brehm*, 746 A.2d at 263).

threat of liability.[98] Plaintiffs must plead specific facts (for example, that defendants ignored explicit "red flags") demonstrating that defendants' behavior exhibited more than gross negligence; typically, that defendants' conduct was so egregious as to establish bad faith.[99] Essentially, shareholders must plead particularized facts proving, among other things, the defendants' unlawful state of mind.[100]

6. Approval by Disinterested Board Members and Shareholders

The duty of loyalty is implicated when a fiduciary has engaged in self-dealing or takes for herself some asset or opportunity that properly belongs to the firm.[101] While the corporation cannot exculpate directors for such claims, Delaware courts nonetheless have extended considerable deference to independent and disinterested board members in duty of loyalty cases, arguably as much deference as in duty of care cases.

Furthermore, Delaware courts have relaxed their oversight of executives' conflicts of interest considerably over the past several decades.[102] At one time, courts scrutinized self-dealing and other conflict of interest transactions using the entire fairness test, a standard that is far more rigorous than the business judgment rule.[103] Under the entire fairness test, it is the defendant fiduciary's burden, rather than the plaintiffs' burden, to prove that the challenged transaction was entirely fair to the corporation.[104] To satisfy this

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[98]Wood v. Baum, 953 A.2d 136, 141 (Del. 2008).

[99]*See* Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007) (holding that to plead failure-of-oversight liability sufficiently, plaintiffs must show "that the directors acted with the state of mind traditionally used to define the mindset of a disloyal director").

[100]*See* Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006); *see also In re* Am. Int'l Group, Inc. Deriv. Litig., 965 A.2d 763, 800-01 (Del. Ch. 2009) (holding that the plaintiffs had sufficiently pleaded particularized facts to show that defendants knew about material, non-public information to support plaintiffs' insider trading claims).

[101]*See In re Walt Disney Co.*, 907 A.2d at 751 ("The classic example . . . is when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders.").

[102]Historically, courts treated conflicted transactions as voidable, irrespective of fairness to the corporation. However, "[o]ver time, that approach gave way to a more workable rule requiring that the transaction be fair." J. Robert Brown, Jr., *Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 54 (2006).

[103]*See* Seligman, *supra* note 36, at 8 (noting that executives "very rarely lose lawsuits" when courts apply the business judgment rule, but "[t]he odds are considerably less favorable" when the executives themselves must prove the fairness of self-dealing transactions).

[104]*See* Nixon v. Blackwell, 626 A.2d 1366, 1375-76 (Del. 1993) ("[T]he defendants are on both sides of the transaction. For that reason . . . defendants have the burden of showing the entire fairness of those transactions.").

evidentiary burden, the fiduciary must demonstrate both the substantive and procedural fairness of the bargain.[105]

Although the entire fairness test appears to create a difficult burden of proof for fiduciaries, well-counseled corporate managers can, and do, avoid its application. Executives shield self-dealing transactions by utilizing statutory procedures that, if followed, may obviate the need for judicial examination under the entire fairness test. Relying on these state safe harbor statutes, executives generally direct decisions or transactions involving conflicts of interest to disinterested directors or shareholders for their approval.[106] Assuming that fully-informed, disinterested directors or shareholders sanctioned the transaction, Delaware courts may apply the business judgment rule.[107] The courts then limit their review of the decisions authorizing such transactions; the shareholders attacking the transaction will have the burden to prove that the transaction amounted to a gift or waste.[108] Commentators have criticized this approach:

> The courts have never provided an adequate justification for applying the business judgment rule to a conflict of interest transaction approved by a board that contains a majority of independent directors. Section 144(a) does not, as some courts have suggested, compel applying the outcome. Nor does it result from expungement of the conflict. In fact, the approach makes no effort to ensure that a decision-making process is free of the conflict of interest.[109]

Not only do the Delaware courts generally refuse to consider how structural bias and social relationships disqualify purportedly "independent"

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[105]Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

[106]*See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a)(1)-(2) (2006) (providing business judgment protections to interested transactions approved by either a fully-informed disinterested board or the disinterested shareholders).

[107]*See* Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) ("[S]ection 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule.").

[108]*See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366 n.34 (Del. 1993) ("Under this statute, approval of an interested transaction by either a fully-informed disinterested board of directors or the disinterested shareholders provides business judgment protection." (citation omitted)), *modified in part*, 636 A.2d 956 (Del. 1994).

[109]Brown, *supra* note 102, at 69.

directors,[110] but because plaintiffs must satisfy heightened pleading standards without access to any discovery, the courts have no way to determine whether the "independent" directors were fully informed and what influence, if any, the interested executive had on their decisions. In light of disturbing revelations that interested executives withheld material information and even intentionally deceived the outside directors at Enron, WorldCom, and many other public companies, relaxed judicial oversight of insiders' conflict-of-interest transactions is especially troubling. I will return to this point later.[111]

Given the gauntlet of procedural and substantive obstacles plaintiffs must navigate under Delaware law, it is not surprising that shareholders' suits against directors and officers rarely proceed past the pleading stage. Courts dismiss many civil actions filed against corporate executives early in the litigation. Shareholder plaintiffs cannot enforce fiduciary duties through derivative litigation because they cannot sufficiently plead, without discovery, facts that excuse board demand (i.e., facts showing that a majority of the board was not truly independent or was interested in the decision). Nor can shareholders establish, without discovery, a cognizable claim that the defendant executives breached their fiduciary duties and did so in such a way (intentionally or at least in bad faith) that they can be held liable to the corporation.

Thus, as the ultimate outcome of the *Disney* litigation made clear, corporate executives will not incur fiduciary liability under Delaware law even where their conduct "fall[s] far short of what shareholders expect and demand from those entrusted with a fiduciary position" and "does not comport with how fiduciaries of Delaware corporations are expected to act."[112] Illustrative of such judicial opinions is the recent decision by Delaware Chancellor William Chandler dismissing all but one of the state law claims asserted against Citigroup's management in *In re Citigroup Inc. Shareholder Derivative Litigation*.[113]

### B. *Enforcing Fiduciary Duties in Delaware: The* Citigroup *Example*

Many large financial institutions engaged in excessive risk taking in the years preceding the subprime mortgage crisis and the bursting of the real

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[110] *See, e.g.*, Beam *ex rel.* Martha Stewart Living Omnimedia v. Stewart, 845 A.2d 1040, 1050-51 (Del. 2004).

[111] *See infra* Part VI.E.

[112] *In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 763 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

[113] 964 A.2d 106 (Del. Ch. 2009).

estate bubble. Despite long odds against success, shareholders have filed derivative lawsuits against the directors and officers of financial institutions that failed or nearly failed in 2008, alleging that the companies' executives breached their fiduciary duties. For example, shareholders sued the executives of Citigroup, one of "the poster children for the excesses that created [the financial] crisis,"[114] after massive investments in subprime mortgages and complex debt instruments imperiled the giant bank and threatened its survival. Citigroup posted a $27 billion loss—and its stock price fell some 77%[115]—before the federal government rescued it in 2008.[116] Having determined that the bank was too big to fail, the Treasury Department bailed out the firm, spending approximately $45 billion of taxpayers' money to infuse Citigroup with capital under the controversial Troubled Asset Relief Program (TARP).[117]

Before the government came to Citigroup's rescue, several shareholders sued the responsible executives, seeking to recover some of the more than $25 billion in losses incurred by the company in subprime mortgages and related assets.[118] Alleging that demand on Citigroup's board was excused, plaintiffs instituted a derivative action in the Delaware Court of Chancery against the thirteen then-current members of Citigroup's board, several former directors, and certain current and former officers and senior managers.[119] The complaint alleged that the defendants breached their fiduciary duties by failing to oversee and manage Citigroup's massive subprime mortgage investments, assets that ultimately comprised some 43% of Citigroup's equity.[120] Despite many red flags warning them that the real estate and credit markets were collapsing, the defendants' alleged failures to monitor Citigroup's subprime portfolio exposed the firm to enormous losses and resulted in billions of write-downs.[121] The complaint also asserted that the defendants failed to ensure the accuracy of Citigroup's financial reporting

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[114]Colin Barr, *Citi's Vikram Pandit on the Hot Seat*, FORTUNE, June 5, 2009, http://money.cnn.com/2009/06/05/news/pandit.crosshairs.fortune/index.htm.

[115]*See* CNNMoney.com, Fortune 500 2009, http://money.cnn.com/magazines/fortune/fortune500/2009/snapshots/2927.html (last visited Nov. 10, 2009).

[116]*See* David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup—Plan Injects $20 Billion in Fresh Capital, Guarantees $306 Billion in Toxic Assets*, WALL ST. J., Nov. 24, 2008, at A1.

[117]*See id.* (explaining that the Department of Treasury gave Citigroup $20 billion in addition to the $25 billion previously provided).

[118]*See* Consolidated Second Amended Derivative Complaint, *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106 (Del. Ch. 2009) (No. 3338-CC).

[119]*See id.* at 7-14 (listing the defendants).

[120]*See id.* at 1-3.

[121]*Id.* at 114.

and other disclosures.[122] Finally, plaintiffs maintained that certain defendants wasted Citigroup's assets by approving a controversial, multimillion dollar exit package for the company's outgoing chairman and CEO, Charles Prince.[123] The board ultimately forced Prince to resign after he recommended to them that Citigroup write down billions of dollars in bad subprime investments.[124]

The defendants moved to dismiss the complaint in its entirety, arguing that the plaintiffs failed to plead demand futility with the particularity required under Delaware law.[125] Plaintiffs countered that the court should excuse demand because a majority of Citigroup's board members faced a substantial likelihood of liability.[126] According to plaintiffs, the defendants faced a substantial likelihood of liability for violating their duty of loyalty in failing to discharge their oversight obligation in good faith by consciously ignoring Citigroup's enormous exposure to risky subprime investments.[127]

Chancellor Chandler disagreed. While acknowledging Citigroup's "staggering" losses, the court refused to excuse demand and granted the defendants' motion to dismiss all but one of the shareholders' claims.[128] Significantly, the court determined that plaintiffs' allegations against the Citigroup executives did not even give rise to *Caremark*-type claims for oversight failure.[129] The court purposely distinguished the allegations in *Caremark* (that the defendant-directors' failure to monitor allowed illegal activity to transpire) from the allegations pled against the Citigroup defendants (that the defendant-directors failed to monitor Citigroup's business risk adequately, resulting in the firm's overexposure to risk from subprime mortgage investments):

> While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing

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[122] *In re Citigroup*, 964 A.2d at 114.

[123] Under Prince's leadership, Citigroup overinvested in risky subprime assets, refusing to liquidate or hedge against the risks. Several months before the board demanded his resignation, Prince famously justified the strategy, explaining to reporters, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Michiyo Nakamoto & David Wighton, *Bullish Citigroup Is "Still Dancing" to the Beat of the Buy-Out Boom*, FIN. TIMES (London), July 10, 2007, at 1.

[124] *See* Eric Dash, *Fixing Citigroup Will Test Rubin*, N.Y. TIMES, Nov. 5, 2007, at A1.

[125] *In re Citigroup*, 964 A.2d at 112.

[126] *Id.* at 121.

[127] *Id.*

[128] *Id.* at 139-40.

[129] *In re Citigroup*, 964 A.2d at 123 ("Plaintiffs' theory of how the director defendants will face personal liability is a bit of a twist on the traditional *Caremark* claim.").

> *Caremark*-type duties on directors to monitor business risk is fundamentally different. . . . Oversight duties under Delaware law are not designed to subject directors . . . to personal liability for failure to . . . properly evaluate business risk.[130]

Chancellor Chandler characterized the complaint as "essentially amount[ing] to a claim that the director defendants should be personally liable to the Company [for breach of fiduciary duty] because they failed to fully recognize the risk posed by subprime securities."[131] The court sharply criticized this attempt to hold the Citigroup executives personally liable.[132]

By rejecting plaintiffs' theory and applying the business judgment rule to their failure-of-oversight claims, the court protected Citigroup's directors. How did the court rationalize its novel approach? According to Chancellor Chandler, to allow plaintiffs' claims to go forward would be to "abandon . . . bedrock principles of Delaware fiduciary duty law" and engage in the "kind of judicial second guessing" about the firm's investments that "the business judgment rule was designed to prevent."[133] As the court emphasized, "Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk."[134] Although the business community praised Chancellor Chandler's decision, the result in *Citigroup* sends the message that state law immunizes corporate executives from liability. Indeed, shareholders' claims will not even get a hearing.[135]

What allegations are sufficient to withstand early dismissal? Allegations of criminal wrongdoing, as Vice Chancellor Leo Strine decided shortly before *Citigroup* came down. Vice Chancellor Strine denied the motions to dismiss filed by certain former executives of AIG, including its deposed former-CEO Hank Greenberg.[136] Explaining his unusual decision to allow the suit to go forward, Strine remarked that the "diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary."[137] Indeed, the court described AIG as a "criminal organization"[138]

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[130] *Id.* at 131.

[131] *Id.* at 124.

[132] *See id.* at 126 ("To impose liability on directors for making a 'wrong' business decision would cripple their ability to earn returns for investors by taking business risks.").

[133] *In re Citigroup*, 964 A.2d at 126.

[134] *Id.* at 131.

[135] *See* Posting of J. Robert Brown to TheRacetotheBottom.org, http://www.theracetothe bottom. org/ shareholder-rights/delaware-courts-and-exonerating -the-board-from-supervising-r-4.html (Mar. 12, 2009, 9:00 EST) (criticizing the *Citigroup* decision).

[136] *In re* Am. Int'l Group, Inc. Deriv. Litig. (*In re AIG*), 965 A.2d 763 (Del. Ch. 2009).

[137] *Id.* at 799.

and underscored that the alleged corruption within the company was not confined to certain business areas but, rather, permeated the entire firm.[139] Moreover, the complaint alleged that Greenberg and his executive co-defendants were, themselves, directly responsible for the business units engaged in the alleged misconduct.[140] Thus, Strine emphasized, the complaint included sufficient facts to support plaintiffs' claim that AIG's executives had personal knowledge of the wrongdoing.[141]

Read both separately and together, the decisions in *Citigroup* and *AIG* illustrate the exceptionally high threshold that shareholders must surpass merely to advance a Delaware derivative suit past the pleadings stage. Unless public company executives managed a firm engaged in pervasive wrongdoing, or they appear to have committed some grievously dishonest and disloyal act themselves, the defendant directors and officers will not be adjudicated liable for breaching their state law fiduciary duties.[142]

### C. *Obstacles to Civil Enforcement in Federal Court*

Shareholders of public companies also may attempt to remedy management's fiduciary duty breaches by litigating civil claims in federal court. Before Congress imposed substantial limits on private securities enforcement, plaintiffs sometimes included state law claims in their putative class action complaints filed in federal court.[143] Specifically, shareholders alleged that the defendant executives violated one or more federal antifraud statutes (typically, section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934[144]) and that one or more of the defendant executives breached their fiduciary duties under applicable state law.[145] While Congress enacted the federal antifraud statutes to protect shareholders rather than the corporation, harm to the corporation's shareholders usually, if not inevitably, results in injury to the corporation. Rarely is harming the corporation beneficial to its

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[138] *Id.*

[139] *Id.* at 774-75.

[140] *See In re AIG*, 965 A.2d at 780-81.

[141] *Id.* at 799.

[142] *See id.*; *In re* Citigroup Inc. S'holder Deriv. Litig., 964 A.2d 106, 125 (Del. Ch. 2009).

[143] *See, e.g.*, *In re* Donald J. Trump Casino Sec. Litig. (*Taj Mahal Litig.*), 7 F.3d 357 (3d Cir. 1993).

[144] *See* 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2009).

[145] *See, e.g.*, *Taj Mahal Litig.*, 7 F.3d at 366 (relying on 28 U.S.C. § 1367(a) (2006) to assert jurisdiction over state law breach of fiduciary duty claim). Federal courts have supplemental jurisdiction over state law claims brought in connection with, and forming the same case or controversy as, claims over which the courts have original jurisdiction, like federal securities claims. *See id.*; *cf.* 28 U.S.C. § 1367(c) (2006) (permitting district courts to dismiss pendent state law claims where there are novel or complex issues of state law or when the court has dismissed all federal claims).

shareholders, nor is defrauding the shareholders beneficial to the corporation. In fact, one wrong often begets the other. A fiduciary-duty-breaching executive will injure the firm and then mislead the firm's shareholders about the damage, thereby directly harming the shareholders as well.

While analytically distinct, executives' breaches of fiduciary duty to the corporation and their misrepresentations or omissions to investors often occur in tandem. Before 1998, shareholders could invoke the federal courts' supplemental jurisdiction over pendent state law claims in order to bypass the burdensome procedural obstructions associated with derivative litigation, such as the demand requirement. But Congress cut off this detour in the late 1990s when it passed two laws designed to curb the filing of "abusive and meritless" securities litigation. The first, the Private Securities Litigation Reform Act of 1995 (PSLRA), limited the rights of shareholders to file federal class action lawsuits and proceed with discovery.[146] The PSLRA also reduced the civil liability of companies, as well as their directors, officers, and advisors, under the federal securities laws. As a result, it became more difficult, expensive, and risky for shareholders to sue corporate officers and directors in federal court for violating the federal antifraud provisions.

Less than three years later, public company executives returned to Capitol Hill, seeking additional protections from shareholder lawsuits. They testified that plaintiffs' lawyers were evading federal reforms by filing their securities fraud complaints in state courts.[147] When successful, this tactic enabled shareholders to obtain discovery from defendants in state court, frustrating Congress's intent.[148] Congress reacted by enacting a second statute, the Securities Litigation Uniform Standards Act of 1998 (SLUSA).[149]

SLUSA stopped shareholders' attempts to end-run the PSLRA, but the law also effectively halted shareholders' ability to obtain redress for

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[146]Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

[147]Congress gave federal courts exclusive jurisdiction for violations of the Securities Exchange Act of 1934, but it gave federal and state courts concurrent jurisdiction to hear investors' claims under the Securities Act of 1933. *See* Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (2006); Securities Act of 1933 § 22(a), 15 U.S.C. § 77v(a) (2006).

[148]*See* H.R. REP. NO. 105-803, at 14 (1998) (Conf. Rep.); *see also* Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L.J. 141, 142 (1999) (providing an in-depth analysis of SLUSA, its legislative history, and objectives).

[149]Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77p, 78bb (2006)).

securities fraud under state law and through the state courts.[150] With limited exceptions, SLUSA preempts shareholders' state law breaches of fiduciary duty if plaintiffs assert such causes of action as independent claims and the alleged breaches are in connection with the purchase or sale of a "covered security."[151] By preempting their state law claims, SLUSA substantially disabled shareholders from prosecuting fiduciary duty claims in federal court.[152] When a claim for breach of fiduciary duty against a public company is rooted in misrepresentations or omissions, SLUSA may preempt its prosecution as a stand-alone claim.[153] In fact, SLUSA actually sweeps more broadly than section 10(b).[154] If the fiduciary's alleged breach "'coincide[s]' with a securities transaction—*whether by the plaintiff or by someone else*," that coincidence is enough to preempt the state law claim.[155] As a result, even if the plaintiff shareholder is a "holder" and did not actually purchase or sell the company's security, that plaintiff would have no claim under federal law.[156] SLUSA even "pre-empts state-law class-action claims for which federal law provides no private remedy."[157]

Shareholders still may attempt to hold corporate fiduciaries liable under the antifraud provisions of the federal securities laws—typically, section 10(b) and Rule 10b-5.[158] Although conduct violating the antifraud

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[150] *See* Casey, *supra* note 148, at 142.

[151] *See* 15 U.S.C. § 78bb(f) (2006). Specifically, SLUSA provides that

> [n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

*Id.*; *see id.* § 78bb(f)(5)(B) (defining "covered class action"); *id.* § 78bb(f)(5)(E) (defining "covered security"). For securities traded on a national exchange, an independent state law claim for breach of fiduciary duty is preempted if it alleges any misstatements, omissions, or deception in connection with the purchase or sale of the company's securities. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 82-83 (2005).

[152] *See* David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 31 (1998).

[153] *See* 15 U.S.C. § 78bb(f).

[154] *See Dabit*, 547 U.S. at 84-86.

[155] *See id.* at 85 (emphasis added).

[156] *See id.*

[157] *Id.* at 74. In *Dabit*, "holders" of various securities asserted breach of fiduciary duty claims in connection with the dissemination of misleading research. *Id.* at 75. Even though the class consisted of shareholders who had not purchased during the relevant time period, their claims also were preempted. *Id.* at 88-89.

[158] *See* 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2009). The prototype class action complaint alleges that the defendant issuer, through its senior management and/or advisors, misrepresented or fraudulently failed to disclose material information about the company to the market,

statutes is only a subset of the conduct that offends the duties of care and loyalty, Professors Thompson and Sale have demonstrated empirically that plaintiffs can reformulate fiduciary breach allegations as actionable securities fraud claims.[159] Either way, the law favors early dismissal of plaintiffs' claims. Federal courts dismiss many civil securities fraud complaints on the pleadings, before discovery.[160] Indeed, because the PSLRA established the most stringent pleading standards in civil litigation,[161] its 1995 enactment practically guaranteed that defendants would move to dismiss, rather than answer, shareholders' complaints. The PSLRA mandates that plaintiffs plead with particularity facts giving rise to a strong inference of the defendants' required state of mind; for actions under section 10(b) and Rule 10b-5, this means knowledge or recklessness.[162] In addition, plaintiffs must specify "each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[163] Finally, plaintiffs must plead loss causation adequately.[164] Again, plaintiffs must satisfy this extraordinary pleading standard without the benefit of any discovery from the firm or the individual defendants.[165]

Major decisions from the Supreme Court over the past 35 years also make federal civil liability unlikely. First and foremost, the Court has interpreted the federal securities laws narrowly, precluding federal liability for

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inflating the company's stock price artificially. When truthful information about the company is revealed to the market, the price of the securities corrects to its "proper" level, damaging investors who traded in the interim.

[159] *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003) (comparing class actions alleging Rule 10b-5 violations with shareholder actions filed in Delaware).

[160] *See* Stephanie Plancich & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2009 Year-End Update* (NERA Econ. Consulting, New York, N.Y.), Dec. 2009, at 9-10 (finding dismissal rates between 14% and 45% from 2000-2008).

[161] *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007).

[162] *See* 15 U.S.C. § 78u-4(b)(2) (2006); *see Tellabs*, 551 U.S. at 314 (construing scienter requirement). In order to survive a defendant's motion to dismiss after *Tellabs*, the pleadings of both the plaintiff and the defendant when read together must set forth a "cogent and compelling" inference that it is at least equally as likely that a knowing or reckless misrepresentation was committed as not. *Id.* at 324.

[163] 15 U.S.C. § 78u-4(b)(1).

[164] *See id.* § 78u-4(b)(4) ("[T]he plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate [the Securities Exchange Act] caused the loss for which the plaintiff seeks to recover damages."); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005) (holding that a plaintiff must allege facts demonstrating that defendants' material misrepresentation caused plaintiff's actual economic loss, not simply purchase price inflation).

[165] Practically, plaintiffs' firms must engage in costly private investigators and rely on confidential informants to uncover enough non-public information about the defendants' wrongdoing to satisfy the threshold pleading standards.

conduct regulated by well-established state law.[166] In *Santa Fe Industries, Inc. v. Green*, the Court held that mere breaches of fiduciary duty are not cognizable claims under section 10(b) and Rule 10b-5.[167] In so deciding, the Court expressed concern that applying federal law to claims of fiduciary breaches by corporate management, an area traditionally governed by state law, would create problems.[168] According to the Court, the logic that would permit such a result "could not be easily contained."[169] Allowing a breach of fiduciary duty to satisfy section 10(b)'s "manipulative or deceptive device or contrivance" language would expand the scope of the prohibited conduct impermissibly. According to the Court, it would be difficult to distinguish that conduct from "other types of fiduciary self-dealing involving transactions in securities" and, as a result, "bring within . . . [Rule 10b-5] a wide variety of corporate conduct traditionally left to state regulation."[170]

The Court also asserted that allowing federal courts to create and apply a "federal fiduciary principle" via the securities laws would "overlap and quite possibly interfere" with "established" state corporate law.[171] Without a "clear indication of congressional intent," the Court opted to leave the regulation of corporate internal affairs to state law.[172] Overarching federalism concerns, substantive questions about the scope of corporate managers' fiduciary duties, and basic notice concerns all supported the Court's decision to restrict the implied private right of action under section 10(b) to complaints alleging misrepresentations or omissions.[173] Reading *Santa Fe* and *Dabit* together, executives' fiduciary duty breaches that coincide with securities transactions seem to be insulated from liability.

The Court's 2008 decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* followed a similar analysis.[174] The majority again interpreted section 10(b) narrowly to restrict expansion of private antifraud enforcement to disputed contractual transactions, another area traditionally

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[166]*See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 478 (1977).

[167]*Id.* at 471-75.

[168]*Id.* at 478-79.

[169]*Id.* at 478.

[170]*Santa Fe*, 430 U.S. at 478.

[171]*Id.* at 478-79. The Court worried that Rule 10b-5 could be interpreted to "impose a stricter standard of fiduciary duty than that required by the law of some States." *Id.* at 479 n.16.

[172]*Id.* at 479.

[173]This is a substantive difference, not simply a semantic distinction. Plaintiffs cannot "'bootstrap' a claim of breach of fiduciary duty into a federal securities claim by alleging that [a defendant] failed to disclose that breach of fiduciary duty." Kas v. Fin. Gen. Bankshares, Inc., 796 F.2d 508, 513 (D.C. Cir. 1986).

[174]*See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 161-62 (2008).

regulated by state law.[175] As in *Santa Fe*, the Court considered extra-statutory principles counseling against extending the statute to reach the conduct alleged.[176] Writing for the majority, Justice Kennedy first examined federalism concerns and respect for state law.[177] The Court declined to apply section 10(b) to ordinary business transactions because such a reading would risk "that the federal power would be used to invite litigation beyond the immediate sphere of securities litigation and in areas already governed by functioning and effective state-law guarantees."[178] Second, Justice Kennedy wrote that separation of powers concerns constrained the Court.[179] The decision to extend the reach of a judicially-created, implied right of action "beyond its present boundaries" belonged to Congress, not the Court.[180] Third, the Court found that the existence of other enforcement vehicles addressing the secondary actors' alleged misconduct—namely, criminal securities fraud, SEC enforcement, and sometimes express private rights of action—counseled against section 10(b) liability.[181] Finally, the Court noted that after *Central Bank*, Congress declined to reinstate aiding and abetting liability by including an express private right of action in the PSLRA.[182] As in *Santa Fe*, consideration of these combined factors compelled the Court to restrict the statute's reach.

The Supreme Court's prior securities law jurisprudence highlights some important normative judgments about the ill-defined border between state and federal regimes governing the liability of corporate executives, perhaps foreshadowing how the Court will analyze the honest services statute. Prosecuting executives under § 1346 federalizes enforcement of corporate executives' fiduciary duties, affecting these same interests, as I explain in Part V. While most appellate courts interpreting § 1346 have ignored the decision model utilized by the Court in *Santa Fe* and *Stoneridge*, competing constructions of § 1346 necessarily implicate federalism, respect for state law, separation of powers, and the enforcement mechanisms available under state corporate law.

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[175] According to the Court, section 10(b) "does not reach all commercial transactions that are fraudulent and affect the price of a security in some attenuated way." *Id.* (citing *SEC v. Zandford*, 535 U.S. 813, 820 (2002), in which the Court stated that section 10(b) "must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation").

[176] *Id.* at 161.

[177] *Id.*

[178] *Stoneridge*, 552 U.S. at 161.

[179] *Id.* at 164-65.

[180] *Id.* at 165.

[181] *Id.* at 166.

[182] *Stoneridge*, 552 U.S. at 157-58, 162.

### D. *Empirical Evidence: Directors and Officers Rarely Liable for Breaching Their Fiduciary Duties*

Rarely is civil liability imposed on public company executives. Not surprisingly, boards seldom authorize such lawsuits. In the exceptional circumstance that directors approve such litigation, they previously terminated the executive, yet the firm avoided bankruptcy after the executive's wrongdoing became public.[183] Empirical research also demonstrates that shareholders rarely obtain judgments holding executives liable for fiduciary duty violations. A well-publicized study by Professor Bernard Black and colleagues determined that, from 1980 through 2005, only five derivative suits against outside directors of public companies went to trial, and plaintiffs won just two of them.[184] Professors Robert Thompson and Randall Thomas examined all Delaware derivative suits filed during 1999 and 2000 and found that, out of the fifty lead cases resolved, only six resulted in any monetary recovery for the corporations.[185] This past year, Professor Black and his colleagues published another article, this time comparing shareholder litigation against public company directors in the United States and the United Kingdom.[186] Searching nationwide in the United States for lawsuits filed between 2000 and 2007 alleging a breach of duty, they found that only a small percentage of such cases were sufficiently contentious that the U.S. courts issued written decisions, and a substantial fraction of those cases were dismissed.[187] When the researchers matched their U.S. lawsuit data to the data from Thompson and Thomas' Delaware studies, they determined that only one in seven complaints filed against directors in Delaware produced a written decision.[188] Most written decisions favored the defendants, but, more often than not, judges dismissed the complaints without any written

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[183]The shareholders' derivative action filed against former HealthSouth chairman and CEO Richard Scrushy exemplifies such a lawsuit. *See, e.g.*, Valerie Bauerlein & Mike Esterl, *Judge Orders Scrushy to Pay $2.88 Billion in Civil Suit*, WALL ST. J., June 19, 2009, at B1.

[184]Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1064-66 (2006).

[185]Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1775-76 (2004). Professors Thompson and Thomas examined certain lawsuits in more detail in a separate article. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004). Critics of derivative litigation emphasize that even if the plaintiff-shareholder recovers money damages on behalf of the corporation, the proceeds may come from the corporation's D&O liability policy, and increases to the company's premiums may offset much of the recovery.

[186]John Armour et al., *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US*, 6 J. EMPIRICAL LEGAL STUD. (forthcoming 2009) (manuscript at 1, *available at* http://ssrn.com/abstract=1105355).

[187]*Id.* (manuscript at 12, 18).

[188]*See id.* (manuscript at 15).

opinion.[189] Indeed, the researchers located just ten written decisions (3% of all written decisions) entering judgments against defendants and awarding damages following trials on the merits.[190] In those cases, D&O insurance likely covered almost all payments owed by the defendants.[191]

Empirical studies also confirm that, applying the PSLRA's heightened pleading standards, courts have dismissed more securities fraud class actions on pre-discovery motions by the defendants, as Congress intended. After enactment of the PSLRA, securities class action dismissals doubled.[192] In the Ninth Circuit, previously a "hotbed" of securities litigation, the dismissal rate nearly tripled.[193] An early study found that courts granted, at least in part, 79% of defendants' motions to dismiss securities fraud class actions.[194] Another more recent study reported that courts had dismissed some 44% of all post-PSLRA securities fraud complaints.[195] Furthermore, there is some evidence that courts are dismissing an even higher fraction of cases since the Court's 2005 *Dura* decision.[196]

If plaintiffs' complaint survives defendants' motions to dismiss and the trial court certifies the shareholder class, defendants almost always settle rather than proceed to trial.[197] But the defendant corporation and its insurer

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[189] *See id.* (manuscript at 15, 16, tbl.6). The authors found no written decisions in a breach of fiduciary duty suit filed solely against non-director officers. *Id.* (manuscript at 12 n.55).

[190] *See* Armour et al., *supra* note 186 (manuscript at 16 tbl.6).

[191] *Id.* (manuscript at 16-17).

[192] *Compare* ELAINE BUCKBERG ET AL., RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLDCOM AND ENRON THE NEW STANDARD? 3 (2005) (discussing courts' dismissal of some 20.3% of securities class actions from 1991 through 1995), *with* RONALD I. MILLER, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEYOND THE MEGA-SETTLEMENTS, IS STABILIZATION AHEAD? 4 (2006) (explaining that from 1998 through 2003, the dismissal rate in securities class actions was 40.3%).

[193] *See* James D. Cox et al., *Do Differences in Pleading Standards Cause Forum Shopping in Securities Class Actions?: Doctrinal and Empirical Analyses*, 2009 WIS. L. REV. 421, 442 (noting that dismissal rates for cases filed in the Ninth Circuit went from 20.8% just before PSLRA to 34.9% by 2003 and 57.1% by 2005). An intriguing new empirical study suggests that the trend may be diminishing, if not reversing somewhat. *See* Stephen J. Choi & Adam C. Pritchard, *The Supreme Court's Impact on Securities Class Actions: An Empirical Assessment* 25 (NYU Ctr. for Law, Econ. & Org., Law & Econ. Research Paper Series, Working Paper No. 09-34, 2009), *available at* http://ssrn.com/abstract=1457085.

[194] *See* Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 116 n.94 (2002) (reporting 72 of 91 motions to dismiss granted in full or in large part).

[195] Stephanie Plancich & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2009 Mid-Year Update* (NERA Econ. Consulting, New York, N.Y.), July 2009, at 15.

[196] *Id.* at 2, 30 (inferring that plaintiffs have found it more challenging to meet their burden of proof and show loss causation in their complaints).

[197] *See* Black et al., *supra* note 184, at 1084.

fund the settlements.[198] Individual defendants rarely contribute funds out of their own pockets to settle securities fraud litigation,[199] a fact that has led many academics to question the deterrence value of securities class actions.[200] Plaintiffs seldom name outside directors as defendants in a typical section 10(b)/Rule 10b-5 lawsuit. When plaintiffs have sued outside directors,[201] and those director-defendants actually contributed to the settlements, the amounts paid by the directors were small compared to the individuals' overall net worth, and trivial compared to the massive damages (hundreds of billions of dollars) claimed by the defrauded shareholders. In most cases, plaintiffs do not seek damages directly from culpable corporate executives even if the executives personally profited from the fraud or their conduct was egregious.

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Part III has shown that public company managers are seldom held accountable under civil law for breaching their fiduciary duties. As the *Citigroup* decision illustrates, Delaware judges still insulate public company directors from civil liability through resolute enforcement of the business judgment rule, exculpatory charter provisions exonerating directors from monetary damages, and generous indemnification rights.[202] Shareholders do not fare much better when they sue executives in federal court. Congress and the United States Supreme Court have restricted shareholders' federal remedies over the past three decades. On the civil side, then, the trend in the law is against enforcement. From both a procedural and substantive perspective, fiduciary breaches by public company executives seem increasingly likely to go unremedied under civil law. Yet, as I show next, corporate fiduciaries face greater potential criminal liability under criminal law for breaching these same state law duties.

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[198] *See id.* at 1080.

[199] *See id.* at 1068, 1084.

[200] *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006); James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 38 (1999); *cf.* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627 (2007) (analyzing civil law remedies available to recover ill-gotten gains from executive wrongdoers).

[201] *See* Thompson & Sale, *supra* note 159, at 896-97 (demonstrating that non-officer directors are rarely named as defendants in securities fraud actions).

[202] For more information, see *supra* Part III.B.

## IV. PROSECUTING BREACHES OF FIDUCIARY DUTY AS CRIMINAL VIOLATIONS

Because shareholder litigation is an expensive but ineffective disciplinary device, civil enforcement of executives' fiduciary duties is deficient in at least two important respects. First, such lawsuits do not seem to deter opportunistic behavior and dishonesty by public company executives. Second, the actions fail to provide incentives to outside directors to exercise diligent monitoring that might detect, and even prevent, managerial wrongdoing. Without any plausible threat of enforcement, liability rules arguably cannot function, and certainly not optimally, to constrain fiduciary opportunism.[203] Might criminal prosecutions against offending fiduciaries fill this enforcement gap?

### A. *Prosecuting Corporate Executives for Honest Services Fraud*

Federal prosecutors have used § 1346 to criminalize a progressively wider range of conduct since its enactment in 1988. For the first decade, the government employed the statute principally to prosecute public corruption, indicting state legislators, political machine operatives, and, occasionally, state governors.[204] Less common was prosecutors' use of § 1346 to combat corporate fraud, self-dealing, or other unlawful activity arising in the purely private sphere;[205] that is, until just after the turn of this century, when Congress and the executive branch declared "war" on corporate crime.[206] Criminal indictments of public company executives increased at that time, with prosecutors charging, among the myriad of other federal crimes, violations of § 1346.[207]

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[203] *See supra* Part III.D.

[204] For example, in April 2009, a federal grand jury indicted former Illinois Governor Rod Blagojevich on eleven counts of wire fraud arising from an alleged scheme to deprive Illinois of his honest services. *See* Press Release, U.S. Dep't of Justice, Former Illinois Gov. Rod R. Blagojevich, His Brother, Two Former Top Aides and Two Businessmen Indicted on Federal Corruption Charges Alleging Pervasive Fraud (Apr. 2, 2009), *available at* www.usdoj.gov/usao/iln/pr/chicago/2009/pr0402_01.pdf.

[205] Research revealed few reported decisions charging corporate officers with honest services fraud in the late 1990s. *See* United States v. Skeddle, 940 F. Supp. 1146, 1148 (N.D. Ohio 1996) (charging senior officers of Libbey-Owens-Ford Co. with alleged undisclosed self-dealing); United States v. Brennan, 938 F. Supp. 1111, 1115, 1125 (E.D.N.Y. 1996) (prosecuting former president and CEO of United States Aviation Underwriters, Inc. for mail fraud), *rev'd*, 183 F.3d 139 (2d Cir. 1999).

[206] *See The Unlikeliest Scourge—Bush and Big Business*, ECONOMIST, July 13, 2002, at 26.

[207] Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 357-59 (2003).

1. The Motivation

The catalysts for more aggressive criminal enforcement were, of course, Enron and WorldCom—or, more precisely, revelations of massive financial frauds, shameful management self-dealing, and even outright looting by executives of those corporations and other of the country's largest public companies.[208] Enron collapsed first. Stock prices fell. WorldCom failed six months later, and its bankruptcy, just six months after Enron's failure, caused capital to flee the stock markets. Between the two then-largest corporate bankruptcies in history came weekly, even daily, news that yet another public company had discovered misstatements in its prior financial reports and would have to file restatements. Some of those companies include Adelphia, Xerox, Global Crossing, Lucent, Qwest, and Rite Aid. Meanwhile, as Congress held hearings to dissect Enron's fraudulent financial reporting and off-balance sheet entities, abusive executive loans, and other conflict-of-interest transactions, the media reported on the gross misuse of corporate funds by top officers of other public companies. Otherwise reputable corporate boards, comprised mostly of outside directors, claimed that they, too, were deceived by corrupt CEOs, CFOs, and other senior officers. Stock prices fell further. The public voiced outrage, and commentators urged criminal prosecutions for those responsible. Even *Fortune* magazine's cover declared: "They lie, they cheat, they steal and they've been getting away with it for too long."[209]

In July 2002, with share prices and investors' confidence in a free fall and mid-term elections fast approaching, Democrats and Republicans alike called for the scalps of public company executives. Both the White House and Congress, reacting quickly to WorldCom's devastating announcement, developed and championed policies promoting the aggressive prosecution of corrupt officers. Looking to distance himself from Enron and its former chairman Kenneth Lay, a supporter and family friend, President George W. Bush got out of the gate first.[210] Vowing that his administration would "put the bad guys in prison and take away their money,"[211] the president established the Corporate Fraud Task Force (CFTF) by executive order on July 9, 2002.[212] "[W]e will use the full weight of the law to expose and root

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[208] *Id.*

[209] Clifton Leaf, *Enough Is Enough*, FORTUNE, Mar. 18, 2002, cover.

[210] *See, e.g.*, *The Unlikeliest Scourge*, *supra* note 206, at 26 (referring to creation of DOJ "financial-crimes SWAT team").

[211] Paula Dwyer, *Nowhere to Run, Nowhere to Hide*, BUS. WK., Oct. 14, 2002, at 44 (quoting Deputy Attorney General Larry Thompson).

[212] *See* Exec. Order No. 13,271, 67 Fed. Reg. 46,091 (July 9, 2002).

out corruption," he said that day.[213] "My administration will do everything in our power to end the days of cooking the books, shading the truth and breaking our laws."[214] Notably, President Bush also called on Congress to "give the Administration new powers to enforce corporate responsibility and to improve oversight of corporate America" including, as its first request, "[t]ough new criminal penalties for *mail and wire fraud*."[215]

Just two weeks after President Bush established the CFTF, Congress passed the Sarbanes-Oxley Act of 2002 (SOX).[216] SOX boosted criminal enforcement by creating new crimes punishing securities fraud (without proof of technical elements otherwise required under the securities laws), conspiracy to commit mail, wire, or securities fraud (without proof of an overt act),[217] obstruction of justice,[218] and retaliation against whistle-blowers.[219] Following enactment of SOX, criminal penalties also could be imposed on CEOs and CFOs who knowingly or willfully certified false financial statements.[220] Additionally, Congress quadrupled the maximum prison term for mail and wire fraud to twenty years,[221] doubled (from ten to twenty years) the maximum prison term for securities fraud, and directed the U.S. Sentencing Commission to revise the sentencing guidelines to lengthen sentences for public company officers and directors convicted of fraud.[222]

Importantly, Sarbanes-Oxley did almost nothing to enhance private enforcement of fiduciaries' obligations.[223] In the wake of Enron, WorldCom, and the rest, Congress created no new civil rules or remedies to discipline

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[213]President George W. Bush, Address Calling for New Era of Corporate Responsibility (July 9, 2002), *available at* http://transcripts.cnn.com/TRANSCRIPTS/0207/09/se.02.html.

[214]*Id.*

[215]White House Website, President's Ten-Point Plan, http://georgewbush-whitehouse.archives.gov/infocus/corporateresponsibility/index2.html (last visited Dec. 12, 2009) (emphasis added).

[216]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 and 18 U.S.C.). This article does not examine the corporate governance regulations included in SOX.

[217]*Id.* § 902(a) (adding 18 U.S.C. § 1349, conspiracy and attempt).

[218]*Id.* § 805.

[219]*Id.* § 1107.

[220]Sarbanes-Oxley Act §§ 302, 906.

[221]*Id.* § 903.

[222]*Id.* § 1104. When Congress enacted Sarbanes-Oxley, the "popular imagination" was that "white-collar criminals spend a couple of years in a country-club jail and emerge, reborn, as earnest philanthropists—like, say, Michael Milken, who was convicted during America's last big corporate crime wave, in the 1980s, and spent just two years in jail." *Bosses Behind Bars*, ECONOMIST, Sept. 21, 2004, at 1.

[223]The only reform directed to improving private enforcement was extending the statute of limitations for securities fraud claims. *See* Sarbanes-Oxley Act § 804 (lengthening statute of limitations from one to two years and the period of repose from three to five years).

executives who breach their fiduciary duties.[224] Public company fiduciaries still faced little risk of civil liability, regardless of their culpability or harm to the corporations they managed. Despite the recognized need to punish corrupt acts and hold responsible executives more accountable, shareholder litigation remained politically disfavored as a deterrent.[225] In contrast, even the head of the U.S. Chamber of Commerce endorsed criminal enforcement.[226]

### 2. The Results

Although government lawyers suffered several embarrassing defeats, the Justice Department recorded an unprecedented number of successful prosecutions of corporate executives.[227] From the CFTF's inception through January 6, 2009, federal prosecutors obtained nearly 1,300 corporate fraud convictions,[228] most of which (1,236) came in its first five years of operation. Among the convicted felons were more than 200 chief executive officers and presidents, more than 120 corporate vice presidents, and more than 50 chief financial officers. In addition to jail terms, sentencing judges also imposed substantial financial penalties on convicted executives, including criminal fines, restitution, and forfeiture. Indeed, the DOJ obtained more than $1 billion in forfeitures from defendants convicted of financial offenses.[229]

While federal prosecutors have charged executives with a host of criminal violations,[230] mail and wire fraud counts appeared in many, if not most, indictments. To be sure, the vast majority of mail and wire counts

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[224]*See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 395, 405-07 (2005).

[225]For the same reason, Delaware legislators and judges have taken almost no action to make responsible directors and officers more accountable for breaching their fiduciary duties.

[226]At a press conference in July 2002, Chamber President Tom Donahue pounded his fist on a table and demanded, "Put 'em in jail!" *The Unlikeliest Scourge, supra* note 206, at 26.

[227]*See* William Donaldson, Chairman, SEC & Larry Thompson, Deputy Attorney Gen., Press Briefing (July 22, 2003), *available at* http://www.justice.gov/dag/cftf/press/072203whitehouse cftfbriefing.htm ("Before the task force was created, . . . [the DOJ] didn't keep statistics with respect to corporate fraud in a discreet [sic] manner. They were lumped in with other white collar criminal activity.").

[228]Press Release, Dep't of Justice, President's Corporate Fraud Task Force Adds Six New Member Agencies (Jan. 6, 2009), *available at* http://www.usdoj.gov/opa/pr/2009/January/09-odag-003.html.

[229]*Id.*

[230]*See id.* ("Prosecutors . . . have brought charges for accounting fraud, securities fraud, insider trading, market manipulation, wire fraud, obstruction of justice, false statements, money laundering, Foreign Corrupt Practices Act violations, stock option backdating and conspiracy, among things.").

alleged deprivations of money and property. A number of indictments, however, also included mail and wire fraud counts alleging deprivations of honest services, including, most notably, many of the indictments charging former Enron executives. It seems that government lawyers often allege mail and wire frauds, including honest services fraud, because the statutes are versatile, and the violations serve as predicate offenses for money laundering and/or racketeering under the Racketeer Influenced and Corrupt Organization Act (RICO) charges. By indicting and convicting the corporate executive for money laundering or RICO, prosecutors can seek criminal forfeiture of the ill-gotten gains still in the executive's possession and control.

Unfortunately, we can only estimate the number of corporate executives charged with honest services fraud. The DOJ's Statistics Bureau does not treat honest services fraud as a crime separate from mail fraud and wire fraud.[231] Thus, government records do not distinguish indictments alleging honest services deprivations under § 1346 from those relying solely on money or property theories under §§ 1341 and 1343.[232] Nonetheless, using online resources,[233] I developed a noncomprehensive catalog of the corporate executives charged with honest services fraud after 2000. Available records indicate that federal prosecutors charged at least 113 corporate officers, directors, and other senior corporate officers with violating § 1346. Among the indicted were at least twenty-five chief executive officers, about a third of whom served as chairmen of the board. Also charged were at least six non-chair directors, five presidents, four chief operating officers, fifteen

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[231]Because § 1346 is a definitional provision that expanded the scope of mail and wire fraud, information on the government's use of § 1346 is not captured systematically. Obtaining data directly from district court dockets proved underinclusive as well; honest services fraud charges often are omitted from docket entries due to inconsistent charging conventions and docketing practices. In the absence of a searchable public data base containing the texts of all federal indictments, any comprehensive analysis of § 1346 usage is subject to error.

[232]*See* U.S. Dep't of Justice, Bureau of Justice Statistics, Federal Justice Statistics, http:// www. ojp.usdoj.gov/bjs/fed.htm (last visited Dec. 12, 2009).

[233]The listing of corporate executives charged with honest services fraud (and available from the author) was compiled by searching a variety of online databases. Westlaw's docket database was searched for federal dockets mentioning 18 U.S.C. § 1346 or "honest services." Next, the indictments from potentially relevant dockets were cross-checked to identify defendants alleged to be corporate executives. The results were incomplete, however, as many relevant dockets do not explicitly reference § 1346 or honest services. The original listing then was supplemented with additional prosecutions found on the CFTF webpage at the DOJ's website (especially its "Significant Criminal Cases and Charging Documents" heading), the DOJ's media releases, and other major media outlets. These resources also provided names of corporate executives charged with mail and wire fraud and court filing information. Finally, indictments were accessed and reviewed to determine whether the charges included honest services fraud.

chief financial officers, and twenty-six vice-presidents and executive vice-presidents.[234] Many of these defendants were former executives of companies that were the subjects of well-publicized frauds, including Enron, Adelphia, Rite Aid, AOL, and Qwest. In addition to Conrad Black[235] and Jeff Skilling,[236] the defendants included other now well-known executives: Enron's Andrew Fastow[237] and Richard Causey,[238] Adelphia's John Rigas,[239] and HealthSouth's Richard Scrushy,[240] who was acquitted of all charges following a jury trial in 2005. Also convicted of honest services fraud were many professionals who advised top management, such as attorneys and investment bankers. To the extent the charging documents identified a specific duty breached, the indictments alleged breaches of the duty of loyalty.

In 2006, federal prosecutors also began charging honest services fraud in high-profile prosecutions of corporate executives accused of "backdating" stock options.[241] Nonetheless, after President Bush's second term began, the number of corporate executives charged with honest services fraud declined,[242] in parallel with the reported decline in major corporate fraud indictments overall.[243] Since other evidence indicates that use of § 1346 for public corruption remained high,[244] the observed decline likely reflects the overall decline in corporate fraud prosecutions during the same period.[245]

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[234]The remainder included at least six general counsel, one corporate treasurer, a chief accounting officer, and various managers, owners, controllers, division directors, and other senior personnel.

[235]United States v. Black, 526 F. Supp. 2d 870 (N.D. Ill. 2007), *aff'd*, 530 F.3d 596 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 2379 (U.S. May 18, 2009) (No. 08-876).

[236]United States v. Causey, No. H-04-025, 2004 WL 2414438 (S.D. Tex. Oct. 19, 2004), *aff'd sub. nom.* United States v. Skilling, 554 F.3d 529 (5th Cir. 2009), *cert granted*, 130 S. Ct. 393 (U.S. Oct. 13, 2009) (No. 08-1394).

[237]United States v. Fastow, No. H-02-0665 (S.D. Tex. filed Oct. 31, 2002).

[238]*Causey*, 2004 WL 2414438.

[239]United States v. Rigas, No. 02-CR-1236, 2004 WL 2434965 (S.D.N.Y. Nov. 1, 2004), *aff'd*, 583 F.3d 108 (2d Cir. 2009).

[240]United States v. Scrushy, No. CR-03-BE-0530-S (N.D. Ala. filed Oct. 29, 2003).

[241]*See, e.g.*, United States v. Nicholas, No. SACR 08-00139, 2008 WL 5233199 (C.D. Cal. Dec. 15, 2008). "Backdating" options refers to the practice of setting the grant date retroactively to a date when the stock traded at a lower price, thereby creating an instant paper gain for the recipient.

[242]From 2002 to 2005, the CFTF averaged over 119 indictments annually. From 2006 to 2007, the annual average appears to have dropped to approximately 13. *See* Daphne Eviatar, *Case Closed?*, AM. LAW., Fall 2007, at 19, 21.

[243]*Id.* at 30 (reporting 2007 year-to-date number of white-collar filings was 64% lower than the 2006 number and 77% lower than the 2004 number).

[244]For example, a Westlaw search for federal dockets referencing honest services fraud or § 1346 returned 107 cases from 2008, up from 86 in 2007, and greater than the previous high of 95 from 2005. This number exceeds the 2002-2004 average of 86.7 cases per year. While the search cannot be viewed as comprehensive, it does indicate that the decline in honest services fraud

### B. *Procedural Advantages to Criminal Prosecution*

For public company executives, the federal government's political commitment to fight corporate fraud through aggressive criminal enforcement is troubling enough. But political will aside, government lawyers have significant procedural advantages in criminal cases that lead to sizeable conviction rates. First, prosecutors have the authority to make charging decisions. They determine not only whom to charge but whether and which crimes to charge in any particular case. Government lawyers generally also have the authority to negotiate plea agreements and accept pleas from defendants. Through their authority over charges and dispositions, the law gives prosecutors power to determine the defendant's likely punishment. As they exercise this substantial discretion, prosecutors have the sprawling federal criminal code at their disposal. Critics have long complained that the federal criminal code arms prosecutors with a quasi-legislative, administrative license to brand as "criminal" a variety of non-violent conduct. This prosecutorial power—and its potential for abuse—persists apart from the lack of congressional specificity in drafting § 1346.

Furthermore, prosecutors receive near-total cooperation from grand juries, which rarely refuse to return requested indictments.[246] Commentators attribute prosecutors' success rate to the grand juries' dependence on prosecutors. Grand juries largely have become passive bodies dependent on government lawyers to provide relevant evidence.[247] Prosecutors, moreover, need not present exculpatory evidence to the grand jury.[248] As a result, "the grand jury, having been conceived as a bulwark between the citizen and the Government, is now a tool of the Executive."[249] More colorfully, Sol Wachtler, former chief judge of the New York Court of Appeals, once

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indictments is best explained by an overall decline in corporate fraud prosecutions, rather than a decline in the use of § 1346.

[245] *See, e.g.*, Eviatar, *supra* note 242, at 21 (discussing decline in corporate fraud prosecutions following President George W. Bush's re-election in 2004, reporting that "corporate fraud indictments slowed to a trickle" by 2007).

[246] An analysis of the 785 federal grand juries impaneled in 1991 revealed that grand jurors refused to return indictments in only 16 of 25,943 cases (less than 0.1%). Roger Roots, *If It's Not a Runaway, It's Not a Real Grand Jury*, 33 CREIGHTON L. REV. 821, 827-28 (2000). A 1984 study found only 68 rejections out of 17,419 cases (0.4%). Andrew D. Leipold, *Why Grand Juries Do Not (and Cannot) Protect the Accused*, 80 CORNELL L. REV. 260, 274-75 (1995).

[247] Geraldine Szott Moohr, *Prosecutorial Power in an Adversarial System: Lessons from Current White Collar Cases and the Inquisitorial Model*, 8 BUFF. CRIM. L. REV. 165, 203-04 (2004).

[248] *Id.* at 204.

[249] United States v. Mara, 410 U.S. 19, 23 (1973) (Douglas, J., dissenting); *see* Kevin K. Washburn, *Restoring the Grand Jury*, 76 FORDHAM L. REV. 2333, 2352 n.99 (2008) (detailing the extent to which grand juries are viewed as "rubber stamps").

suggested that prosecutors could convince a grand jury to indict a ham sandwich.[250]

Motions to dismiss also pose little threat to prosecutors' criminal charges. Unlike shareholder plaintiffs, who must plead fraud with heightened particularity in both state and federal court, prosecutors need only provide a "plain, concise, and definite written statement of the essential facts constituting the offense charged."[251] In contrast to the requirements under Delaware law and the PSLRA, courts do not analyze the sufficiency of any factual allegations, and scienter and causation need not be plead at all, much less with great specificity. The government need not allege its theory of the case or specify its supporting evidence,[252] and no law requires that the government plead or prove harm, loss, or damage to anyone. To survive dismissal, the indictment need only (1) contain the elements of the offense charged, (2) inform the defendant of the nature of the charges against him in order to allow him to prepare an adequate defense, and (3) be specific enough to preclude subsequent prosecutions for the same offense.[253] Indictments very rarely fail this modest pleading standard. Thus, trial courts routinely deny criminal defendants' motions to dismiss after relatively perfunctory hearings.[254]

Rather than proceeding to trial, however, most criminal cases conclude with the defendant pleading guilty to one or more charges. According to government statistics, federal prosecutors obtained some sort of conviction in 90% of all federal criminal cases closed from 2005 through 2007, and nearly all of those convictions, 96%, were obtained through guilty pleas.[255]

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[250]*See* Washburn, *supra* note 249, at 2352 & n.99.

[251]FED. R. CRIM. P. 7(c)(1).

[252]*See, e.g.*, United States v. Vega, 309 F. Supp. 2d 609, 616 (S.D.N.Y. 2004) (holding that the government need not "disclos[e] the manner in which it will attempt to prove the charges, the precise manner in which the defendant committed the crimes charged, or a preview of the Government's evidence or legal theories").

[253]*See, e.g.*, Hamling v. United States, 418 U.S. 87, 117 (1974); United States v. Hausmann, 345 F.3d 952, 955 (7th Cir. 2003); *see also* United States v. deVegter, 198 F.3d 1324, 1330 (11th Cir. 1999) (finding honest services fraud indictment sufficient even when government failed to allege defendant owed any fiduciary duty).

[254]Of the cases which charged § 1341 or § 1343 violations that closed from 2005 through 2007, 7.8% ended in dismissals (or nolle prosequi). *See* STATISTICS DIV., ADMIN. OFFICE OF THE U.S. COURTS, STATISTICAL TABLES FOR THE FEDERAL JUDICIARY 81 tbl.D-4 (2007), *available at* http://www.uscourts.gov/stats/dec07/D04Dec07.pdf; STATISTICS DIV., ADMIN. OFFICE OF THE U.S. COURTS, STATISTICAL TABLES FOR THE FEDERAL JUDICIARY 81 tbl.D-4 (2006), *available at* http://www.uscourts.gov/stats/dec06/D04Dec06.pdf; STATISTICS DIV., ADMIN. OFFICE OF THE U.S. COURTS, STATISTICAL TABLES FOR THE FEDERAL JUDICIARY 81 tbl.D-4 (2005), *available at* http://www.uscourts.gov/stats/dec05/D04dec05.pdf.

[255]*See infra* note 254.

The numbers are even higher in cases charging mail and wire fraud; prosecutors racked up a 91.4% conviction rate during that time.[256]

Federal prosecutors' substantial record of success underscores the importance of the Supreme Court's upcoming review of § 1346 for corporate fiduciaries. How might the Court narrow or even eliminate honest services fraud as a substantive criminal offense? The next section addresses these questions.

## V. THE EVOLVING CRIME OF HONEST SERVICES FRAUD

Before analyzing the complex interpretive problems facing the Supreme Court—puzzles that have confounded federal appellate courts for two decades—Part V begins by exploring the statute's origins, including the antecedent development of the intangible rights theory that preceded the enactment of § 1346. As the lower federal courts have recognized, the statute cannot be understood without reference to Congress's overall scheme for prohibiting fraud through use of the mails and wires.[257]

### A. *A Brief History of Honest Services Fraud*[258]

Although honest services fraud had an inauspicious beginning, the doctrine unexpectedly grew "like a kudzu vine"[259] in the late 1970s and the 1980s before the Supreme Court took action to prune it back in 1987. The next year, however, Congress responded to the Supreme Court's decision to eliminate honest services fraud by enacting § 1346. Since then, honest services fraud has become increasingly prominent in prosecutions of both public corruption and corporate crime.[260]

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[256] *See infra* note 254.

[257] *See* United States v. Brown, 459 F.3d 509, 519 (5th Cir. 2006) ("[Section 1346] can be understood only in the light of the long history of the mail- and wire-fraud statutes, which were intentionally written broadly to protect the mail and, later, the wires from being used to initiate fraudulent schemes.").

[258] *See* Casey, *supra* note 23, at 179-206 (describing the judicial and legislative history of honest services fraud, including its mail and wire fraud antecedents, and citing background articles). *Class Action Criminality* examines the DOJ's prosecution of the Milberg Weiss law firm and its four senior partners for honest services fraud. The government indicted the defendants for sharing court-awarded attorneys' fees with their clients who served as named plaintiffs in securities fraud class actions. Because the indictments centered on alleged breaches of "fiduciary duties" not recognized under state or federal law, the article concluded that government lawyers overreached by grounding their prosecution on honest services fraud. *Id.* at 225-34.

[259] John C. Coffee, Jr., *Modern Mail Fraud: The Restoration of the Public/Private Distinction*, 35 AM. CRIM. L. REV. 427, 427 (1998) (analogizing honest services fraud to the kudzu vine).

[260] *See* U.S. DEP'T OF JUSTICE, PUBLIC INTEGRITY SECTION, REPORT TO CONGRESS ON THE

Initially, it is important to identify honest services fraud as a species of mail and wire fraud.[261] Indeed, some of the interpretive issues associated with honest services fraud follow from the controversial features of the mail and wire fraud statutes.[262] The federal mail and wire fraud laws have generated disapproval and debate ever since Congress enacted the first such statute in 1872,[263] criminalizing fraudulent mail schemes apparently perpetrated by urban "flimflam artists"[264] and "rapscallions" against "the innocent people in the country."[265] Described as a "first line of defense" to new frauds, the statute's broad language has been rationalized as "a stopgap device to deal on a temporary basis with the new phenomenon, until particularized legislation can be developed and passed to deal directly with the evil."[266] Nonetheless, the malleability of the mail and wire fraud statutes has engendered significant criticism. Detractors have described the statutes as creating "essentially element-free criminal liability," enabling prosecutors to employ "virtually unbridled discretion" to combat "virtually every type of untoward activity known to man."[267]

In the post-Watergate 1970s, government lawyers persuaded the federal courts to extend the reach of the mail and wire fraud statutes to prosecute public officials who allegedly had deprived the public, not of money or property, but of the public's "intangible right" to the officials'

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ACTIVITIES AND OPERATIONS OF THE PUBLIC INTEGRITY SECTION FOR 2007, at 18-19 (2007), *available at* http://www.usdoj.gov/criminal/pin; U.S. SENTENCING COMM'N, SOURCEBOOK OF FEDERAL SENTENCING STATISTICS FOR 1998, at 22-23, 30 (1998), *available at* http://www.ussc.gov/annrpts.htm (sentences under U.S.S.G. § 2C1.7 (2004)). Both sources separately track only public corruption honest services fraud prosecutions. Nonetheless, the growing body of private honest services fraud case law demonstrates a parallel, if not greater, trend in the private arena.

[261] *See* 18 U.S.C. § 1341 (2006) (mail fraud); *id.* § 1343 (wire fraud). Sections 1341 and 1343 are construed to require (1) a scheme to defraud, (2) intent to deprive another of money or property, and (3) use of the mails (or wires) in furtherance of that scheme. *See, e.g.*, United States v. Turner, 465 F.3d 667, 680 (6th Cir. 2006).

[262] Section 1346 "can be understood only in the light of the long history of the mail- and wire-fraud statutes, which were intentionally written broadly to protect the mail and, later, the wires from being used to initiate fraudulent schemes." *Brown*, 459 F.3d at 519.

[263] *See* Daniel W. Hurson, Comment, *Mail Fraud, The Intangible Rights Doctrine, and the Infusion of State Law: A Bermuda Triangle of Sorts*, 38 HOUS. L. REV. 297, 302 (2001) (calling "the mail fraud statute one of the most criticized yet utilized of federal criminal statutes").

[264] United States v. Bronston, 658 F.2d 920, 931 (2d Cir. 1981) (Van Graafeiland, J., dissenting) ("[T]he statute was originally aimed at flimflam artists who use the mails to defraud the gullible."); Geraldine Szott Moohr, *Mail Fraud and the Intangible Rights Doctrine: Someone to Watch Over Us*, 31 HARV. J. ON LEGIS. 153, 158 (1994) (discussing original enactment of the mail fraud statute to address sending counterfeit currency through the mail).

[265] McNally v. United States, 483 U.S. 350, 356 (1987) (quoting CONG. GLOBE, 41st Cong., 3d Sess. 35 (1870) (remarks of Rep. Farnsworth)).

[266] United States v. Maze, 414 U.S. 395, 405-06 (1974) (Burger, C.J., dissenting).

[267] *See, e.g.*, Daniel J. Hurson, *Limiting the Federal Mail Fraud Statute—A Legislative Approach*, 20 AM. CRIM. L. REV. 423, 424-25, 436 (1983).

"honest services."[268] Judicial opinions sanctioning this new theory often used broad, aspirational language to describe the duties owed by an elected official to her constituents.[269] Courts largely agreed with Justice Department prosecutors that the citizenry had the "right to conscientious, loyal, faithful, disinterested and honest government."[270] A scheme to defraud citizens of those rights that involves "bribery and non-disclosure and concealment of material information . . . [then] may come within the purview of the federal mail fraud statute *even though no state or federal statute or common law is transgressed in terms*."[271]

Prosecutors gradually expanded the intangible rights theory of mail fraud to cases beyond the public sphere—that is, to cases involving purely private relationships. Grounding charges on breaches of the duty of loyalty, prosecutors charged employees with honest services fraud,[272] later adapting the theory to other principal-agent relationships.[273] Government prosecutors found the statute useful particularly when a putative victim suffered no financial or property loss; indeed, some victims were not even threatened with such losses.[274]

By the early 1980s, the Justice Department had invoked the honest services theory to charge private fiduciaries for failing to divulge their conflicts of interest. Because fiduciary duty law is especially "soft-edged and aspirational,"[275] predicating criminal liability on fiduciary breaches—

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[268] *See, e.g.*, United States v. Mandel, 591 F.2d 1347, 1362 (4th Cir. 1979) (litigation against governor of Maryland), *vacated*, 602 F.2d 653 (4th Cir. 1979) (en banc); United States v. Isaacs, 493 F.2d 1124, 1149-50 (7th Cir. 1974) (litigation against governor of Illinois).

[269] *See, e.g.*, *Mandel*, 591 F.2d at 1361 (explaining that mail fraud statute could be used to prosecute any "scheme involving deception that employs the mails in its execution that is contrary to public policy and conflicts with accepted standards of moral uprightness, fundamental honesty, fair play and right dealing").

[270] *Id.* at 1359.

[271] *Id.* at 1359-60 (emphasis added) (footnote omitted).

[272] *See, e.g.*, United States v. Conner, 752 F.2d 566, 569-72 (11th Cir. 1985); United States v. George, 477 F.2d 508 (7th Cir. 1973); *cf.* United States v. Brown, 459 F.3d 509, 519 (5th Cir. 2006) ("'Honest services are services owed to an employer under state law,' including fiduciary duties defined by the employer-employee relationship." (quoting United States v. Caldwell, 302 F.3d 399, 409 (5th Cir. 2002)).

[273] *See, e.g.*, United States v. Bronston, 658 F.2d 920 (2d Cir. 1981) (attorney-client relationship).

[274] *See, e.g.*, United States v. Margiotta, 688 F.2d 108, 121 (2d Cir. 1982) ("In the private sector, it is now a commonplace that a breach of fiduciary duty in violation of the mail fraud statute may be based on artifices which do not deprive any person of money or other forms of tangible property.").

[275] John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1879 (1992); *see also Margiotta*, 688 F.2d at 142 (Winter, J., concurring in part and dissenting in part) ("The words fiduciary duty are no more than a legal conclusion and the legal obligations actually imposed under that label vary

and particularly on alleged failures to disclose conflicts of interest—greatly expanded the reach of the mail and wire fraud laws. The honest services theory threatened to morph the mail and wire fraud statutes into mandatory conflict of interest disclosure laws with criminal sanctions for violation.[276]

The Supreme Court halted the government's expansion of the intangible rights theory in 1987, if only briefly. In *McNally v. United States*,[277] a public corruption case, the Court held that the mail and wire fraud statutes prohibited only deprivations of money or property, not the "intangible right of the citizenry to good government."[278] There, federal prosecutors indicted two Kentucky officials for directing that the Commonwealth buy insurance through an agent who then shared his commissions with an agency partly owned by one of the officials.[279] This undisclosed arrangement allowed the owner-defendant to profit from the transactions,[280] although nothing in the record suggested that Kentucky paid inflated premiums or received substandard insurance.[281] Without any claim involving the deprivation of property or money, the Court reversed the defendants' convictions.[282] Despite the statute's historically broad construction, the Court concluded that § 1341 did not criminalize deprivations of intangible rights to honest services.[283]

In reaching its conclusion, the Court reasoned:

> [W]hen there are two rational readings of a criminal statute, one harsher than the other, we are to choose the harsher only when Congress has spoken in clear and definite language. As the Court said in a mail fraud case years ago: "There are no constructive offenses; and before one can be punished, it must be shown that his case is plainly within the statute." Rather than construe the statute in a manner that leaves its outer boundaries ambiguous and involves the Federal Government in

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greatly from relationship to relationship. . . . Partners, employees, trustees and corporate directors are all fiduciaries, yet their legal obligations may be wholly dissimilar.").

[276] *See, e.g.*, Hurson, *supra* note 267, at 429.

> Almost any action undertaken by a fiduciary, agent, or employee which causes detriment to his beneficiary, principal, or employer and which involves some material deception, will likely trigger a responsibility to make disclosure. Failure to disclose will be construed as a breach of fiduciary duty and subject the actor to federal prosecution for mail fraud.

*Id.*

[277] 483 U.S. 350 (1987).

[278] *Id.* at 356.

[279] *Id.* at 352-53.

[280] *Id.* at 360-61.

[281] *McNally*, 483 U.S. at 360.

[282] *Id.* at 360-61.

[283] *Id.* at 356-59.

> setting standards of disclosure and good government for local and state officials, we read § 1341 as limited in scope to the protection of property rights. If Congress desires to go further, it must speak more clearly than it has.[284]

In this brief paragraph, the *McNally* Court identified a number of interrelated concerns about honest services fraud, including lenity, the need to clearly define the criminalized conduct, fair notice, separation of powers, and respect for federalism.

At the urging of the Justice Department, Congress responded to *McNally* by enacting § 1346 the next year.[285] The statute reads, in its entirety: "For the purposes of [mail and wire fraud], the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services."[286] There is no reliable legislative history to guide the courts as to the meaning of this language, and Congress has never amended the statute. Thus, Congress left federal courts with numerous interpretive questions. What is the "intangible right of honest services"? Whose right is it? Where does the right come from, and must the right be recognized under state law? Who must do the "depriving"? Must there be some tangible harm to a victim or economic benefit to the defendant?

From its enactment and continuing through today, courts and commentators have complained about the statute repeatedly. According to its critics, § 1346 is too "vague and undefined,"[287] "amorphous and open-ended."[288] Because its language "provides no perimeters"[289] for prosecutors, the statute, if read literally, could criminalize any dishonesty by an employee[290] Defendants, along with some jurists and academics, have argued that these defects render the statute unconstitutional, although no appellate court has struck down the statute.[291] Thus, while passage of § 1346 satisfied

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[284] *Id.* at 359-60 (internal citations omitted).

[285] For more detail on the statute's limited legislative history, see Casey, *supra* note 23, at 186-88.

[286] 18 U.S.C. § 1346 (2006).

[287] United States v. Urciuoli, 513 F.3d 290, 294 (1st Cir. 2008).

[288] United States v. Sorich, 523 F.3d 702, 707 (7th Cir. 2008).

[289] United States v. Brown, 459 F.3d 509, 519 (5th Cir. 2006).

[290] United States v. Frost, 125 F.3d 346, 368 (6th Cir. 1997); *see also* United States v. Kincaid-Chauncey, 556 F.3d 923, 940 (9th Cir. 2009) ("[R]ead literally, [§1346] would make a crime of the nondisclosure of virtually every breach of any public or private employment relationship—turning §1346 into a 'draconian personnel regulation' that transforms private and governmental 'workplace violations into felonies'" (quoting Julie R. O'Sullivan, *The Federal Criminal "Code" is a Disgrace: Obstruction Statutes as Case Study*, 96 J. CRIM. L. & CRIMINOLOGY 643, 663 (2006))).

[291] Although a panel of the Second Circuit determined the law to be unconstitutional, United

Congress's reflexive need to respond to the Court's invitation to "speak more clearly," the statute actually did little to address the concerns that animated *McNally*. Indeed, as I argue next, enactment of § 1346 actually jumbled some pieces of the honest services puzzle.[292]

### B. *Private Honest Services Fraud*

In the two decades since § 1346 became law, courts have grappled with many of the same issues that confounded them before Congress enacted the statute. Courts agree only that Congress intended to overturn the result in *McNally*.[293] They dispute how much pre-*McNally* case law—an incoherent body of decisions—was resurrected.[294] And no courts have concurred as to whether they should construe § 1346 as addressing the policy concerns raised in *McNally*. Consequently, appellate courts have not only failed to agree on the statute's scope, but the promulgation of § 1346 created even more doctrinal disarray.

This part examines key pieces of the honest services fraud puzzle, paying particular attention to how the issues likely will present themselves to the Supreme Court in *Black*, *Weyhrauch*, and *Skilling*. Where applicable, I also identify points of friction with Delaware corporate law. Finally, I consider how specific interpretive problems—and their potential resolution by the Court this Term—affect the standards of conduct applicable to public company executives.

#### 1. The Fiduciary Duty Requirement

Defendants who may have breached their fiduciary duties in purely private transactions (and even defendants who transacted business with them) confront acute complexity in ascertaining the breadth of § 1346.

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States v. Handakas, 286 F.3d 92, 112 (2d Cir. 2002), *overruled by* United States v. Rybicki (*Rybicki II*), 354 F.3d 124 (2d Cir. 2003) (en banc), the Second Circuit reviewed a similar challenge en banc shortly thereafter and upheld the constitutionality of § 1346. *Rybicki II*, 354 F.3d at 144. Furthermore, other decisions have implied that the constitutional question is close. The Fifth Circuit described decisions upholding the statute against vagueness challenges as having "divined [clarity] from a jumble of disparate cases." *Brown*, 459 F.3d at 523.

[292] *See Kincaid-Chauncey*, 556 F.3d at 939-40. "'The 'intangible rights' theory [of honest services fraud] has been a subject of controversy in the history of the federal mail and wire fraud statutes,' and, we would add, it continues to cause controversy despite (or perhaps because of) Congress's statutory abrogation of *McNally*." *Id.* (quoting United States v. Williams, 441 F.3d 716, 721 (9th Cir. 2006)).

[293] *Rybicki II*, 354 F.3d at 136.

[294] *See Kincaid-Chauncey*, 556 F.3d at 939 (listing the holdings of the different circuits regarding the extent to which enactment of the statute resurrected pre-*McNally* case law).

Courts generally concur that honest services fraud requires more than a simple breach of contract, or even breach of the covenant of good faith inherent in contractual relationships.[295] Although § 1346 does not mention fiduciaries, courts usually restrict honest services fraud to situations where someone (but not always the defendant) owed a fiduciary duty to provide honest services to the victim.[296] Many opinions also emphasize that not every breach of fiduciary duty constitutes an honest services fraud.[297] That said, the courts have failed to reach consensus on the doctrinal boundary between fiduciary breach and federal felony. Part of the difficulty arises from using fiduciary duty as the benchmark for liability. Fiduciary relations, and their attendant duties, are highly fact-sensitive associations.[298] However, courts also have created confusion by applying a variety of approaches to the basic statutory construction problem. Multiple methodologies have led to irregular, and even conflicting, interpretations. This problem, of course, is not unique to § 1346, or even statutory construction generally. In this context, however, with the liberty of fiduciaries at stake, the courts' inconsistent approaches raise acute concerns. A defendant's freedom should not depend on the vagaries of geography or a potentially idiosyncratic application of prosecutorial discretion.

To date, the seminal case construing § 1346 is the Second Circuit's en banc decision in *United States v. Rybicki*.[299] While widely cited, the court's opinion ultimately leaves a number of the most vexing interpretive issues—issues especially important to corporate fiduciaries—unresolved. In fact, the decision's analysis seems to have added further confusion to an already convoluted jurisprudence.

The defendants in *Rybicki*, two law firm partners, secretly paid insurance adjusters, encouraging them to process their clients' claims more

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[295] *See, e.g.*, *Handakas*, 286 F.3d at 106-07; United States v. deVetger, 198 F.3d 1324, 1328 (11th Cir. 1999) ("Most private sector interactions do not involve duties of, or right to, the 'honest services' of either party.").

[296] *See, e.g.*, United States v. Turner, 465 F.3d 667, 675 (6th Cir. 2006) (noting that pre-*McNally* case law also required the "finding of a fiduciary duty owed by the defendant to the victim").

[297] *See* United States v. Carpenter, 791 F.2d 1024, 1035 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

[298] *See* United States v. Margiotta, 688 F.2d 108, 142 (2d Cir. 1982) (Winter, J., concurring in part and dissenting in part).

[299] The case was originally heard by a panel in United States v. Rybicki (*Rybicki I*), 287 F.3d 257 (2d Cir. 2002), but was later heard en banc in United States v. Rybicki (*Rybicki II*), 354 F.3d 124 (2d Cir. 2003) (en banc), where Justice Sotomayor, then sitting on the Second Circuit, sided with the majority.