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Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance

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STRANGE BEDFELLOWS: CORPORATE FIDUCIARIES AND THE GENERAL LAW COMPLIANCE OBLIGATION IN SECTION 2.01(a) OF THE AMERICAN LAW INSTITUTE'S *PRINCIPLES OF CORPORATE GOVERNANCE*

Patrick J. Ryan*

Abstract: Business and corporate crime is a controversial social problem. Less well known is the extent to which corporate legal doctrine permits derivative litigation against corporate officials arising from deviance episodes. In this Article, Professor Ryan examines both the traditional applications of fiduciary obligation to corporate deviance and the American Law Institute's revised formulations in the still-unfinished *Principles of Corporate Governance.* His findings reveal the difficulties encountered in trying to enforce general legal obligations by means of corporate governance mechanisms. He predicts that the ex ante effects of the ALI provisions will be two in nature. First, fiduciary obligation and its enforcement by derivative litigation could have a deterrent effect on corporate deviance, but only if judges commit themselves to the *Principles'* notion that fiduciary responsibility for corporate law violations is the most significant component of the duty of care. This commitment would be measured by judges' reluctance to grant easy and routine dismissals in corporate deviance cases, even when dismissal is recommended by a special litigation committee. Second, the *Principles'* general law compliance obligation can have a hortatory effect on managers in particular situations. The *Principles'* general law compliance obligation thus works to reinforce managers' preexisting socialization toward law compliance.

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I. INTRODUCTION

Major business scandals seem to occur just frequently enough to help keep alive American popular distrust of the business community in general and of large corporate organizations in particular. Widespread price-fixing,[1] domestic and foreign political payments,[2] and abuses in connection with government contracting and regulatory decisionmaking[3] throw business community deviance from legal

1. Some of the most famous price-fixing episodes (involving heavy electrical equipment, pharmaceuticals, and plumbing fixtures) are discussed, with references, in M. CLINARD & P. YEAGER, CORPORATE CRIME (1980). The electrical equipment episodes were among the first instances in which major corporate executives received jail terms, and are also detailed in chapter 7 of J. BROOKS, BUSINESS ADVENTURES (1969); *see also* R. MOKHIBER, CORPORATE CRIME AND VIOLENCE 213–20 (1989); Smith, *The Incredible Electrical Conspiracy*, FORTUNE, May 1961, at 161; *id.* April 1961, at 132.

2. The mid-1970s revelations about questionable payments generated much comment. A brief and useful history is provided in Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and An Effective Legal Response*, 63 VA. L. REV. 1099, 1115–27 (1977).

3. These episodes dot the governmental landscape. Recently, charges of influence peddling to obtain federal subsidies for housing projects have plagued the Department of Housing and Urban Development (HUD). Most of the alleged improprieties occurred under former HUD Secretary Samuel R. Pierce, Jr. *See* Winerip, *Builders Helped by H.U.D. Aide Hired Him After He Left Agency*, N.Y. Times, July 29, 1989 at 1, col. 4; Shenon, *Bush Consultant Peddled Influence at H.U.D., He Says*, N.Y. Times, June 21, 1989, at A1, col. 6. Similar problems may have occurred during the Bush Administration. *See* Shenon, *Housing Dept. Opens an Inquiry On Contracts to Ex-Reagan Aides*, N.Y. Times, Mar. 31, 1990, at A7, col. 5.

The attempted federal bailout of troubled savings and loan institutions has brought to light a mix of serious allegations, from improper political payments to managerial opportunism and regulatory incompetence. *See* J. ADAMS, THE BIG FIX: INSIDE THE S & L SCANDAL—HOW AN UNHOLY ALLIANCE OF POLITICS AND MONEY DESTROYED AMERICA'S BANKING SYSTEM (1990). These charges included allegations that five United States Senators acted improperly to assist Charles H. Keating, Jr., and his Lincoln Savings and Loan despite regulatory efforts to close down or curtail his operations. These senators were labelled "The Keating Five." Neither Mr. Keating's problems, nor President Bush's son Neil's involvement with Silverado Banking Savings and Loan Association should overshadow the breadth of the savings and loan scandal. In mid-summer of 1990, the federal Office of Thrift Supervision provided a list of 100 firms to the

norms into high relief. Stock trading violations,[4] consumer fraud,[5] and environmental disasters[6] also contribute to perceptions of business lawlessness. Although not all firms engage in questionable or illegal

Justice Department for "top-priority" prosecution. Johnston, *S. & L. Criminal Inquiries Confirmed,* N.Y. Times, Oct. 3, 1990, at D4, col. 1.

In 1985, the federal government announced a criminal investigation dubbed "Operation Ill Wind," which extended to 45 of the largest 100 military contractors. *See* W. KNEPPER & D. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 231 (4th ed. 1988); Pasztor, *Galvin Admits That He Bribed Pentagon Aides,* Wall St. J., Mar. 29, 1990, at A14, col. 4. By early spring of 1990, 35 individuals and companies had been convicted or had pleaded guilty in this long-running investigation of defense procurement misconduct that included bribes to high government officials. *See* Wines, *Guilty Plea in Pentagon Fraud Case,* N.Y. Times, March 29, 1990, at D1, col. 3. The convicted companies include Hazeltine, Teledyne, Boeing, Loral, RCA (now part of General Electric), Hughes Aircraft, Grumman and Raytheon. *See* Smart & Payne, *Look What Ill Wind Is Blowing In,* BUS. WK., Apr. 16, 1990, at 27. Unisys (successor to Sperry Corp.) and United Technologies are the most prominent among the remaining targets. *See id.*

4. Trading violations include stock manipulation and insider trading. Opportunities for these types of violations increased during the financial hyperactivity accompanying the 1980s' takeover wave. GAF Corporation was fined $2 million for manipulating Union Carbide stock during two days in 1986 in an attempt to profit further from GAF's pre-bid 10% beachhead in Union Carbide stock. GAF had acquired much of this stock during its unsuccessful bid to acquire Union Carbide. GAF's vice chairman received a six month prison term in connection with the misconduct. Labaton, *GAF Fined; Executive Sentenced,* N.Y. Times, March 31, 1990, at 31, col. 6. The insider trading scandals linking Dennis Levine and Ivan Boesky confirmed some people's suspicions that parts of the "takeover game" were rigged. *See* Dennis, *This Little Piggy Went to Market: The Regulation of Risk Arbitrage after Boesky,* 52 ALB. L. REV. 841, 841 nn.1–2 (1988). Michael Milken's advocacy of low-grade debt made Drexel Burnham Lambert a major financial player; its own reliance on debt eventually drove it to financial illegalities, and then to the bankruptcy courts as regulators closed in. Drexel's imminent and eventual collapse probably contributed to the drastic curtailment of the junk bond and takeover markets during the latter half of 1989 and early 1990. The bond market softening may have significant effects for many firms in need of additional financing as earlier restructuring obligations come due in the early 1990s. *See* Light & Nathans, *The Junk-Bond Time Bombs Could Go Off,* BUS. WK., Apr. 9, 1990, at 68. The slowdown in the control market may create problems in corporate governance, at least to the extent that an active market for corporate control had become a substantial goad to satisfy shareholder interests. *See* Bartlett, *Life in the Executive Suite After Drexel,* N.Y. Times, Feb. 18, 1990, § 3, at 1, col. 4.

5. Perhaps the most publicized recent example of consumer fraud by a major corporation was Beech-Nut's decision to sell ersatz apple juice in its baby-food line. *See* Welles, *What Led Beech-Nut Down the Road to Disgrace,* BUS. WK., Feb. 22, 1988, at 124; Traub, *Into the Mouths of Babes,* N.Y. Times, July 24, 1988, § 7 (Magazine), at 18.

6. In 1989 and 1990, Exxon's oil operations in Alaska and New Jersey were plagued by several major oil spills. The tanker *Valdez*'s grounding and its environmental consequences received particularly extensive coverage. *See, e.g.,* Wells & Sullivan, *Stuck in Alaska: Exxon's Army Scrubs The Beaches, But They Don't Stay Cleaned,* Wall. St. J., July 27, 1989, at A1, col. 6. Nearly a year after the Alaskan accident, some analysts began to attribute part of Exxon's problems to its mid-1980s' restructuring efforts. *See* Sullivan, *Stretched Thin: Exxon's Restructuring In the Past Is Blamed for Recent Accidents,* Wall St. J., March 16, 1990, at A1, col. 6.

practices,[7] enough do that business deviance is regarded as a serious and persistent problem.[8]

Illegal behavior by corporate[9] actors constitutes a significant part of the business deviance problem, if for no other reason than the corporate form's preeminent role in the national economy. Like other disfavored behavior, corporate deviance is imperfectly regulated by social controls, which range from the family, schools, workplace, and religious groups through market mechanisms to explicit criminal sanctions, and back again. Although no one social control is sufficient to prevent deviant behavior, each has some effect. For particular individuals and groups, some forms of social control may be more effective than others;[10] one mechanism's results can vary as well across different types of disfavored conduct.[11] In any event, controlling deviant behavior, corporate or otherwise, is a complex social phenomenon involving several overlapping systems to shape human behavior.

In the abstract, at least, corporate governance doctrine itself could operate as one of the social controls on corporate deviance. Corporate governance doctrine is that body of legal rules concerned with the internal relationships between shareholders and corporate management.[12] These governance rules allocate powers between shareholders

7. *See* M. CLINARD, CORPORATE ETHICS AND CRIME: THE ROLE OF MIDDLE MANAGEMENT 16 (1983). For example, even during the widespread "questionable payments" scandals of the mid-1970s, approximately 40% of the Fortune 500 companies were not charged with any law violations by any of the 25 federal enforcement agencies operating at that time. *Id.* So as not to bear false witness with statistics, it should be pointed out that this figure also means that approximately 60% of the Fortune 500 companies *were* charged with some sort of violation by one or more federal agencies.

8. *Id.* at 14–15.

9. As used in this Article, "corporation" refers to a publicly-held corporation unless the context otherwise indicates. For the modern typology of firms doing business under the corporate form, see W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE—LEGAL AND ECONOMIC PRINCIPLES 97–103 (4th ed. 1990).

10. For some actors, socialization by family, schools, and religious groups may be sufficient to prevent undesirable conduct, so that these actors may conform to socially acceptable behavior without internal reference to explicit criminal sanctions. Thus, some individuals may respect persons or property because they have been taught by parents or religious authority figures that to do otherwise is "wrong;" internally, these people conform to social expectations because of the social controls provided by family or religious groups, rather than from a desire to avoid criminal prosecution for assault or theft. Of course, mixed motives of varying proportions would be a substantial possibility; but the existence of mixed motives would preclude any attempts to champion one control as determinative.

11. It is possible to imagine, for instance, that home, school, or religious training might be more effective in training against physical assault or murder than in reducing drunken driving or tax evasion.

12. *See* PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982) xxiii–xxv [hereinafter Draft No. 1]. Draft No. 1 has been superseded by later drafts that have not included its introductory statements.

and managers, and impose supervisory and fiduciary duties upon management. Governance rules become deviance controls when cast to include powers and obligations regarding general law obedience. For example, corporate governance rules could be employed to police corporate deviance by defining managerial fiduciary duties as including two distinct obligations: obedience by management itself to general legal standards,[13] and supervision of corporate activities to insure general law compliance by all corporate actors, including employees.[14] In a traditional corporate governance framework, shareholders enforce these managerial duties through derivative suits brought in the corporate name against directors and officers who breach their law compliance obligations.[15]

The American Law Institute's (the ALI's) *Principles of Corporate Governance* (the *Principles*) directly implicate the relationship between corporate governance and corporate deviance. For more than a decade, the ALI's Corporate Governance Project has worked to generate the *Principles*,[16] which are the ALI's attempt to preserve and refurbish

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Consequently, Draft No. 1's introductory language is unapproved; however, the final version probably will include a revised general introduction drawing in part upon it. Something like this definition of corporate governance most likely will appear in the final document.

13. As used throughout this Article, "general legal standards" refers to legal standards other than those provided by corporate governance.

14. Explicit inclusion of law compliance obligations is not inherent in corporate relationships. Alternative corporate governance arrangements are possible. For example, corporate governance rules could omit entirely any managerial obligation to comply with general legal obligations, or to supervise such compliance. This formulation would eliminate corporate shareholders as enforcers of general legal obligations. Instead, law compliance by corporate actors would be left to external enforcers, such as governmental regulators, criminal prosecutors, and tort plaintiffs. Some middle ground between the extremes of explicit inclusion and exclusion of law compliance obligations could be reached by permitting corporations to opt out of the obligation.

15. In reality, much shareholder litigation is brought by attorneys specializing in derivative litigation who make temporary alliances with small-stake shareholders so that particular suits may be brought. *See infra* notes 29, 301–03 and accompanying text. *See generally* W. KLEIN & J. COFFEE, *supra* note 9, at 178–83.

16. Specific discussions of the *Principles* can be found in Baysinger & Butler, *Race for the Bottom v. Climb to the Top: The American Law Institute Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431 (1985); Branson, *The American Law Institute Principles of Corporate Governance and the Derivative Action: A View From the Other Side*, 43 WASH. & LEE L. REV. 399 (1986); Branson, *Countertrends in Corporation Law: Model Business Corporations Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53 (1983); Carney, *Section 4.01 of the ALI's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U.L.Q. 239 (1988); Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959; Eisenberg, *The American Law Institute's Corporate Governance Project*, 52 GEO. WASH. L. REV. 495 (1984); Fine, *The Corporate Governance Debate and the ALI Proposals: Reform or Restatement?*, 40 VAND. L. REV. 693 (1987); Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Hansen, *The ALI Corporate Governance Project: Of*

fundamental corporate law doctrines. The ALI has tentatively approved almost all the corporate governance provisions, subject to revision by the Reporters and final reconsideration. Among these is the ALI's declaration of the fundamental corporate objective, which explicitly articulates an obligation to comply with general legal provisions:

> § 2.01 *The Objective and Conduct of the Business Corporation*
>
> A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business (a) is obliged, to the same extent as a natural person, to act within the boundaries set by law . . . .[17]

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the Duty of Due Care and the Business Judgment Rule: A Commentary, 41 BUS. LAW. 1237 (1986); Mofsky & Rubin, *A Symposium on The American Law Institute Corporate Governance Project*, 37 U. MIAMI L. REV. 169 (1983); Perkins, *The American Law Institute Corporate Governance Project In Midstream*, 41 BUS. LAW. 1195 (1986); Ribstein, *Edited Transcript of Proceedings of the Business Roundtable: Emory University Law and Economics Center Conference on Remedies Under the ALI Proposals: Law and Economics (New Orleans, Louisiana, May 2–5, 1985)*, 71 CORNELL L. REV. 357 (1986); Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH L. REV. 325 (1987); Schwartz, *The ALI Corporate Governance Project*, 14 INST. ON SEC. REG. 173 (1983); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983); Subak, *A Snapshot of the Law Being Carved In Stone*, 42 BUS. LAW. 761 (1987); Titus, *Limiting Directors' Liability: The Case For A More Balanced Approach—The Corporate Governance Project Alternative*, 11 W. NEW ENG. L. REV. 1 (1989); Veasey & Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483 (1985); Weiss, *Economic Analysis, Corporate Law and the American Law Institute Corporate Governance Project*, 70 CORNELL L. REV. 1 (1984); Werner, *Corporation Law In Search of Its Future*, 81 COLUM. L. REV. 1611 (1981); *Symposium on Corporate Governance*, 8 CARDOZO L. REV. 657 (1987); *The ALI's Corporate Governance Project: Law and Economics*, 9 DEL. J. CORP L. 513 (1984). The cited symposia include articles by many of the most prominent corporate legal scholars. *See also* Note, *Corporate Ethics and Corporate Governance: A Critique of the ALI Statement on Corporate Governance Section 2.01(b)*, 71 CALIF. L. REV. 994 (1983); Note, *When Opportunity Knocks: An Analysis of the Brudney & Clark and ALI Principles of Corporate Governance Proposals For Deciding Corporate Opportunity Claims*, 11 J. CORP. L. 255 (1986); Note, *The Proposed Restatement of Corporate Governance: Is Reform Really Necessary?*, 11 PEPPERDINE L. REV. 499 (1984).

17. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 2 1984), § 2.01, at 25 [hereinafter Draft No. 2]. Section 2.01(a)'s obligation to comply with the general law can be illustrated hypothetically. Imagine that the managers of a chemical corporation undertake a thorough costs analysis, and discover that illegal dumping of toxic waste would increase significantly the corporation's annual net profits relative to the net profit level obtained when complying with regulatory standards for hazardous waste disposal. The traditional corporate law consensus, echoed by the *Principles*' commentary to § 2.01(a), is that the managers would have acted improperly if they ordered their waste disposal employees to

Section 2.01(a)'s law compliance obligation is not limited solely to obedience to state and federal regulations embodied in corporate doctrine and securities regulations, but extends to general legal prohibitions.[18] Section 2.01(a) does not create a unique status for corporate actors, however, who are neither more nor less obligated to obey the law than non-corporate actors.[19]

Although the *Principles* have been among the most controversial developments in the recent history of corporate legal doctrine,[20] little direct attention has been paid to section 2.01(a)'s general law compliance obligation.[21] Section 2.01(a) has remained non-controversial

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dump the toxic byproducts in violation of applicable law, even if the result would be greater corporate profitability. *Id.* at 32–36 (especially illustration 10).

Section 2.01 further shapes the fundamental corporate objective of profit and gain by permitting the corporation to "take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business," and to "devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes." *See id.* at 25, § 2.01(b) & (c).

Section 2.01 has provoked some discussion about corporate profit-making and shareholder gain as primary corporate objectives, and about the ethical and charitable permissive provisions in subsections (b) and (c); these discussions occurred both during the ALI's plenary consideration of § 2.01 and in the legal literature. These discussions reflect little authentic disagreement about the fundamental corporate objective, however, especially when compared to the heated debates that have taken place over other sections of the *Principles.* For a reaction to the debates over § 2.01(b) & (c), see White, *How Should We Talk About Corporations? The Language of Economics and of Citizenship,* 94 YALE L.J. 1416 (1985). *See generally* Seligman, *supra* note 16, at 325.

The ALI has tentatively approved § 2.01(a), subject to revision by the Reporters. *See* 61 A.L.I. PROC. 511 (1985). Although not yet promulgated after redrafting, it appears that this section will be modified only slightly, and with no substantive changes regarding the obligation to act within the boundaries of the law. *Id.* at 465–67; *see also* Schwartz, *Defining the Corporate Objective: Section 2.01 of the ALI's Principles,* 52 GEO. WASH. L. REV 511, 511–12 & n.4.

18. *See* Draft No. 2, *supra* note 17, at 34.

19. *See id.* at 33.

20. *See generally* Seligman, *supra* note 16, at 325.

21. *Id.* at 351–54. Professor Seligman's encapsulation of the debate over § 2.01 accurately reflects the content of the ALI debates, and the scholarly commentary. The only commentary that raises a question about § 2.01(a)'s general law compliance obligation is Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1271 (1982). After acknowledging a general law compliance obligation to obey "restriction[s] on corporate conduct . . . embodied in a statute," Fischel goes on to suggest summarily that "[a] firm may also find it advantageous to violate a law deliberately and pay the penalty for the same reason that an individual in some cases may prefer to breach a contract and pay damages." *Id.* A commentator with a decidedly different political stance has made a similar observation as a criticism of corporate criminal punishment. *See* J. BRAITHWAITHE, CORPORATE CRIME IN THE PHARMACEUTICAL INDUSTRY 331 (1984) ("Fines as they currently operate are justifiably criticised as licence fees to break the law.").

Fischel makes no attempt in this observation to distinguish between § 2.01(a)'s aspirational effect and the problems attending any derivative enforcement mechanism. *See infra* notes 216, 318–23 and accompanying text. Fischel's relatively undeveloped observation fundamentally disagrees with the Reporters' own commentary to § 2.01(a):

even as the ALI membership considered and tentatively approved later sections, some of which provide or suggest shareholder enforcement mechanisms for corporate violations of general law.[22] This combination of obligation and enforcement in the *Principles* means that the ALI envisions some role for corporate governance rules in policing corporate deviance. This vision and its implications have never been isolated and explored, although some commentators have provided tantalizing glimpses of the problem during more general discussions of fiduciary duty and shareholder litigation.[23]

> It is sometimes maintained that whether a corporation should adhere to a given legal rule may properly depend on a kind of cost-benefit analysis, in which probable corporate gains are weighed against either probable social costs, measured by the dollar liability imposed for engaging in such conduct, or probable corporate losses, measured by potential dollar liability discounted for likelihood of detection. *Section 2.01 does not adopt this position.* With few exceptions, dollar liability is not a "price" that can properly be paid for the privilege of engaging in legally wrongful conduct.

Draft No. 2, *supra* note 17, at 32 (emphasis added). One Reporter believes that Fischel fundamentally mistakes the nature of legislative command. *See* Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis,* 52 GEO. WASH. L. REV. 789, 794 n.11 (1984). Neither the reporters nor Fischel are able to give any hard and fast guidelines for ascertaining when departures from legal norms, for profit, would be tolerable, although the comments to § 2.01(a) do suggest that corporate actors may breach contracts and pay damages without incurring additional liability under § 2.01 or its enforcement provisions. *See* Draft No. 2, *supra* note 17, at 34. To some extent, judicial standards for dismissing corporate deviance derivative suits may eventually declare the limits of "tolerable" crime, from a corporate law perspective.

In other contexts, general law compliance has been treated as a fundamental component of corporate governance. *See* Brudney, *The Role of the Board of Directors: The ALI and Its Critics,* 37 U. MIAMI L. REV. 223, 239 (1983) ("[T]he most significant role that [independent directors] can play is in the matter of encouraging corporate compliance with law."); Brudney, *The Independent Director—Heavenly City or Potemkin Village?,* 95 HARV. L. REV. 597, 656–58 (1982) (law compliance is most critical aspect of the director's duty of care); *see also* Engel, *An Approach to Corporate Social Responsibility,* 32 STAN. L. REV. 1 (1979) (general law is so fundamental to modern corporate governance that it displaces a large portion of what might otherwise be called "corporate social responsibility"); Ryan, *Corporate Directors and the "Social Costs" of Takeovers—Reflections on the Tin Parachute,* 64 TUL. L. REV. 3, 62 (1989). The shift to general law provisions to regulate undesirable social consequences of business activity has worked to moot Adolf Berle's "corporate constitutionalism." *See* Draft No. 1, *supra* note 12, at xxv; *see also* Ryan, *supra,* at 41–42 n.125.

22. *See infra* notes 219–32 and accompanying text.

23. *See* Coffee, *supra* note 21; Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures,* 52 GEO. WASH. L. REV. 745 (1984); Phillips, *Principles of Corporate Governance: A Critique of Part IV,* 52 GEO. WASH. L. REV. 653 (1984).

Professor Phillips offers brief comments on the problems of using fiduciary duty to enforce general law compliance as part of his critique of early drafts of Part IV. *See id.* at 687–92. Most helpful among his comments is his recognition of the possibility that general law compliance enforcement may have more to do with general social protection than with traditional corporate governance objectives per se. *Id.* at 688–89.

Professor Cox analyzes the corporate deviance fiduciary cases in his article on the relative importance of compensation and deterrence interests in shareholder derivative litigation. *See* Cox, *supra,* at 763–66. Professor Cox's use of these cases is sophisticated and somewhat

Recent events[24] suggest that it may be time to attempt a specific discussion of corporate governance and corporate deviance.

One aspect of the problem has to do with the nature of "corporate deviance" itself. Scholars and scientists have extensively studied ille-

complex. His thesis is that derivative suits may be more effective if their compensation aspects are emphasized over their deterrent capacity. The corporate deviance fiduciary breach cases, *see infra* notes 128–77 and accompanying text, also tend to be leading examples of deterrence, and he attempts to discount their impact by reading them as if they "really" enforced a compensation interest. *See* Cox, *supra,* at 763–64. One consequence of this reading is Cox's clear statement that corporate fiduciary duties may have no place in enforcing societal expectations of general law compliance if the underlying conduct was profitable to the corporation; he attributes this doctrinal disability to the derivative suit's limited capacities as a general law enforcement mechanism. *Id.* at 765. The net-loss rule's formulation is important to Professor Cox's compensation thesis; he takes a somewhat monolithic approach to provable corporate loss, in an understandably hurried treatment of the problem. *Id.* at 764 & n.92 and accompanying text. The problem of proving corporate loss is discussed *infra* at notes 156–77 and accompanying text. One of Professor Cox's criticisms of the *Principles* is that they might encourage too much derivative litigation over general law compliance issues, providing doubtful public interest enforcement at the expense of the corporate treasury. *See* Cox, *supra,* at 778–83.

Professor Coffee's response to Professor Cox, and others, is especially significant because Coffee is the Reporter for Part VII of the *Principles,* which governs the derivative suit. This symposium article is in particular a defense of his work on Part VII, but builds on positions he has taken elsewhere. Professor Coffee acknowledges the limitations of the derivative suit as a corporate governance device, but argues that it should be redesigned and retained because of the "common recognition of the need for an effective litigation remedy as part of an overall system of corporate accountability. The dispute . . . is limited to the subsidiary question of what duties should be so enforced and to what extent." Coffee, *supra* note 21, at 826. While Professor Coffee recommends that duty of care liability should be reduced for managerial negligence, he argues that the duty of care should be retained as a liability standard in one situation: the duty to monitor corporate law compliance. *Id.* at 803. The law compliance component of the duty of care is special, Coffee argues, because fiduciary protest can influence a knowing board decision to violate the law far more powerfully than ordinary disagreement would affect ordinary business planning. *Id.* at 801, 803. Because such dissent is powerful, fiduciaries *can* act effectively to reduce corporate deviance. Fiduciaries thus would be appropriate cost-avoiders if the costs of corporate misconduct are wholly or partially shifted to them by the possibility of litigation over law compliance. *Id.* at 803. Greater risk-aversion by fiduciaries, as compared to shareholders, is a virtue where law compliance is involved. *Id.* Also, because law violations frequently are "one-shot" incidents of corporate misconduct, market discounting and penalties are less efficacious as social controls: the markets can process the information about the violation only after it happens, and significant discounting would occur only if there was a likelihood of repetition. *Id.*

However, Professor Coffee does not propose that continuing an ex post liability standard for corporate deviance should be a "license to litigate." *Id.* at 815–17. Instead, a crucial aspect of designing this governance mechanism is articulating standards by which judges can decide when to let duty of care litigation proceed in corporate deviance situations. *Id.* Finally, Professor Coffee clearly envisions both the general duty of care and the law compliance obligation to have considerable significance as aspirational standards. *Id.* at 792, 796–99.

24. These events are the recent spate of significant business deviance problems, *see supra* notes 3–6, and the recurring difficulties in finding an acceptable system of corporate criminal punishment, *see* Etzioni, *Going Soft on Corporate Crime,* Wash. Post, Apr. 1, 1990, at C3, col. 1 (discussing recent struggles over federal sentencing guidelines for corporate crime). The relative currency of the *Principles* makes timely some inquiry into the extent to which corporate governance rules can play a part in reducing corporate deviance.

gal conduct by corporate actors as an identifiable social phenomenon.[25] By describing and analyzing corporate deviance, these studies

25. The most accessible collection of references to this literature may be that provided by CORPORATIONS AS CRIMINALS 33–37, 66–68, 83–84, 101–02, 128–30, 144–45, 163–65 (E. Hochstedler ed. 1984). Complementary additional references may be found in D. VAUGHAN, CONTROLLING UNLAWFUL ORGANIZATIONAL BEHAVIOR: SOCIAL STRUCTURE AND CORPORATE MISCONDUCT 159–68 (1983). A representative sample of the legal academic literature on the subject includes R. CLARK, CORPORATE LAW 684–88 (1986); R. POSNER, ECONOMIC ANALYSIS OF LAW 397–99 (3d ed. 1986); C. STONE, WHERE THE LAW ENDS (1975); Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control,* 80 MICH. L. REV. 1466 (1982); Coffee, Gruner & Stone, *Standards for Organizational Probation: A Proposal to the United States Sentencing Commission,* 10 WHITTIER L. REV. 77 (1988); Coffee, *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment,* 79 MICH. L. REV. 386 (1981) [hereinafter Coffee, *No Soul to Damn*]; Coffee, *Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions,* 17 AM. CRIM. L. REV. 419 (1980) [hereinafter Coffee, *A Non-Chicago View*]; Coffee, *Making the Punishment Fit the Corporation: The Problems of Finding an Optimal Corporation Criminal Sanction,* 1 N. ILL. L. REV. 3 (1980); Coffee, *Rebuttal: The Individual or the Firm? Focusing the Threat of Criminal Liability,* 1 N. ILL. L. REV. 48 (1980); Coffee, *supra* note 2; Crane, *Commentary: The Due Process Considerations in the Imposition of Corporate Liability,* 1 N. ILL. L. REV. 39 (1980); Emerson, *The Director As Corporate Legal Monitor: Environmental Legislation and Pandora's Box,* 15 SETON HALL L. REV. 593 (1985); Fischel, *supra* note 21, at 1271–72 (1982); Fisse, *Community Service as a Sanction Against Corporations,* 1981 WIS. L. REV. 970; Glasbeek, *Why Corporate Deviance Is Not Treated As A Crime—The Need to Make "Profits" A Dirty Word,* 22 OSGOODE HALL L.J. 393 (1984); Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls,* 93 YALE L.J. 857 (1984); Leigh, *The Criminal Liability of Corporations and Other Groups: A Comparative View,* 80 MICH. L. REV. 1508 (1982); Moore, *Corporate Officer & Director Liability: Is Corporate Behavior Beyond the Control of Our Legal System?,* 10 CAP. U.L. REV. 69 (1980); Morris, *Commentary: The Interplay Between Corporate Liability and the Liability of Corporate Officers,* 1 N. ILL. L. REV. 36 (1980); Nagel & Hagan, *The Sentencing of White-Collar Criminals in Federal Courts: A Socio-Legal Exploration of Disparity,* 80 MICH. L. REV. 1427 (1982); Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct,* 90 YALE L.J. 1 (1980); Vaughan, *Toward Understanding Unlawful Organizational Behavior,* 80 MICH. L. REV. 1377 (1982); Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse,* 28 UCLA L. REV. 343 (1981); Wheeler & Rothman, *The Organization as Weapon in White-Collar Crime,* 80 MICH. L. REV. 1403 (1982).

The problem of appropriate sanctions in particular has been of considerable interest. *See* Brickey, *Rethinking Corporate Liability Under the Model Penal Code,* 19 RUTGERS L.J. 593 (1988); Brickey, *Criminal Liability of Corporate Officers for Strict Liability Offenses—Another View,* 35 VAND. L. REV. 1337 (1982); Brickey, *Corporate Criminal Accountability: A Brief History and An Observation,* 60 WASH. U.L.Q. 393 (1982); Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions,* 56 S. CAL. L. REV. 1141 (1983); Hamilton, *Corporate Criminal Liability in Texas,* 47 TEX. L. REV. 60 (1968); McAdams, *The Appropriate Sanctions For Corporate Criminal Liability: An Eclectic Alternative,* 46 U. CIN. L. REV. 989 (1978); Mueller, *Mens Rea and the Corporation—A Study of the Model Penal Code Position on Corporate Criminal Liability,* 19 U. PITT. L. REV. 21 (1957); Posner, *Optimal Sentences for White-Collar Criminals,* 17 AM. CRIM. L. REV. 409 (1980); Note, *Corporate Criminal Liability for Acts in Violation of Company Policy,* 50 GEO. L.J. 547 (1962); Note, *Indemnification of the Corporate Official for Fines and Expenses Resulting from Criminal Antitrust Litigation,* 50 GEO. L.J. 566 (1962); *Developments in the Law—Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions,* 92 HARV. L. REV. 1227 (1979);

help to determine whether corporate governance rules can be effective in regulating deviance, or in ameliorating its effects. "Corporate deviance" thus is worth some exploration, if only to aid in understanding the *Principles*' provisions that attempt to address it.

Traditional corporate governance patterns of fiduciary duty and derivative litigation present other difficulties. In and of itself, the shareholder derivative suit is one of the most controversial topics in corporate governance doctrine.[26] The complications multiply when derivative litigation is applied to the problem of corporate deviance. For example, section 2.01(a)'s clear declaration that corporate actors must obey the law in the conduct of their business, regardless of profit, raises special problems if the primary method of fiduciary duty enforcement will be the shareholder derivative suit. If *all* legal disobedience can be the basis for fiduciary liability, corporate funds would be expended in derivative litigation even if the violated legal provision were a relatively minor one, such as a traffic regulation.[27]

More crucial is that section 2.01(a)'s language raises the possibility that fiduciaries may be liable to the corporation for illegal corporate activities even when the corporation has made a profit from the illegality.[28] Recovery for profitable deviance could mean a windfall to the corporation, which would be able to recover from fiduciaries for profitable misconduct while keeping the profits originally obtained from the illegal activities. Perhaps more accurately, fiduciary liability for profitable illegal acts could be a windfall to the plaintiffs' corporate bar, which is the engine that drives shareholder litigation.[29] On the other

Comment, *Limits on Individual Accountability For Corporate Crimes*, 67 MARQ. L. REV. 604 (1984). *See generally* Professor Coffee's articles, *supra*; Etzioni, *supra* note 24.

26. *See generally* articles cited *supra* note 23.

27. *See* Draft No. 2, *supra* note 17, at 36, illustration 10, which declares that a hypothetical trucking firm's knowing policy of violating highway speed limits to obtain higher profits violates the law obedience principle recounted in § 2.01(a).

28. Section 2.01 "serves, indirectly, as a general guide for the conduct of corporate officials, and as a foundation for provisions in Parts IV (Duty of Care and the Business Judgment Rule) . . . that set out specific standards of conduct for such officials and govern liability for conduct that falls below those standards." *Id.*

29. The "real party in interest" on the plaintiffs' side in derivative suits is the plaintiffs' attorney. *See* W. KLEIN & J. COFFEE, *supra* note 9, at 179; Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Coffee, *The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (Summer 1985). Little would be gained by recapitulating the literature on this question, and the central role of the plaintiffs' bar simply is assumed in much of the following discussion.

See *infra* notes 158, 164–76 and accompanying text for a discussion of the windfall problem; see *infra* notes 301–03 and accompanying text for a brief discussion of the role of the plaintiffs' corporate bar in shareholder litigation.

hand, absolute prohibition of shareholder litigation when corporate deviance has been profitable might tend to give the impression that corporate law is willing to tolerate crime, as long as it pays.[30] Avoiding corporate windfalls without appearing to condone criminal activity is a central challenge in designing corporate governance rules about general law compliance. No arrangement of corporate doctrinal rules, however, is likely to remove all the tension between these two goals.[31]

Another unavoidable problem with corporate deviance derivative suits is that section 2.01(a) enforcement inescapably becomes part of the recent dispute over managerial power to dismiss derivative litigation after determining that a particular suit is "not in the corporation's best interests."[32] Whether the deviance was profitable or not, this managerial power, left unrestrained, could of its own operation completely eliminate any meaningful derivative enforcement. Consequently, the *Principles*' formulation of this managerial power would determine whether section 2.01(a) actually is enforceable. If section 2.01(a) is to have any deterrent or compensatory effect, the *Principles* must articulate particular deviance litigation situations in which managerial power to dismiss could be overridden.[33]

A different issue under section 2.01(a) and related provisions is whether the fiduciary liability provisions ought to distinguish between corporate illegal acts in which fiduciaries are personally involved in the decision to disregard the law, and those situations in which the illegality takes place partially as a result of the fiduciaries' failure to adequately supervise corporate employees. A corporate compensation interest is at least part of the reason for recognizing fiduciary liability for illegal activities that cause losses. From a compensation perspective, the fiduciaries' relative moral culpability does not appear to mat-

30. *See* Cox, *supra* note 23, at 765.

31. Critics of derivative litigation traditionally have labelled it a "strike suit," a device by which a nominal shareholder sues to coerce management into a favorable settlement. More sophisticated modern analysts point to the existence of the plaintiffs' bar and to the possibility of a "collusive settlement," in which the corporation takes a low recovery, or agrees to procedural reforms, and pays substantial attorneys' fees to the derivative plaintiffs' representative. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 8 1988) at 5, Introductory Note to Part VII [hereinafter Draft No. 8]. From this modern perspective, the existence of fiduciary indemnification and insurance, combined with derivative litigation, makes shareholder enforcement of fiduciary duty a particularly roundabout form of corporate cost-spreading. *See* Coffee, *supra* note 21, at 805–06. Trying to articulate a unified rationale for derivative litigation also is difficult. Draft No. 8 refuses to elect either a deterrence or a compensation rationale. *See* Draft No. 8, *supra,* at 11–15. Instead, Draft No. 8 treats the compensation interest as a limitation on the deterrence rationale. *See* Coffee, *supra* note 21, at 807–08.

32. *See infra* notes 180–93 and accompanying text.

33. *See* Coffee, *supra* note 21, at 815–17.

ter. However, corporate compensation is not the only possible justification for fiduciary law compliance duties: derivative suit enforcement of law compliance duties also might serve to deter illegal misconduct. Making it harder to punish fiduciaries who fail to supervise thus could impair deterrence by creating perverse incentives for fiduciaries to "look the other way" instead of attempting to intervene when other corporate actors first broach the possibility of an illegal course of conduct. And inadequate supervision may deserve greater fiduciary liability than direct involvement, if other social controls are considered. Direct involvement carries the risk of independent criminal liability for the fiduciary, so the threat of criminal liability might provide sufficient deterrence in direct involvement situations. In contrast, because criminal liability is far less likely when supervisory failures cause corporate criminal conduct,[34] civil liability could provide an additional deterrent to keep ordinary corporate activity from breaking the law.

These technical issues introduce much of the problem of corporate deviance and corporate governance.[35] The problem is not merely technical, however. Fiduciary liability for corporate illegality tests the limits of corporate governance doctrine. Although from a perspective external to corporate governance, society as a whole might expect that corporate governance would include a reliable mechanism to assist in law enforcement, it is not at all clear that such an arrangement is necessary from an internal, purely corporate governance point of view.[36]

34. Respondeat superior types of criminal liability are relatively rare. Recent insider trading legislation creates enhanced civil liability when trading firms fail to supervise and prevent inside trading by firm employees. This liability runs to civil regulatory penalties as well as private damages. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (adding section 21A, to be codified at 15 U.S.C. § 78u-1); *see also* Lavoie, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 22 REV. SEC. & COMMODITIES REG. 1 (1989). Earlier attempts to use trading firms' supervisory powers as regulatory surrogates were well established before this. *See* McLucas & Morse, *Liability of a Branch Office Manager for Failure to Supervise*, 23 REV. SEC. & COMMODITIES REG. 1 (1990). These are relatively specific regulatory devices, however, and do not have the broad application of general corporate governance doctrine.

35. This introduction excludes some interesting corporate governance issues that arise from the general law compliance duty. For example, fiduciary breaches of the law compliance duty could be used by insurgents as one key issue in proxy fights during annual or special director elections, even serving to justify removal for cause. Moreover, if governance doctrine makes law compliance a *corporate* duty as well as a fiduciary duty—as the *Principles* do in § 2.01(a)—then shareholders may be able to sue the corporation, as well as the fiduciaries, for injunctive or other equitable relief to stop or limit the consequences of the illegal activity. Except for sporadic references to equitable relief, this Article does not discuss these possibilities. It concentrates instead on the general law compliance obligation and its relationship to the fiduciary duty of care and derivative suit procedures.

36. *See* Phillips, *supra* note 23, at 687–92. *But see* Coffee, *supra* note 21, at 794.

It is possible to imagine a set of corporate governance rules that are relatively *neutral* on the question of corporate deviance. Those rules, while not encouraging law violations, would provide no special enforcement mechanism in deviance situations. It is therefore possible to ask why, ultimately, the *Principles*' include general law compliance as part of corporate and fiduciary obligations.

This Article explores the ALI's approach to corporate deviance as a corporate governance problem. Part II briefly presents corporate deviance as a distinct subject of study, and discusses past judicial interpretations of corporate fiduciary duties in deviance cases. Part III describes the ALI's provisions designed to address corporate deviance and attempts to predict their application to and impact on shareholder litigation over corporate deviance. Part IV evaluates the ALI's decision to include a general law compliance obligation in its reworking of corporate governance doctrine.

The ALI's *Principles* adjust traditional doctrine to permit more effective use of derivative litigation against corporate fiduciaries after especially egregious episodes of corporate lawbreaking; otherwise, the *Principles* adopt aspirational standards to influence managers tempted to profit by deviance. This approach combines deterrence and compensation mechanisms with hortatory language and is significantly more coherent than the scattered case law from which it is derived. The *Principles* rely heavily, however, on judicial willingness to censure corporate actors for extreme violations, and on the less-than-precise effect of aspirational values in persuading managers to forego corporate profit from illegal acts. Ultimately, the *Principles*' approach to corporate deviance may say as much about the limits of corporate doctrine as it does about the substantive problem of corporate law compliance.

II. CORPORATE DEVIANCE AND FIDUCIARY DUTY

A. A Sketch of Corporate Deviance

For this Article's purposes, "corporate deviance" means behavior by corporate actors that violates a "general" legal obligation, which is an obligation other than one arising from specific regulation of the corporate form. This definition thus excludes failures to comply with capital surplus rules relating to dividends, for example,[37] but includes, among other things, horizontal price-fixing, bribery, and illicit dump-

37. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170 (1989); N.Y. BUS. CORP. LAW § 510 (McKinney 1989). For a brief discussion of derivative litigation over violations of corporate regulations, see Coffee, *supra* note 21, at 816.

ing of toxic waste.[38] So defined, "corporate deviance" functions as a convenient label for conduct that would violate the obligation to comply with legal norms of section 2.01(a).

The corporate deviance literature collects many theoretical and empirical observations about legal noncompliance by corporate actors,[39] although it is difficult to make generalizations about the raw "amount" of corporate misconduct for several reasons. By the very nature of the offense, price-fixing scandals are market specific[40] and arguably narrow in relation to the national economy; other patterns of violations, such as questionable payments, have seemed more widespread.[41] Another factor complicating any evaluation of this problem is that compliance expectations and regulatory obligations have increased markedly during the post-World War II era. None of the major scandals has involved trivial numbers, however. In addition to documenting the corporate deviance phenomenon, positive science has endeavored to understand its causes. The individual "white collar" criminal was the earliest object of study.[42] These studies continue, but recent investigations also examine the social and organizational frameworks in which law violations occur.[43] What follows are brief samples of corporate deviance studies.

1. Corporate Deviance as Distinct Behavior

Corporate deviance is not a unitary set of behaviors, indistinguishable from other forms of prohibited conduct except for its location in

38. Another key to understanding a general legal obligation is that its prohibitions normally would apply to actors whether or not their actions involve business activities under the corporate form.

39. The most accessible introductions to corporate deviance may be found in M. CLINARD, *supra* note 7; M. ERMANN & R. LUNDMAN, CORPORATE DEVIANCE (1982) [hereinafter ERMANN & LUNDMAN I]; M. ERMANN & R. LUNDMAN, CORPORATE AND GOVERNMENTAL DEVIANCE: PROBLEMS OF ORGANIZATIONAL BEHAVIOR IN CONTEMPORARY SOCIETY (2d ed. 1982) [hereinafter ERMANN & LUNDMAN II]; and D. VAUGHAN, CONTROLLING UNLAWFUL ORGANIZATIONAL BEHAVIOR: SOCIAL STRUCTURE AND CORPORATE MISCONDUCT (1983); *see also* J. BRAITHWAITE, *supra* note 21; M. CLINARD & P. YEAGER, *supra* note 1; N. FRANK & M. LOMBNESS, CONTROLLING CORPORATE ILLEGALITY: THE REGULATORY JUSTICE SYSTEM (1988); CORPORATIONS AS CRIMINALS (E. Hochstedler ed. 1984); D. SIMON & D. EITZEN, ELITE DEVIANCE (1982).

40. Price-fixing necessarily implies that one market is involved where competitors agree to set prices. Perhaps the best known episode was the electrical conspiracy, in which 29 companies, including General Electric and Westinghouse, and 45 company executives were convicted of violations in the sale of heavy electrical equipment. *See* M. CLINARD & P. YEAGER, *supra* note 1, at 6. Price-fixing in the pharmaceutical industry and in the manufacture of plumbing fixtures also were "single market" offenses. *Id.*

41. *See* Coffee, *supra* note 2, at 1115–25.

42. *See* M. CLINARD, *supra* note 7, at 10–11.

43. *Id.* at 11–12.

legitimate businesses. Rather, corporate deviance is special precisely because of its location. To a considerable extent, corporate deviance is possible because of corporate complexity itself. The fundamental task in a large business organization like a corporation[44] is to coordinate various individuals and groups into a common endeavor or series of endeavors so that a net gain results for the organization. Accordingly, one way to understand corporate deviance is to consider its relationship to the problems of coordinating a complex firm.

If corporate deviance is treated in coordination terms, three fundamental types of deviance can be identified.[45] One of these is deviance that is a result of limited information and responsibility.[46] Production can be broken down into discrete tasks, with a substantial increase in total output and efficiency.[47] In a large organization, however, specialization may reduce individual or small group information to such a degree that an unlawful act results, or that the risk of such an act increases significantly. Consider as a hypothetical example the prohibited release of radioactive contaminants from a nuclear power plant owned and operated by Little Power Co.[48] The illicit emission occurred as plant operators were responding to a crisis situation in the reactor control room. On later investigation, it turned out that the emission was avoidable. Plant safety engineers had known about prior, similar crises at other reactors and had designed operating procedures to respond to such situations. In these circumstances, the eventual regulatory sanctions would be attributable to limited information resulting from specialization because the operating team did not know of the safety engineers' solution. The organizational lapse described in this hypothetical is miscoordination. Although Little Power Co. obtained efficiencies by fragmenting the tasks of running a

44. Many of the organizational characteristics described in the next several pages could be present in any large firm, corporate or otherwise. Because so many of the largest firms do employ the corporate form, corporate status will be assumed in the following discussion unless otherwise apparent from the context.

45. These three types are those identified by Ermann and Lundman, although the labels they use have been modified to emphasize coordination aspects. *See* ERMANN & LUNDMAN I, *supra* note 39, at 9–11.

46. Under Ermann and Lundman's typology, these behaviors are "acts traceable to the complexity of corporation positions." *Id.* at 9.

47. This is the point of Adam Smith's famous pin factory. *See* A. SMITH, THE WEALTH OF NATIONS (1776).

48. This example is based on ERMANN & LUNDMAN I, *supra* note 39, at 9–10, which itself borrows completely from C. STONE, WHERE THE LAW ENDS 51–52 (1975). Organizational theory suggests that "innocent" complexity may not simply unmask the law's preoccupation with individual acts; this complexity also creates incentives to block information flows, making discovery and control more difficult. *See infra* notes 54–68 and accompanying text.

nuclear power plant, the company failed to establish and maintain information flows between the operating group and the safety engineering group. These increased information flows would have tended to offset the informational isolation resulting from specialization.

Another fundamental type of corporate deviance is an unintended result of attempted coordination.[49] When corporate senior managers set performance goals in general terms but, as they must, delegate implementation of those goals within the organization, there remains a risk that line employees may violate legal prohibitions in an attempt to meet those goals. Assume that senior management of Airbreak, Inc., an aircraft brake manufacturer, proclaims that one very important short-term corporate objective is to obtain a particular government subcontract for the brakes on a new fighter aircraft. Without consulting anyone, a member of the engineering technical support staff approaches a friend employed by the Defense Department's procurement division and asks that the specifications of Airbreak's standard light brake assembly be written into the contract specifications. In exchange, Airbreak's employee offers his friend a lump sum cash payment and lifetime employment with Airbreak on departure from government service. The procurement employee defers, calls the FBI, and wears a recording device at a later meeting where the lump sum is paid and the "deal" concluded. As a consequence of this attempted bribe, Airbreak is decertified from eligibility for government contracts. This hypothetical situation represents another coordination failure (not the least part of which is the obvious accounting control problem presented by a relatively low-level employee's ability to obtain funds sufficient to make a credible bribe). Senior managers established a legitimate organizational objective (the new subcontract), but did so without effective policies or internal controls against bribery undertaken in furtherance of the corporate interest.[50]

Finally, corporate deviance may be a deliberate act by members of the control group.[51] Senior managers are capable of prohibited conduct as they try to cut costs, limit losses, or protect market share, all of which are legitimate corporate objectives. Imagine that the United States passenger airline industry is dominated by two large carriers,

49. This behavior is identical to Ermann & Lundman's "deviance indirectly traceable to organizational elites." *See* ERMANN & LUNDMAN I, *supra* note 39, at 10.

50. An effective policy could include the aspirational and educational efforts typical of most compliance programs, *see infra* notes 199–200; accounting and negotiation controls also would be necessary to make it less easy for one corporate actor to use corporate resources to pay bribes.

51. For Ermann and Lundman, these are "acts directly traceable to corporate elites." *See* ERMANN & LUNDMAN I, *supra* note 39, at 10–11.

Western Flight and Eastern Transport. Both firms have suffered inroads in their market shares as a result of increased competition from several strong regional airlines. Western and Eastern are direct competitors, but their chief executive officers meet secretly at the Bohemian Club and agree to divide the domestic market into two exclusive service regions of roughly equal size.[52] Each company will direct its activities in accordance with this agreement. The arrangement is discovered, and both companies are prosecuted and fined for antitrust violations. In this last example, the corporate actors responsible for coordination have themselves chosen prohibited conduct (an agreement not to compete between horizontal competitors) to accomplish the legitimate corporate objective of consolidating market share.

These examples show how coordination analysis brings into focus senior management's role in directing corporate conduct. Managerial decisions that organize business subunits can contribute to corporate deviance when informational isolation between subunits is not supplemented by supervisory coordination and results in prohibited conduct. Other managerial decisions that set organizational goals can create deviance opportunities when goal implementation is delegated but is undersupervised, and subordinates pursue illicit means to obtain lawful corporate ends. Finally, senior managers themselves are able to commit illegal acts in furtherance of corporate goals. A managerial focus is helpful in understanding how corporate fiduciary duties might function as corporate deviance controls because it emphasizes the organizational role of senior management and, less directly, the board of directors. These directors and officers are the corporate players subjected to traditional corporate fiduciary obligations.[53] Under coordination analysis, it can be said that corporate deviance results from corporate fiduciaries' *direct involvement* in prohibited conduct, or from their *failures to adequately supervise* corporate operations, whether these failures are caused by over-compartmentalization with-

52. This hypothetical presents horizontal market allocation between direct competitors, which arguably is a per se antitrust violation. Those who are unconvinced that such conduct constitutes a per se violation should assume further that no integration benefits can be obtained from the horizontal market allocation.

53. *See infra* Part II.B. This traditional fiduciary focus on senior officers and directors, however, does not necessarily foreclose the possibility that other corporate employees might owe law compliance obligations to their corporate employers. Traditionally, these obligations would lie in agency or employment law rather than in corporate governance doctrine. Shareholders could attempt derivative suit enforcement of claims against corporate actors other than directors or officers, but would be unable to challenge a decision by the board to forego prosecution of such claims. *See* Draft No. 8, *supra* note 31, at 110, § 7.07(1), comment a ("all other subordinate corporate personnel" may be subjected to corporate claims, but the board has virtually absolute business discretion to refuse to prosecute such claims).

out supplementary information flows, or by insufficient guidance to subordinates charged with implementing policy. Coordination analysis illuminates the basic corporate deviance patterns; its managerialist bias suggests why corporate governance is willing to apply fiduciary doctrine to corporate deviance. It should be kept in mind as subsequent sections describe the doctrinal developments at common law and under the ALI *Principles*.

2. *Structural Factors*

Organizational theory fills in the picture provided by coordination analysis and has supported particularly rich studies of corporate deviance.[54] Taking partial inspiration from the Berle and Means[55] observation about the separation of ownership and control in the large public corporation, organizational theorists have identified several characteristics which can cause or facilitate corporate misconduct in large firms.

Because of decentralization, corporate managers are subject to "authority leakage," a progressive loss of control over subordinate units as the organization expands in size and the distance increases between those units and top management.[56] Moreover, as subordinate units multiply in number, lower-level managers will compete with one another in "subgoal pursuit," a rational strategy of subunit self-preservation, even when the subunit's goals are contrary to overall welfare maximization for the firm.[57] The organization's information flow further complicates these control difficulties. This flow is serial in nature—all employees report to an immediate supervisor, who in turn reports to an immediate supervisor, and so on. As information flows upwards to management, the quality of that information deteriorates because of the (conscious and unconscious) human proclivity to suppress negative information.[58] In organizations with many management levels, each stage of the informational relay also adds "noise" to

54. Among modern corporate legal scholars, Professor Coffee has made the most extensive use of organizational theory. For organizational theory applications to corporate deviance problems, see especially Coffee, *supra* note 2; *A Non-Chicago View, supra* note 25; Coffee, *No Soul to Damn, supra* note 25. For a summary of the differences among organizational theorists, see Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 25–40 (1986).

55. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

56. Coffee, *supra* note 2, at 1136–37. For ease of reference, organization theory citations will be limited to this one source, though Professor Coffee also discusses these problems in *No Soul to Damn, supra* note 25, at 393–400. His own citations to other primary organizational theory sources are quite clear, and little would be gained by duplicating them here.

57. Coffee, *supra* note 2, at 1135–36.

58. *Id.* at 1137–38.

the communication, further diluting its value.[59] But trying to reduce noise by "flattening" the firm's superstructure (eliminating intermediate management layers) can create informational overload at the top, which may have even more serious consequences.[60]

All these tendencies result in what Professor Coffee characterizes as "information blockages," damming the information flow to monitoring groups such as senior management and the board of directors.[61] Informational blockages worsen when subordinates do not trust their superiors, because lack of "support" from superiors increases information suppression by subordinates.[62] Further problems arise from the organizational tendency to "bury" the difficult decision.[63] Despite the popular notion that organizational higher-ups are the ones who wrestle with complicated policy choices, managers and supervisors tend to delegate the hard choices.[64] And "persistence behaviors" complicate the internal correction process in some organizations—subunits sometimes persist in behavioral patterns because of sunk costs, long after the conduct has become counterproductive to the enterprise as a whole.[65] Finally, there is some evidence that group decisionmaking in organizations undergoes a "risky shift," in which a group facing alternative choices undertakes one bearing a higher degree of risk than would individual decisionmakers given the same choices.[66]

These organizational observations can be seen to flesh out the notion that, despite the easily-grasped managerial focus provided by coordination analysis, corporate actors operate in a realm of "bounded rationality."[67] The attempt to overcome individual or small group limitations by creating hierarchical economic collectives (such as corporations) cannot escape those human limitations, which continue to bedevil the organizational hierarchies these limitations make necessary.[68] These observations also describe sobering organizational reali-

59. *Id.* at 1138.
60. *Id.* at 1138–39.
61. *Id.* at 1131.
62. *Id.* at 1144.
63. *Id.* at 1125.
64. *Id.* at 1151.
65. *Id.* at 1125.
66. *See* Coffee, *No Soul to Damn*, *supra* note 25, at 395.
67. "Bounded rationality" means "bounds on the rate at which information can be absorbed per unit of time, limits to the information storage capacity (in an effective retrieval sense), and bounds on the processing ability of the decision-maker." O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR: AN INQUIRY INTO THE EFFECTS OF ORGANIZATION FORM ON ENTERPRISE BEHAVIOR 20 (1970). This definition is a clear departure from the neoclassical economic model of the human actor.
68. *Id.* at 31.

ties that must be taken into account in evaluating any remedial or preventative scheme. When corporate deviance is buried deeply within an organization, information blockages will impair the ability of traditional corporate fiduciaries to detect and correct misbehavior.[69] Fiduciary liability based on this sort of deviance would be characterized as a failure-to-supervise case;[70] but the organizational structure itself would tend to work against any attempts by fiduciaries to improve their own law compliance supervisory activities. Deviance supervision is impaired in two distinct ways. First, discovery is difficult through normal channels because it is reasonable to assume that lower-level employees would tend to suppress criminal activity more thoroughly than other sorts of internal "bad news." Second, attempts to increase fiduciary involvement may result in informational overload to those fiduciaries. For these reasons, failure-to-supervise liability seems inextricably linked to compliance programs in large organizations—it may be unfair to expect fiduciaries to supervise directly, so some degree of delegation to law compliance specialists may be the only reasonable response.[71] How modern duty of care standards could stimulate appropriate fiduciary behavior regarding compliance programs presents problems of a different order,[72] and will be discussed later in this Article.[73]

Another salutary effect of organizational theory is its unequivocal reminder that corporate organizations are not monoliths: corporations, as human collectives, are made up of groups and subgroups, whose interests may diverge and whose activities cannot be perfectly supervised. This fragmentation means that "the corporation's best interests" cannot always be reduced to unitary measures of net profit. Nor can its "best interests" always be assured by uncritical, constant, ex post deferral to the wishes of current senior management or its supervising board of directors.

69. *See* Coffee, *supra* note 2.

70. *See supra* note 54 and accompanying text.

71. This partially explains the ALI's receptivity to compliance programs. *See infra* notes 199–200, 225–31 and accompanying text.

72. There would eventually be proof problems here as an ex post litigation remedy attempts to sort backwards through a corporate culture to evaluate whether a particular delegation was a reasonable discharge of supervisory duties regarding law compliance. This line of inquiry would be foreclosed if full or partial limits were adopted for all duty of care liability. *See* DEL. CODE ANN. tit. 8, § 102(7) (1989); *see also infra* notes 210, 281–83 and accompanying text (discussing the *Principles* approach to the duty of care "opt-out").

73. *See infra* notes 199–200, 225–31 and accompanying text.

3. *Sociological Insights*

Sociological studies approach corporate deviance from yet another perspective. Using a framework derived from Robert K. Merton's studies of organizational deviance,[74] Professor Vaughan describes how corporate deviance is generated from social structures. Briefly stated, her assumptions are that economic success is a socially-approved goal[75] and that competition is a fundamental means for reaching economic success.[76] Deviance results from the erosion of the norms that distinguish legitimate forms of competition from illegitimate ones.[77] Several factors contribute to norm erosion, among them overemphasis on economic success,[78] blocked access to legitimate means for achieving such success,[79] subgoal variability,[80] norm mutability,[81] and rapid organizational turnover that prevents norms from stabilizing.[82] These norm-eroding factors probably are unavoidable: some firms would experience them at least some of the time as they compete for scarce resources in a complex modern business environment.

A sociological approach helps in understanding organizational actors' responses to legal strictures, particularly by making clear that law compliance is not an organizational goal for business enterprises,

74. *See* D. VAUGHN, *supra* note 39, at 55–56 (citing R. MERTON, *Social Structure and Anomie*, in SOCIAL THEORY AND SOCIAL STRUCTURE 131–60 (1968)).

75. Some degree of economic success is necessary for the survival of any economic player. *See* D. VAUGHAN, *supra* note 39, at 56–58. However, this assumption of the legitimate goal of economic success is not the same as a rule of absolute profit-maximization. *Id.* at 56–57.

76. *Id.* at 57–59.

77. *Id.* at 55. As norms lose effectiveness, "innovation" (deviance) becomes a probable response as actors pursue desired and legitimate goals by expedient but socially illegitimate means. *Id.*

78. *Id.*

79. These blockages can occur either as a complete market exclusion because of scarce resources, or as lack of success because of scarcity, even after obtaining market access. *Id.* at 58–59. "Scarcity" may be due to actual shortages of inputs to production, or to prohibition by market controllers. *Id.*

80. This variability can happen in two different ways. One is that definitions of success can vary at different times for a particular organization depending on its current position in the competitive hierarchy. *Id.* at 59. The other is that achievement of a particular subgoal is followed quickly by a new subgoal definition. With each new subgoal declaration possibilities of blocked access are renewed. *Id.*

81. To the extent that most legal regulations of organizational behavior do not codify eternal verities and can be modified, one significant class of norms can be changed in response to pressure from the social competitors for economic success. Some norm erosion is attributable to this mutability, and to the realization that many laws benefit some competitors at other competitors' expense because the former have the clout to get laws drafted in their favor. *Id.* at 61.

82. *Id.* at 60–61.

it is "only" a norm.[83] Because the law is "just" a norm to non-legal organizations, groups, or individuals, the law is much less central to their experiences. Legal rules are one norm among many others, such as those generated by family, religious community, friends, and coworkers. Law compliance competes with other norms, such as loyalty or status: any normative effect of law can be overborne, intentionally or unintentionally, by organizational recruiting, by self-selection, and by fluidity of members within the organization. In extreme situations, an express hostility to legal norms can develop.[84] For organizations in which law compliance has ceased to be an effective behavioral norm, law compliance enhancement will take more than simple adoption of more regulations. Instead, some reinforcement of law as a meaningful norm must take place.

4. Neoclassical Economics and Corporate Deviance

Law and economics scholars also have shed light on corporate deviance problems in two distinct ways. One line of thought analyzes corporate deviance in agency-cost terms. Another line of inquiry attempts to discern whether capital market characteristics and strategies are sufficiently effective to remedy corporate deviance problems.

The agency-cost analysis assumes that corporate firms' primary objective is to maximize profits to the extent possible within the bounds of the law,[85] and focuses instead on the problem (or non-problem) of divergence by the manager-agent from the profit-maximizing goals of the shareholder-principal.[86] For these scholars, excessive legal non-compliance by corporate actors results from non-optimal settings of legal sanctions.[87]

83. On the other hand, lawyers (or the group that includes members of the bar, legal academics, and judicial, legislative, and administrative regulators) are concerned about law compliance not as a means but as an end. For lawyers, law compliance is a collective goal, not merely a norm. A somewhat different observation about this distinction is made in Greenawalt, *A Contextual Approach to Disobedience,* 70 COLUM. L. REV. 48, 49 (1970).

Section 2.01(a) of the ALI *Principles* was drafted, intentionally or otherwise, in a way that reflects this distinction between norms and goals. Section 2.01 makes it clear that the corporate objective is one of economic success, constrained by compliance with legal norms. *See supra* note 17 and accompanying text.

84. Most business lawyers have witnessed (or endured) expressions of business community dislike of the regulatory state in general and lawyers in particular. *See* M. CLINARD, *supra* note 7, at 105–07; *see also* E. BARDACH & R. KAGAN, GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS (1982).

85. Even Professor Fischel restates the broad law compliance assumption before hinting at its possible superfluity. *See supra* note 21.

86. *See generally* R. POSNER, *supra* note 25, at 368.

87. *See generally* A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 75–86 (2d ed. 1989); R. POSNER, *supra* note 25, at 205–12; Fischel, *supra* note 21, at 1271. The neoclassical

Judge Posner, the leading law and economics scholar, does acknowledge a beneficial role for *criminal* pecuniary sanctions against the corporation. For Posner, these criminal sanctions remedy a defect in the ex ante contracting between shareholder-principal and manager-agent. He assumes first that the manager is a perfect agent so that any revenue obtained from criminal activity inures to the shareholders. Judge Posner then suggests that failure to impose a fine on the corporation would create incentives for shareholders to hire managers willing to commit crimes on the corporation's behalf.[88] Even if corporate criminal activity does not benefit the shareholders because the manager diverts the ill-gotten gains, the corporation provides the means to commit criminal acts, and shareholders must be given some incentives to be careful in selecting managers.[89] In this view, sanctioning the corporation for illegal acts puts an appropriate financial burden on the shareholders, and improves the necessary incentives to select and supervise managers for law compliance. Judge Posner's theories of corporate criminal liability are controversial,[90] and his preference for criminal fines against the corporation suggests a low opinion of derivative litigation as a deviance control mechanism. But his observations

approach has been criticized for ignoring the organizational dynamics within the firm and treating the corporation as a "black box." *See* Coffee, *No Soul to Damn, supra* note 25, at 395; *see also* Stone, *supra* note 25, at 7–10. Although neoclassicism's typically lucid reasoning is seductively straightforward, its most prominent economically-minded critics regard the approach as too "lean," rendering only an incomplete description of corporate deviance. *See* Coffee, *No Soul to Damn, supra* note 25, at 395.

88. *See* Posner, *supra* note 25, at 398.

89. *Id.* Alternatively stated, absent some sanction against the corporation itself, shareholder limited liability creates at least a moral hazard of corporate deviance, since shareholders are given no incentive to be careful about whom they hire as managers.

90. *Compare* Coffee, *A Non-Chicago View, supra* note 25, at 419 *with* Posner, *supra* note 25, at 409. Crucial to this dispute are varying assumptions about the effectiveness of enterprise sanctions in the form of corporate criminal fines, compared with individual criminal liability for corporate actors.

If removed from the question about appropriate criminal law sanctions for corporate misconduct, Judge Posner's analysis loses some of its force because of its initial assumption of "perfect agency" by corporate actors. By assuming that deviant managers are perfect agents, Judge Posner brushes aside any governance problems. Posner says, in effect, that criminal law sanctions can cope with profitable deviance, and that unprofitable deviance will be regulated by other devices, most important among them the market for corporate control. What he does not address is the possibility that shareholders willing to tolerate illegally-obtained gains might be less forgiving of illegally-obtained losses, and whether the legal structure should include a short-cut mechanism for removing fiduciaries or obtaining corporate compensation when deviance results from acts by "imperfect" agents.

Judge Posner's message is best received by recognizing both the power and limitations of his assumption about "perfect agency," and seeing that some aspects of agency-cost analysis may not be particularly helpful in studying the governance aspects of deviance undertaken in furtherance of the corporate interest. His analysis does suggest that, at best, shareholders would be intermittently concerned about corporate deviance.

about shareholder incentives to supervise criminal behavior raise an important issue about the shareholders' role in enforcing law compliance by corporate actors. If shareholders are without meaningful incentives to supervise corporate misconduct, whether ex ante or ex post, any corporate deviance remedy that relies too heavily upon shareholder bargaining or enforcement will be relatively ineffective.

Judge Posner's thesis, reduced to its essence, is that corporate fines are the most appropriate criminal sanction for corporate deviance. Professor Coffee reaches a different conclusion about the appropriate criminal sanction by applying a different aspect of cost analysis. Professor Coffee suggests that corporate fiduciaries are in a far better structural position than shareholders to reduce the risk of criminal misconduct because they can participate in, or review, corporate decisions. A fiduciary protest against illegal activity before it gets out of hand would tend to prevent such misconduct because the protesting director would have to dissent publicly to avoid personal liability for the illegal activity. Particularly when assisted by a compliance program, directors and officers are relatively more effective cost bearers if the risk of deviance-related losses could somehow be shifted to them.[91] Professor Coffee urges this observation, and others, in support of individual criminal liability for corporate actors rather than complete reliance on corporate fines.[92] He also offers it as justification for retaining some degree of fiduciary liability for breach of due care when corporate illegality causes corporate losses.[93]

Economic analysis of possible market remedies for loss-causing deviance also suggests that shareholders will be less-than-perfect monitors of corporate deviance.[94] The modern rational shareholder, particularly one employing a buy-and-hold strategy, maintains a diversified portfolio to reduce firm-specific risk. However, since corporate deviance episodes tend to be irregular, and prosecution of such episodes incomplete, it would be difficult to identify ex ante what sort of firms should be included in a balanced, deviance-risk-reduced portfolio. Moreover, because any criminal prosecutions that do occur typically are one-shot affairs, the market will be less able to discount based on the likelihood of future prosecutions; consequently, shareholders will be unable to use the price function to buy greater or lesser levels of deviance risk (if the ability to make such purchases would be toler-

91. *See* Coffee, *supra* note 21, at 803.

92. *See* Coffee, *A Non-Chicago View*, *supra* note 25.

93. *See* Coffee, *supra* note 21, at 803.

94. This of course completely excludes the problem of profitable deviance: the markets will have nothing to "remedy" if the corporation has made a profit from illegal activity.

ated).[95] These modern investment strategies remove most shareholder incentives to pay regular attention to corporate specifics.[96] Diversification itself thus would tend to limit shareholder monitoring of deviance-related losses; in other words, if shareholders usually are not paying attention because they are diversified, there is little chance that they will be effective early monitors of deviance problems *as deviance problems.*[97] As already noted, profitable deviance might not disturb most shareholders. Loss-causing deviance, however, would draw shareholder attention; these losses increase the likelihood of shareholder litigation because ex ante loss-avoidance strategies, such as diversifying a portfolio or the price function discount, are not as effective against deviance-related losses as they might generally be against other forms of loss.

These various economic insights do not encourage wildly optimistic expectations about corporate governance as a general law compliance tool,[98] especially if "corporate governance" is casually identified with authentic shareholder activism of one sort or another. Economic insights do suggest, however, that corporate governance and law compliance could forge at least a limited alliance when deviance causes corporate losses. Moreover, because of the corporate plaintiff's bar, derivative enforcement of fiduciary obligation does not *depend* on rational (institutional) investors. If governance rules are drafted to exploit the plaintiff's bar as part of the governance mechanisms, a stronger case emerges for derivative enforcement of fiduciary law compliance duties.

95. *See* Coffee, *supra* note 21, at 803.

96. *See generally* Fama, *Agency Problems and the Theory of the Firm,* 88 J. POL. ECON. 288, 290–92 (1980).

97. This is different from the observation that derivative litigation should be retained in corporate deviance situations because market remedies do not respond adequately to deviance episodes. *See* Coffee, *supra* note 21, at 803. The effect of a diversified portfolio would tend to diminish a general monitoring capacity in shareholders. The largest modern shareholders are institutional and hold diversified portfolios almost without exception.

The modern institutional shareholders' investment diversification can be misleading if extended to an assumption that all institutions are careless about profitable corporate deviance. This assumption also excludes any additional deterrent effect that might be obtained from the possibility that the professional plaintiffs' corporate attorney will use derivative litigation when profitable deviance has occurred.

98. These limited expectations are shared, from a different point of view, by both Professors Cox and Coffee. *See supra* note 23. Their disagreement turns on the propriety of tolerating (or encouraging) professional plaintiffs' attorneys that pursue ex post remedies for general law violations.

5. *Hidden Causes and Consequences*

In addition to specific structural or sociological impediments to coordinating a complex firm, corporate deviance reduction is difficult because its effects often are hard to discover, particularly for those not involved in the organization's day-to-day activities. Shareholders are at considerable perceptual "distance" from internal corporate workings; this is matched by legal "distance" from those workings as well, because fiduciary liability to shareholders stops with senior management. If this distance is an impediment to shareholder supervision, shareholder enforcement also would be diluted because many of the harms caused by corporate conduct may have long latency periods.[99] Environmental and products liability problems are the most easily identifiable examples of long-latency harms. Other behaviors, such as price-fixing, have real but diffused effects; some effects may be so diffuse as to appear to some as "victimless" wrongs.[100]

A somewhat related observation is that the victims of corporate deviance fall into distinct groups whose interests may not always coincide. Shareholders, employees, suppliers, customers, competitors, neighbors, the local community, and the public at large frequently will have different perspectives on corporate behavior because not all suffer identical harm from particular corporate acts.[101] In other words, the wrongdoing's "visibility" may vary, which makes the efficacy of a particular deviance preventative or remedy depend greatly on which group is most affected by the harm in question. Finally, organizational theory and common sense both would predict that discovery often is hindered further by cover-up behaviors, whether undertaken for good or bad motives.[102] Altogether, these discovery problems further complicate any attempt to rely on shareholder enforcement by actions against corporate fiduciaries.

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99. This would be especially true for environmental and product liability problems. *See* ERMANN & LUNDMAN I, *supra* note 39, at 20–21.

100. *See* Kramer, *Corporate Criminality: The Development of an Idea*, in CORPORATIONS AS CRIMINALS 13-37 (E. Hochstedler ed. 1984).

101. *See generally* ERMANN & LUNDMAN I, *supra* note 39, at 24–126.

102. *See* M. CLINARD, *supra* note 7, at 114–29, 153–63. Clinard's survey reveals one "good faith" behavior with a coverup effect. Middle managers prefer to handle deviance episodes internally, on the theory that the organization is better equipped to deal with the problem than outsiders would be. Recognizing this managerial attitude aids in understanding coverup behaviors; it does not determine, however, whether all those affected by corporate deviance should be bound absolutely by managers' rosy self-assessment of their institutions as compliance mechanisms.

6. Summary

Corporate deviance is not a unitary phenomenon, and is shaped by many structural and informational characteristics of the corporate form of business organization. Legal noncompliance is not confined to the boardroom, the shop floor, or anywhere in between. "Opportunities" for deviance are created in part by the decentralized nature of a complex firm, and are exacerbated by information blockages and authority leakage within the firm. Blockages and leakage may increase with the size of the firm. Even when internal evidence of noncompliance comes to light, correction can be obstructed by responsibility-shirking conduct (such as information suppression, decision-burying, and persistence behaviors) and by norm erosion. Shareholders may be imperfect monitors of corporate deviance because their limited liability and diversification reduce (but do not completely eliminate) incentives to police deviance.

Organizational realities also complicate efforts to control or reduce corporate deviance. Information blockages and authority leakage work against supervision by higher managers and invite coordination failures. Shareholders are in a relatively poor position to monitor compliance if their corporate interests are unharmed by the misconduct, although the stock price function would trigger some monitoring, by exit through stock sale or otherwise, if the deviance is costly to the firm. If given appropriate incentives, the plaintiff's corporate bar might provide more predictable deviance enforcement. Appreciation for these social functionaries is an acquired taste,[103] however, and, at the very least, requires abandoning naive models of shareholder "democracy" or "ownership."

On the whole, then, the law compliance obligation enforced by derivative litigation is a problematic corporate governance mechanism. It is unexceptionable that corporate governance rules should do nothing to encourage corporate deviance; whether corporate governance doctrine can do much more than that is harder to ascertain. It is possible to expect too much of corporate structures. For example, if the corporate deviance occurs deep within the organization, corporate fiduciaries will have a difficult time in supervising corporate conduct to prevent deviance, mostly because baseline levels of information blockage would tend to increase as subgroups suppressed evidence of their misconduct. Organizational and economic theory thus would counsel relatively modest expectations of shareholder policing of cor-

103. *See supra* note 29.

porate misconduct.[104] Nevertheless, because these theories also show how corporate structures themselves create deviance opportunities, they do not reject out of hand a corporate interest in reducing deviance.[105]

The theoretical prediction of barriers to fiduciary supervision efforts and of weak shareholder response to general corporate deviance also makes it likely that fiduciary law would be relatively undeveloped in dealing with deviance problems. Because fiduciary supervision is difficult and shareholders are sporadic monitors, derivative enforcement of general law compliance duties will be a rare phenomenon. And if basic enforcement is infrequent, few cases would be reported on shareholder litigation about corporate deviance. This would prevent much doctrinal refinement at least when compared to more frequently litigated questions in contract or tort. These expectations about doctrinal scarcity are borne out in the caselaw of fiduciary obligation and corporate deviance.

B. Corporate Fiduciary Doctrine

Traditional corporate legal doctrine took its basic forms well before the *Principles* were drafted, and the discussion that follows will describe corporate governance rules more or less as they existed when the reporters began working on the Corporate Governance Project. In both caselaw and statutes, corporate governance rules reflect the central role played by corporate fiduciaries in corporate affairs. These rules also reveal the tension between managerial autonomy and accountability because they acknowledge managerial hegemony while subjecting it to fiduciary duties of care and loyalty. Delaware law provides a convenient example of the basic pattern:

> A cardinal precept of [Delaware's] General Corporation Law . . . is that directors, rather than shareholders, manage the business and affairs of the corporation. . . . Section 141(a) states in pertinent part:

104. Relatively higher levels of shareholder monitoring might occur when shareholder interests are harmed by a general law violation, or when the corporate misconduct is so stupendously egregious that some members of a widely-held company's shareholder class become concerned about it. But this would leave many general law violations unsupervised by shareholder response, a state of affairs fully intended under the *Principles*. *See* Coffee, *supra* note 21, at 817; *see also infra* notes 265–84 and accompanying text.

105. *See supra* notes 54–68 and accompanying text. Especially for this inquiry about the ALI's *Principles*, it remains to be seen whether corporate governance doctrine should attempt to create additional deterrence of profitable deviance by permitting derivative litigation about these episodes. This litigation threat arguably would create additional ex ante incentives for fiduciaries to avoid knowing misconduct and to supervise law compliance more carefully.

> "The *business and affairs* of a corporation organized under this chapter *shall be managed by or under the direction* of a board of directors except as may be otherwise provided in this chapter or in its certificate of incorporation." . . . The existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders.[106]

Even this overly simplified summary shows that corporate managerial power lies with the board of directors, and with the officers the board appoints to perform actual day-to-day supervision of corporate affairs. Shareholders exercise formal corporate decision-making power in relatively few situations,[107] although shareholders as a group are far from powerless in the corporate order.[108] One constraint on managerial power, among many others,[109] is fiduciary duty to the corporation as a whole; this binds the directors as well as the officers appointed by the board to supervise corporate affairs on a full-time basis.[110] Corporate fiduciary duties traditionally have been enforced by the shareholder derivative suit, in which a representative shareholder sues on the corporation's behalf to recover for harm done to the corporation by the director or officer who has breached a fiduciary duty.[111]

106. Aronson v. Lewis, 473 A.2d 805, 811–12 (Del. 1984) (citations omitted). *Aronson* is not an ordinary business judgment rule case that applies the standard to an underlying business decision. Instead, the *Aronson* court was struggling to determine when demand should be excused; but its textual description of the business judgment standards are conveniently complete for this Article's purposes.

The Delaware Supreme Court recently reiterated this view of managerial/shareholder relations in Paramount Communications v. Time, Inc., 571 A.2d 1140, 1150, 1154 (Del. 1990).

107. These situations include shareholder voting during directors' elections, mergers, exceptional reorganizations, charter amendments, and voting on shareholder proposals. *See generally* Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy,* 23 GA. L. REV. 97, 104–05 (1988).

108. In addition to director election and proxy voting campaigns, shareholder responses include institutional shareholder lobbying, institutional participation in the market for corporate control, and the ordinary buying and selling of shares. *See id.* at 147–51, 155–63.

109. The *Principles* recognize that corporate governance is not dependent solely on legal rules:

> A variety of social and market forces . . . operate to hold corporate officials accountable: the professional standards of managers, oversight by outside directors, the disciplinary power of the market, and shareholder voting—all these mechanisms plus the regulatory authority of governmental agencies . . . constitute significant protections . . . .

Draft No. 8, *supra* note 31, at 3.

110. *Id.* at 3–7.

111. *Id.*

1. *The Business Judgment Rule*

The derivative suit is hedged about by several obstacles.[112] The most fundamental obstacle is the business judgment rule. Returning again to Delaware's formulation:

> The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors [and officers] under Section 141(a). . . . It is a presumption that in making a business decision the directors [and officers] of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best

112. These include the demand rule, *see, e.g.*, FED. R. CIV. P. 23.1; the contemporaneous shareholder rule, *see, e.g.*, DEL. CODE ANN. tit. 8, § 327 (1989); bond requirements in certain states, *see, e.g.*, N.Y. BUS. CORP. LAW § 627 (McKinney 1989); and the corporate power to dismiss derivative litigation, *see infra* notes 180–93 and accompanying text.

These procedural hurdles are imposed because derivative litigation over managerial conduct could, if encouraged, undermine managerial autonomy. The derivative suit, and recent judicial revisions of its procedures, have generated a great deal of commentary. A representative sample includes: Batista, *Counsel Fees in Derivative Litigation: End of the Golden Harvest?*, 11 SEC. REG. L.J. 153 (1983); Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27 (1981); Buxbaum, *Conflict-of-Interest Statutes and the Need For a Demand On Directors in Derivative Actions*, 68 CALIF. L. REV. 1122 (1980); Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (Summer 1985); Coffee & Schwartz, *Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Cox, *Heroes In the Law: Alford v. Shaw*, 66 N.C.L. REV. 565 (1988); Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959; Dent, *The Power of Directors To Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96 (1980); Emerson, *Aronson and Its Progeny: Limiting Derivative Actions Through Demand Requirements*, 19 MARQ. L. REV. 571 (1986); Fischel & Bradley, *Symposium: The Role of Liability Rules and the Derivative Suit in Corporate Law*, 71 CORNELL L. REV. 261 (1986); Gabaldon, *Free Riders and the Greedy Gadfly: Examining Aspects of Shareholder Litigation As an Exercise in Integrating Ethical Regulation and Laws of General Applicability*, 73 MINN. L. REV. 425 (1988); Harris, *Derivative Actions Based Upon Alleged Antitrust Violations: A Trap For the Unwary*, 37 BROOKLYN L. REV. 337 (1971); Jones, *Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U.L. REV. 542 (1980); Kaplan, *The Business Judgment Rule: Generally and As It Affects Derivative Actions*, 12 INST. ON SEC. REG. 3 (1981); Kessler, *Shareholder Derivative Actions: A Modest Proposal to Revise Federal Rule 23.1*, 7 U. MICH. J.L. REF. 90 (1973); Payson, Goldman & Inskip, *After Maldonado—The Role of the Special Litigation Committee and Dismissal of Derivative Suits*, 37 BUS. LAW. 1199 (1982); Soderquist, *Reconciling Shareholders' Rights and Corporate Responsibility: Close and Small Public Corporations*, 33 VAND. L. REV. 1387 (1980); Steinberg, *The Use of Special Litigation Committees to Terminate Share-holder Derivative Suits*, 35 U. MIAMI L. REV. 1 (1980); *Symposium: Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 1 (Summer 1985); Note, *Effect of Res Judicata on Shareholder Derivative Actions in New York: Parkoff v. General Telephone & Electronics Corp.*, 47 ALB. L. REV. 145 (1982); Comment, *Attorney As Plaintiff and Quasi-Plaintiff in Class and Derivative Actions: Ethical and Procedural Considerations*, 18 B.C. INDUS. & COM. L. REV. 467 (1977); Note, *Demand On Directors in a Shareholder Derivative Suit When the Board Has Approved the Wrong*, 26 B.C.L. REV. 441 (1985); Comment, *Shareholder's Derivative Suits and Shareholders' Welfare: An Evaluation and A Proposal*, 77 NW. U. L. REV. 856 (1983); Comment, *Appealability of District Court Orders Disapproving Proposed Settlement in Shareholder Derivative Suits*, 32 VAND. L. REV. 981 (1981).

> interests of the company. . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[113]

The business judgment rule articulates a judicial policy of extreme deference to corporate managers; courts constantly reiterate their unwillingness to second-guess business decisions.[114] Consequently,[115] a representative plaintiff's success on the merits in derivative litigation against corporate fiduciaries depends almost entirely on avoiding application of the business judgment rule to the managerial conduct at the root of the lawsuit.[116] The relationship between the fiduciary duties and the business judgment rule can be articulated as claims and defense, or as two sides of the same coin. In either expression, the duties and the rule are inextricably bound together as *the* legal doctrine that governs the powers and responsibilities of corporate managers.

2. *Fiduciary Duties*

If judicial deference and business judgment rule protection are the normal case,[117] actionable fiduciary breaches would be the exceptions. Fiduciary duty in corporate law usually is broken down into two distinct duties, the duty of care and the duty of loyalty. Of the two, the duty of loyalty's relationship to business judgment rule protection is easier to grasp. Directors and officers breach their duty of loyalty by failing to act disinterestedly in their corporate dealings. Under traditional reasoning, only disinterested fiduciaries may claim business

113. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

114. Judges often confess a general unwillingness to interfere with business operations as they analyze cases under the business judgment rule:

> [I]t is not [the courts'] function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve.

Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928); *see also* Wheeler v. Pullman Iron & Steel Co., 143 Ill. 197, 207, 32 N.E. 420, 423 (1892) (courts of equity will not undertake to control the policy or business methods of a corporation, although it may be seen that a wiser policy might be adopted and the business be more successful if other methods were pursued); Dodge v. Ford Motor Co., 204 Mich. 459, 508, 170 N.W. 668, 684 (1919) ("The judges are not business experts.")

115. This assumes that the plaintiff overcomes the other significant but nominally procedural obstacles to derivative litigation. *See supra* note 112.

116. In modern cases, this avoidance is brought into high relief by judicial recognition of special litigation committees used to dismiss derivative suits.

117. This certainly is the case in gross statistical terms, given the millions of corporate managerial decisions that never provoke demand or litigation.

judgment protection, because corporate directors and officers may not exploit their corporate positions for personal benefit at the corporation's expense. "From the standpoint of interest, this means that [corporate fiduciaries] can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[118] Although interested transactions are no longer generally prohibited or void, a corporate fiduciary may not obtain business judgment rule protection where a conflict of interest is present, unless the transaction is approved by a majority of disinterested directors,[119] or stockholders,[120] after the conflict is disclosed.

On the other hand, the duty of care's interaction with the business judgment rule is most easily understood by treating the duty of care merely as an alternative expression of the business judgment rule. Courts frequently recite that corporate directors and officers must act with that degree of care and skill that would be exercised by an ordinarily prudent person in similar circumstances.[121] The courts have not agreed, however, on the standard of care's precise wording. The rule in Delaware now is that a disinterested director or officer would breach the duty of care only by conduct equivalent to gross negligence,[122] although most states still impose an ordinary care standard.[123] The modern version of the business judgment rule avoids linguistically confusing negligence terminology: a fiduciary who acts on an informed basis, in good faith, and in the honest belief that the action taken is in the best interests of the company discharges the duty of care and is entitled to business judgment protection.[124]

118. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

119. *Id.* (citations omitted).

120. Shareholder ratification to purge any taint of interest is authorized by the Revised Model Business Corporations Act § 8.31(a)(2) (1984) ("A conflict of interest transaction is not voidable by the corporation solely because of the director's interest in the transaction if . . . the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction . . . .").

121. This form of expression can be traced even to Briggs v. Spaulding, 141 U.S. 132, 147 (1891) ("The degree of care required depends upon the subject to which it is to be applied, and each case has to be determined in view of all the circumstances.").

122. *Aronson,* 473 A.2d at 812 (citations omitted).

123. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 4, 1985) 39–41 [hereinafter Draft No. 4].

124. *See Aronson,* 473 A.2d at 812; *see also infra* note 221. Slightly more functionalist language permits an alternative formulation, that directors must be disinterested, independent, and informed to obtain the protection of the business judgment rule. *See* Gries Sports Enters. v. Cleveland Browns Football Co., 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986).

This summary does not begin to describe the difficulties inherent in judicial review of corporate decision-making,[125] or to recount the recent controversies over the business judgment rule and the duties of care and loyalty. But it does facilitate discussion of those relatively rare cases in which courts have reviewed corporate decisions implicated in acts of corporate deviance.

C. *The Caselaw of Corporate Deviance as Fiduciary Breach*

The cases that discuss corporate deviance in fiduciary breach terminology are not confined to any one era. Instead, they have occurred at relatively long intervals. And though deviance cases are exceedingly rare in the law reports, those that exist do apply familiar corporate fiduciary obligation and litigation doctrines to an easily identifiable subclass of cases. Three distinct questions about corporate deviance fiduciary cases will serve to introduce the practical relationship between traditional corporate doctrines and corporate deviance. First, because the business judgment rule is crucial in deciding state-law claims against corporate fiduciaries, it is important to know whether the courts have broadly invoked the business judgment rule to protect those fiduciaries from liability when the disputed conduct involves general law violations by corporate actors. Second, if general judicial deference to business judgment does not immunize the underlying conduct, the development of alternative devices for controlling derivative suits and reducing fiduciary liability is predictable and significant. Finally, although fiduciary doctrine aims at a limited class of defendants (the directors and officers), corporate deviance can manifest itself not only in the boardroom but also in other corporate locations;[126] therefore, it is important to know whether the fiduciary caselaw distinguishes between direct fiduciary involvement cases and failure to supervise cases.[127]

125. Despite the problems in articulating the standards, judicial scrutiny of managerial conduct more or less amounts to identification of those factual patterns in which a conflict of interest situation has not been adequately purged by disclosure, recusal and disinterested approval, or in which managers have acted without sufficient information, or in bad faith, or without an honest belief that the actions taken are in the corporation's best interest. The disputes arise in applying these standards to the highly complex factual situations represented by corporate decision-making. Behind this reconstruction of judicial scrutiny in corporate cases, the rarity of judicial departures from extreme deference helps to deter casual or half-hearted litigation about managerial conduct.

126. *See supra* notes 37–53 and accompanying text.

127. *See supra* text following note 33.

1. *The Business Judgment Rule in Corporate Deviance Cases*

Scarce as it is, fiduciary doctrine in corporate deviance cases is special because it does not automatically apply the business judgment rule to managerial acts in violation of law. This refusal is most clearly articulated in *Miller v. AT & T.*[128] In *Miller,* AT & T shareholders sued derivatively and alleged that, by failing to take any action to collect a $1.5 million debt for communications services provided by AT & T to the Democratic National Committee during the 1968 Democratic national convention, AT & T's directors and officers had violated the campaign spending laws by making an illegal contribution to the committee.[129] The trial judge invoked the business judgment rule and dismissed the complaint.[130] The Third Circuit reversed, holding that business judgment rule protection was inappropriate under the circumstances:

> Had plaintiffs' complaint alleged only failure to pursue a corporate claim, application of the sound business judgment rule would support the district court's ruling that a shareholder could not attack the directors' decision. . . . Where, however, the decision not to collect a debt owed the corporation is itself alleged to have been an illegal act, different rules apply. When New York law regarding such acts by directors is considered in conjunction with the underlying purposes of the particular statute involved here, we are convinced that the business judgment rule cannot insulate the defendant directors from liability if they did in fact breach 18 U.S.C. § 610, as plaintiffs have charged.[131]

Miller's restatement of New York fiduciary doctrine accurately reflects early articulations of the business judgment rule,[132] as well as

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128. 507 F.2d 759 (3d Cir. 1974).

129. *Id.* at 761. The illegal contribution was an amount equal to the "forgiven" debt.

130. The Third Circuit reversed the district court, but not because the trial judge had applied the wrong legal standard. Although the trial judge invoked the business judgment rule and dismissed the claims, he stated that such dismissal was proper in the absence of an allegation that the directors' conduct was "plainly illegal, unreasonable, or in breach of a fiduciary duty." Miller v. AT & T, 364 F. Supp. 648, 651 (E.D. Pa. 1973), *rev'd,* 507 F.2d 759 (3d Cir. 1974). The Third Circuit reversed because the trial court had failed to give the derivative plaintiffs the opportunity to allege and prove that the uncollected debt was in fact a violation of federal campaign spending laws. *Miller,* 507 F.2d at 763–65.

131. *Miller,* 507 F.2d at 762. The Third Circuit identified shareholders as "within the class for whose protection the statute was enacted," and used this observation to bolster its reasoning. *Id.* at 763. However, the court did not appear to make its decision turn on this observation; and its analysis of *Roth* and *Abrams* would not have supported this requirement because neither Sunday closing nor "runaway shop" laws are enacted to protect shareholders.

132. In what may be the earliest business judgment case, Briggs v. Spaulding, 141 U.S. 132 (1891), the Supreme Court did not attempt to enunciate its corporate fiduciary standards so broadly as to encompass corporate losses caused by illegal acts committed by corporate fiduciaries, or condoned by them. "It is not contended that the defendants knowingly violated,

holdings in actual fiduciary breach cases arising from corporate deviance. The earliest case appears to be *Roth v. Robertson.*[133] In *Roth,* a close corporation shareholder sued the corporation's managing director. The director admittedly had used corporate funds to pay $800 in "hush money" to extortionists, who had threatened to complain to local authorities about unlawful Sunday operation of the corporation's amusement park.[134] The plaintiff argued that the defendant should reimburse the corporation for funds expended in an illegal manner, even if paid in furtherance of a corporate interest.[135] The court allowed corporate recovery against the defendant director on the theory that corporate fiduciaries should be held strictly accountable for illegal payments.[136] Because the illegal transaction was "one bad in morals,"[137] the court refused to accept as an excuse the defendant's uncontroverted assertion of his subjective belief that the payments were in the corporation's best interests.[138]

The business judgment rule is not mentioned in the *Roth* opinion, even to distinguish its application. It is not likely, however, that the rule would have shielded Robertson even if it had been cited. Most telling is the fact that *Roth* imposes liability on a director with no allegation or proof of personal profit by the director from the illegal act.[139] Clearly, the *Roth* court does not analyze fiduciary liability for illegal corporate acts in breach of loyalty terms, choosing instead to compare the case to fiduciary liability for losses caused by ultra vires

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or permitted the violation of, any of the provisions of the banking act, or that they were guilty of any dishonesty in administering the affairs of the bank . . . ." *Id.* at 145.

133. 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909).

134. *Roth,* 118 N.Y.S. at 352. The legal prohibition involved in *Roth* has a turn-of-the-century quaintness about it. *Roth* was decided well before the constitutional controversy about Sunday closing laws. Many such laws have been repealed, or have fallen into desuetude, although certain regions of the country maintain de jure or de facto Sunday closing practices. It appears that *Roth*'s factual pattern furnishes part of the model for illustration 9 to § 2.01(a), which confirms the corporate power to disregard unenforced and decaying laws to the same extent as a natural person. *See* Draft No. 2, *supra* note 17, at 35–36.

135. *Roth,* 118 N.Y.S. at 352.

136. The court stated:

> For reasons of public policy, we are clearly of the opinion that payments of corporate funds for such purposes as those disclosed in this case must be condemned, and officers of a corporation making them held to a strict accountability, and be compelled to refund the amounts so wasted for the benefit of stockholders. . . . To hold any other rule would be establishing a dangerous precedent, tacitly countenancing the wasting of corporate funds for purposes of corrupting public morals.

Id. at 353.

137. *Id.*

138. *Id.*

139. *Cf.* Di Tomasso v. Loverro, 250 A.D. 206, 293 N.Y.S. 912 (close corporation directors who personally profited from an illegal, anti-competitive contract between their corporation and

acts.[140] And the court unequivocally regards outright law violations as worse than ultra vires acts.[141]

The issue of fiduciary liability for corporate illegality reached New York's highest court in *Abrams v. Allen.*[142] *Abrams* was a "runaway shop" case: the defendants allegedly had caused corporate losses to Remington Rand, Inc., by closing and dismantling profitable corporate plants "solely for the purpose of discouraging, intimidating and punishing its employees"[143] and in contravention of state and federal labor laws.[144] After noting that New York law would recognize claims against directors for corporate damages from using corporate property for the doing of an unlawful or immoral act,[145] the Court of Appeals treated the allegations of illegality and loss as sufficient to state a claim of fiduciary breach.[146] Like the trial judge in *Roth,* the *Abrams* court makes no direct reference to the business judgment rule. When these holdings are combined with the refrain in other fiduciary cases that illegal acts are not protected by the business judgment rule, it becomes clear that the Third Circuit, writing nearly thirty years later in *Miller,* correctly restates and applies state fiduciary doctrine in corporate deviance cases. As a doctrinal matter, courts refuse to treat illegal corporate conduct as a species of ordinary business decision-making that lies beyond judicial review.

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another held personally liable to another shareholder/director on a direct shareholder claim), *aff'd,* 276 N.Y. 551, 12 N.E.2d 570 (1937).

Hill v. Murphy, 212 Mass. 1, 98 N.E. 781 (1912), is not on all fours, but is closer to "personal benefit" cases than "corporate benefit" cases. In *Hill,* directors libelled Hill, another officer and director, by statements concerning Hill's performance of his corporate duties. Hill sued successfully for libel, and then prosecuted a derivative action against the tortfeasing directors to reimburse the corporation for damages paid to Hill. The opinion treats this intentional tort as an illegal act, and one done by the defendants "to gratify their own personal ends." 98 N.E. at 782.

140. *See Roth,* 118 N.Y.S. at 353.

141. *Id.*

142. 297 N.Y. 52, 74 N.E.2d 305 (1947).

143. 74 N.E.2d at 306. This can be analogized to the shareholder proposal case involving Dow Chemical, in which corporate executives pursued their own commitment to the Vietnam conflict despite its negative effect on corporate profits. *See* Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated,* 404 U.S. 403 (1972). In *Abrams,* the corporate directors vented their personal animosity to new labor laws at the shareholders' expense.

144. "That the public policy of this State and nation is opposed to the closing or removal of factories, for such purposes as are here asserted, is obvious." *Abrams,* 74 N.E.2d at 307 (citations omitted).

145. *Id.* at 306–7.

146. *Id.* at 307. In upholding this pleading, the Court of Appeals reversed the Appellate Division and reinstated the trial judge's ruling that the complaint was sufficient. Part of the New York courts' development here must be attributed to the growing acceptance of notice pleading in mid-twentieth century.

After *Roth, Abrams,* and *Miller,* state law would seem to favor well-pleaded derivative suits based on corporate illegal acts undertaken by corporate fiduciaries. At least, these suits are "favored" in comparison with most derivative challenges to managerial decisions, which typically have short and unsuccessful lifespans in the face of business judgment rule protection. This favored status is not absolute, however, because corporate deviance cases face other procedural hurdles.

2. *Procedural Restraints on Corporate Deviance Suits*

a. *Proof of the Underlying Violation*

In *Miller,* the Third Circuit reviewed a motion to dismiss for failure to state a claim upon which relief can be granted,[147] and treated the allegations in the complaint in the light most favorable to the plaintiffs.[148] Although the court considered the complaint's short-hand reference to 18 U.S.C. § 610 as an allegation sufficient to survive a motion to dismiss,[149] it stated that the plaintiffs could not recover on the corporation's behalf without "prov[ing] the elements of the statutory violation as part of their proof of breach of fiduciary duty."[150] This burden of proof could be quite substantial in some cases, and would depend on the nature of the violations charged.[151] *Miller* does not suggest, however, that derivative plaintiffs would be required to prove the underlying violation by more than a preponderance of the evidence.[152] These proof problems would be reduced somewhat by the fact that most corporate deviance derivative suits will be brought after criminal prosecutions or investigations by government agencies.[153] In any event, *Miller*'s insistence upon proof of the underlying violation accords with the leading New York cases. In *Roth,* the defendant director admitted the improper payments.[154] The *Abrams* court, like

147. *See* FED. R. CIV. P. 12(b)(6).

148. *See* Miller v. AT & T, 507 F.2d 759, 761 (3d Cir. 1974).

149. *Id.* at 763–64.

150. *Id.* at 764.

151. As a general matter, it would be expected that strict liability offenses, for example, will be easier to prove than intent crimes. The *Miller* court extensively discussed the necessary proof of the underlying violation. *See id.* at 764–65.

152. There are no significant due process issues raised by permitting civil derivative plaintiffs a lesser burden of persuasion. Derivative suit civil liability damages are not the same as criminal penalties, which may include loss of liberties; nor are the civil derivative plaintiff and the criminal prosecutor possessed of relatively equal resources. This aspect of the plaintiff's evidentiary burden has not been directly addressed in the ALI's *Principles.*

153. The impact of issue preclusion doctrine on corporate deviance derivative suits brought after criminal prosecutions is beyond this Article's scope.

154. Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351, 352 (Sup. Ct. 1909).

that in *Miller*, ruled on a dismissed complaint, and treated the accusations of law violations as facts to be proven at trial.[155]

b. Pleading and Proving Corporate Loss

It is almost axiomatic in civil suits that a remedy will not be provided unless the party seeking judicial relief shows that it, or those it represents, suffered (or will suffer) injury or harm caused by the defendant's conduct. For much of their history, derivative suits were no exception. In fiduciary breach cases, the derivative plaintiff was unable to recover for the corporation against individual officers or directors without showing some damage or injury to the corporation.[156] This requirement has not been especially significant in ordinary fiduciary cases involving a breach of the duties of care or loyalty.[157] However, the damages issue has been particularly troublesome in fiduciary cases arising from corporate deviance episodes. This is so because corporate deviance can be profitable to the corporation. Obviously, it is possible to make money by violating the law: if the gains obtained from corporate deviance exceed the sum of all losses attributable to the illegal conduct, it is hard to express in monetary terms just how the corporation has been "damaged" by fiduciary participation in illegality, or by managerial failure to prevent the illegal conduct.[158] On the other hand, restricting derivative recovery to those

155. Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305, 306–07 (1947).

156. *See generally* Note, *Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions,* 64 COLUM. L. REV. 174, 176 n.10 (1964). Some cases have recognized a deterrence interest, most notably Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), discussed *infra* at notes 175–76 and accompanying text. *Diamond* was not decided on pure deterrence grounds because the New York Court of Appeals did consider the possibility that the corporate plaintiff had suffered indirect damages to its reputation and its ability to raise capital from its fiduciaries' inside trading.

157. In a run-of-the-mine duty of care case, the defendants' negligent management (under Delaware law, their grossly negligent management) must have caused corporate losses. Because of the shareholders' focus on stock price, the existence of threshold litigation costs, and the corporate bar's role in selecting cases for prosecution, however, not every corporate loss triggers a lawsuit. Instead, care cases would be initiated after a loss significant enough to draw shareholders' or counsel's attention, and the judicial task would be to decide whether the unhappy outcome is beyond the realm of ordinary business loss attributable to an imperfect world. In a traditional loyalty case, fiduciaries' diversion of corporate assets or opportunities for their own use is even more easily seen by the courts to have caused harm to the corporate fisc.

158. Individual deviance cases pose no such intellectual puzzle, because the indivisible legal identity of individuals makes something like derivative litigation impossible. Individuals cannot sue themselves for undertaking illegal conduct. On the other hand, intracorporate litigation over deviance is possible because the corporate entity includes distinct subgroups like shareholders and managers. Reduced to its essentials, the issue is whether the managerial subgroup should be forced to reimburse the corporate collective when the collective's overall economic standing was not damaged by the illegal activity.

cases where corporate deviance has resulted in a "net loss" to the corporation would make corporate doctrine appear to tolerate illegal activity if the crime *did* pay. This tension between the derivative suit's traditional role as a loss compensation device and its potential to provide deterrence against corporate illegality has left a confusing legacy in the case law, and the courts have struggled with pleading and proof of damages when a fiduciary breach claim involves illegal activity.

Once again, it is the New York courts that have addressed this problem. The cases are not fully reconcilable, although it is possible to identify conflicting policies that account for some of the differences in results. The gradual development of notice pleading through the first half of this century caused part of the confusion.[159] In early deviance cases, some lower courts insisted on specific pleading of damages.[160] When *Abrams v. Allen*[161] finally presented the New York Court of Appeals with a corporate deviance derivative suit, the complaint contained an allegation of corporate loss.[162] Significantly, however, the *Abrams* court was satisfied with a general allegation that the corporation had suffered losses, and did not insist on specific pleading of those losses.[163]

159. *See generally* J. FRIEDENTHAL, M. KANE & A. MILLER, CIVIL PROCEDURE 252–57 (1985).

160. "The acts complained of . . . are not such that injury to the corporation would ordinarily be inferred therefrom as the natural and probable result thereof. Facts establishing damages, rather than a conclusory allegation of waste, should be pleaded." Diamond v. Davis, 263 A.D. 68, 31 N.Y.S. 582, 583 (1941) (affirming trial court's dismissal of derivative complaint's sixth cause of action based on Robinson-Patman Act violations because complaint failed to allege facts showing harm to corporation or establishing the violation; pleading the consent decree held insufficient); *see also* Spinella v. Heights Ice Corp., 186 Misc. 996, 62 N.Y.S.2d 263 (Sup. Ct. 1946) (trial court dismissed fourth amended complaint in derivative action based on antitrust violation for lack of specific allegation of corporate loss or damage in connection with the unlawful practices; mere written allegation of defendant's nolo contendere plea and accurate oral description of $1000 fine insufficient to show corporate loss); Hoffman v. Abbott, 180 Misc. 590, 40 N.Y.S.2d 521, 525 (Sup. Ct. 1943) (trial court dismissed derivative claims based on monopolistic practices by General Electric for lack of specific pleading "showing damage to the corporate defendants"). Justice Shientag decided both *Spinella* and *Hoffman.* These cases do not acknowledge *Roth*'s existence in the law reports, much less distinguish it.

Compare the foregoing cases to Van Schaick v. Aron, 170 Misc. 520, 10 N.Y.S.2d 550 (Sup. Ct. 1938), and Van Schaick v. Carr, 170 Misc. 539, 10 N.Y.S.2d 567 (Sup. Ct. 1938) (derivative suits against insurance company directors by state insurance authorities in liquidation actions, attempting to recover amounts equal to bad investments and loans made in violation of statutory restrictions); and to Broderick v. Marcus, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934) (derivative suit against bank directors by state banking authorities in liquidation action, attempting to recover amounts equal to bad loans made in violation of statutory loan restrictions).

161. 297 N.Y. 52, 74 N.E.2d 305 (1947).

162. 74 N.E.2d at 306.

163. *Id.*

The shift to notice pleading, however, does not fully explain the damages cases, which also reflect a fundamental disagreement about derivative recovery in corporate illegality cases. For example, in *Roth,* the trial judge imposed liability without regard to the ultimate profitability of paying "hush money" to permit continued illegal Sunday operation of the amusement park,[164] and expressly rejected the defendant's attempt to assert that the questionable payment was in the corporation's best interests.[165] Although neither party specifically addressed whether the corporation actually would have profited by paying its extortionists, *Roth* appears to reject such arguments out of hand as a matter of public policy when the act is illegal.[166] The trial judge reasoned in deterrence language, citing concern about use of "corporate funds for purposes of corrupting public morals" as justification for imposing liability on the director.[167] In the *Roth* opinion, "waste" means an improper use of corporate funds; if given a broad reading, the opinion denies any excuse for the guilty director based on his attempt, successful or otherwise, to increase or preserve profits by "investing" the hush money, seeking the long-term gain from continued illegal Sunday operations at the risk of prosecution penalties from local authorities.[168]

In chastising corporate deviance, however, the *Roth* opinion does not address the possibility that derivative recovery in *profitable* deviance cases provides a windfall to the corporation. Consider the following possibilities. The easiest situation to analyze is one where deviant activity, in and of itself, causes corporate losses, such as a statutorily prohibited species of loan that turns out to be uncollectible.[169] From a corporate compensation perspective, this sort of deviance is similar to any corporate loss caused by fiduciary misadventure. No windfall recovery is involved. The fact that the loss-causing conduct

164. Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351, 352 (Sup. Ct. 1909).

165. *Roth,* 118 N.Y.S. at 352–53.

166. The opinion does not analyze the extent to which a derivative suit is designed to provide compensation to the corporation for managerial misadventure, and the court does not specify how the corporation might have been damaged by the managing director's hush money payments. *See id.*

167. *Id.*

168. It is possible to speculate whether the director actually made some calculations along these lines, evaluating among other things the willingness of the potential informers to stay satisfied with their bribes, the possibility for future, additional informers, and the likelihood of independent prosecution from the state.

169. *See, e.g.,* Van Schaick v. Aron, 170 Misc. 520, 10 N.Y.S.2d 550 (Sup. Ct. 1938); Van Schaick v. Carr, 170 Misc. 539, 10 N.Y.S.2d 567 (Sup. Ct. 1938); Broderick v. Marcus, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934). These cases are discussed parenthetically at note 160, *supra.*

happens to be illegal merely makes recovery an issue for trial instead of pre-trial dismissal on motion because the business judgment rule's presumption of managerial propriety does not apply to managers' knowing illegal conduct. As a policy matter, there is little point in shielding directors and officers from derivative liability when the business decision's poor outcome derives from knowing illegal conduct. No corporate good has come from the illegal activity, and its illegality reflects a social judgment that no overall social benefit accrues from the conduct. Liability in these circumstances does not create an "excessive" deterrent, because the conduct deterred is not "risky," it is unlawful. In these cases, pleading and proof of corporate loss would not be a significant problem.[170]

Profitable illegal conduct presents a different corporate loss situation. If a derivative suit is brought before a successful third-party civil suit or criminal prosecution, then the corporation has not yet experienced any corporate losses directly attributable to illegal conduct. All the illegal corporate gains would be corporate profit, though indirect losses, such as litigation expenses or loss of goodwill, might have accrued. Even if a successful prosecution has taken place, however, the corporate losses from the fines and judgments imposed, together with indirect losses, still may not exceed the illegal gains. Under all these circumstances, the illegal activity results in a net profit for the corporation. When this happens, the corporate compensation interest does not justify derivative recovery: the fines, judgments, and indirect expenses could be deemed a "cost of doing business," and no economic harm accrues to the corporation for making these expenditures. On this view, allowing corporate recovery without provable corporate losses would make a windfall of corporate deviance fiduciary claims.

By emphasizing the compensation interest and refusing to countenance corporate windfalls, the lower New York courts started to develop what ultimately came to be called the "net-loss rule." Under this rule, a corporate deviance case is pleaded successfully only when the complaint's allegations exclude the possibility that the illegal activity resulted in a net competitive gain to the corporation[171]—in other words, the corporation must have suffered a "net loss" as a result of the illegal conduct.[172] Furthermore, the lower court cases insisted

170. Compare with the court's treatment of illegal corporate conduct in Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1947), and Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351 (Sup. Ct. 1909), discussed *supra* notes 133–46 and accompanying text.

171. *See* Note, *supra* note 156, at 176–77.

172. *See* Borden v. Cohen, 231 N.Y.S.2d 902 (Sup. Ct. 1962), in which the plaintiff's complaint was dismissed, with leave to amend, for failing to allege damage to the corporation.

that plaintiff must plead and prove this net loss as a precondition to recovery.[173] However, allocating this stringent burden of proof to derivative plaintiffs is unnecessary. Windfall recoveries in corporate deviance cases also could be avoided if the derivative plaintiff is required to plead only that some corporate losses or expenditures have occurred in connection with the illegal conduct, forcing the defendants to answer that the corporation actually profited from the illegal acts.[174] Rearranging these pleading and evidentiary thresholds would make it easier to sue derivatively over illegal corporate conduct that may have caused at least some corporate losses. And the settlement dynamics would change because the defendant fiduciaries would face embarrassment from having to plead and prove that they should escape individual liability because their corporation's crimes did pay. This shift also allocates the evidentiary responsibilities more realistically to the parties' relative access to information. The defendant fiduciaries have far more complete command of the financial information that would demonstrate corporate gains or losses from the illegal conduct.

The damages rules developed by the lower New York courts assume that only a corporate compensation interest is legitimately protected by derivative suits. The New York Court of Appeals may have undermined this assumption by its language in *Diamond v. Oreamuno.*[175] In that fiduciary stock-trading case, which was pleaded under state law, the court stated:

> It is true that the complaint before us does not contain any allegation of damages to the corporation but this has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty. . . . This is because the function of such an action, unlike

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The court recited: "No damage is to be inferred from the conduct of corporate business which happens to violate the Sherman Anti-Trust Act unless the acts constituting such violation also cause independent damage to the corporation, and were against the interests and the benefit of the corporation." *Id.* at 903. In so ruling, the court apparently is unwilling to regard the $50,000 fine assessed against the defendant corporation as a corporate loss. Neither *Roth* nor *Abrams* is cited anywhere in the opinion, so *Roth*'s refusal to excuse illegal acts is not distinguished. Moreover, the *Borden* court simply ignores *Abrams*' declaration that general allegations of loss should withstand a motion to dismiss.

Other New York lower court cases have imposed a relatively strict form of the "net loss" rule. *See* Diamond v. Davis, 263 App. Div. 68, 31 N.Y.S.2d 582 (1941); Smiles v. Elfred, N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (Sup. Ct.); Spinella v. Heights Ice Corp. 186 Misc. 996, 62 N.Y.S.2d 263 (Sup. Ct. 1946). *Contra* Premselaar v. Chenery, Civ. No. 6141 (N.Y. County Sup. Ct. Feb. 18, 1963) (discussed in Note, *supra* note 156, at 175).

173. *See Borden,* 231 N.Y.S.2d at 903–04.

174. *See* Note, *supra* note 156, at 177–79.

175. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

> an ordinary tort or contract case, is not merely to compensate the plaintiff for wrongs committed by the defendant but, as this court declared many years ago . . . , "to *prevent* [wrongs], by removing from agents and trustees all inducement to attempt dealing for their own benefit in matters which they have undertaken for others, or to which their agency or trust relates."[176]

Although not strictly a corporate deviance case within this Article's definition, *Diamond* is pertinent because it treats the derivative suit as a deterrence mechanism in general terms, and does not limit the device simply to protecting the corporate compensation interest. By recognizing a deterrence interest in derivative litigation, the courts could abandon overly restrictive versions of the net-loss rule, and stop creating the impression that windfall avoidance somehow makes profitable deviance episodes tolerable. The *Diamond* court's attitude about deterrence is similar to the *Roth* court's view of corporate deviance, and turns away from the lower New York courts' strict application of the net-loss rule. No court has returned to this specific question to refine the balance between deterrence and compensation in corporate deviance cases so as to minimize possible windfall recoveries. Without guidance on this important question, the net-loss rule's present function in corporate deviance cases remains unclear.

One particular risk from an overly simplistic view of corporate harm is that the proof requirements could be drawn so narrowly that no corporation other than an insolvent one could have suffered a "net loss." On this view, a major corporation does not experience "net losses" if its income is sufficient to cover the amount of a criminal fine actually assessed, or of other losses attributable to the misconduct. And the greater the earnings, the lesser the corporation's derivative chances to recoup the deviance losses. This sort of crude accounting for net-loss purposes assumes a monolithic corporate "interest," and requires that corporate deviance have crippled the firm before derivative suits can be filed. Shifting the pleading and evidentiary burdens would change this picture considerably; other changes could enhance

176. 248 N.E.2d at 912, 301 N.Y.S.2d at 81 (emphasis in original). As already noted, *Diamond* was not decided solely on deterrence grounds. *See supra* note 156. Other courts have criticized *Diamond*'s specific holding of a state law fiduciary disgorgement remedy for corporations whose fiduciaries had engaged in inside trading. *See* Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978). The *Principles* retain *Diamond*, but attempt to modify its doctrine to limit the situations under which a corporation may obtain recovery to those tied more closely to its compensation interest. *See* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 5, 1986) § 5.04 [hereinafter Draft No. 5].

the derivative suit's ability to police or deter deviance-related losses.[177] The common law net-loss rule has lost some of its importance, however, because of recent developments in the directors' power to dismiss derivative suits.

c. Directors' Power to Control Corporate Litigation

Corporate deviance derivative suits are affected by the renewed judicial recognition of directors' power to control corporate litigation and in particular by the development of the special litigation committee as a device for dismissing shareholder derivative litigation. Derivative suits are substitutes for direct actions by the corporation and begin when the prosecuting shareholder and her lawyers disagree with the board of directors about the advisability of pursuing a particular corporate claim.

If the corporate claim lies against corporate outsiders, or "third parties," it is quite easy to see that the decision to pursue the corporate claim ordinarily would be committed to the directors' and officers' managerial discretion. In third-party cases, managers should be able to reach a reasonable decision about how to proceed on the corporate claim. The decision to sue, in and of itself, thus would be protected by the business judgment doctrine.[178] In third-party cases, a shareholder normally must make demand on the board of directors before bringing a derivative suit. If the board agrees to the demand, the corporation itself asserts the claim and the shareholder does not bring derivative litigation. If the demand is refused, the shareholder proceeds with its derivative claim; its ultimate success will depend on the shareholder's ability to plead and prove that the board's refusal to prosecute the corporate claim is wrongful (that is, not protected by the business judgment doctrine). The demand requirement insures that directors have an opportunity to decide whether to bring suit on the corporate claim, thus reinforcing the directors' normal and appropriate managerial hegemony in the corporate order.

When a corporate claim lies against corporate fiduciaries, however, the election to sue requires one group of corporate fiduciaries to determine whether to pursue litigation against fellow fiduciaries. Because corporate managers might be less than completely disinterested when fellow directors or officers face litigation threats, some courts began to excuse demand in fiduciary breach cases. Demand was usually

177. The ALI's further refinements to the net-loss rule are discussed *infra* notes 235–44 and accompanying text.

178. *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

excused only in cases where the alleged misconduct constituted a breach of the duty of loyalty. Until the late 1970s, demand excuse stripped directors of their power to control corporate litigation because their decision was not a procedural prerequisite to suit. Because demand excuse was available chiefly in duty of loyalty cases, derivative plaintiffs sought, whenever possible, to plead their claims as loyalty breaches to avoid demand. Their chances of successful recovery, either by settlement or on the merits, would be greatly improved if the courts' deference to business judgment protected neither the decision to sue nor the underlying fiduciary conduct. Although corporate deviance fiduciary breach cases are not classified as duty of loyalty suits, early New York decisions treated them as demand-excused cases.[179] This makes sense because the courts do not extend routine business judgment protection to the underlying misconduct in corporate deviance situations.

The late 1970s brought renewed recognition that corporate claims, not shareholder claims, lie at the heart of all derivative litigation, and that corporate managers should be the ones to decide whether to pursue those claims unless their decision resulted from inadequate deliberations. Demand-required cases always had preserved this managerial prerogative. Courts reestablished managerial power by permitting corporate directors to seek dismissal of derivative suits, even when demand had been excused.[180] These dismissal motions are fundamentally similar, although the courts differ about how much deference is owed to the corporate decision not to sue.[181] To obtain dismissal of a shareholder derivative suit in a demand-excused case, the board of directors appoints a special committee of directors who are charged to investigate the underlying claim and report whether it is in the corporation's best interest to pursue the claim.[182] The board usually appoints special counsel to assist the committee in making its investigation and report.[183] If the committee recommends against pursuing the claim, the corporation files a motion to dismiss the derivative suit.

Taking Delaware law as an example, a trial court faced with a corporate motion to dismiss a shareholder derivative suit first "should inquire into the independence and good faith of the committee and the

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179. *See* Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351, 354 (Sup. Ct. 1909).

180. *See* Burks v. Lasker, 441 U.S. 471 (1979); Gall v. Exxon Corp., 418 F. Supp. 508 (S.D.N.Y. 1976); Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); Alford v. Shaw, 320 N.C. 465, 358 S.E.2d 323 (1987).

181. *See infra* text accompanying notes 184–88.

182. *See, e.g., Gall,* 418 F. Supp. at 510–11.

183. *See, e.g., id.* at 514 n.12.

bases supporting its conclusions."[184] As the moving party, the corporation has the burden of proving the committee's independence, good faith, and adequate investigation.[185] If the corporation sustains its burden on these issues, a Delaware court must then "determine, applying *its own independent business judgment,* whether the motion should be granted"[186] and the suit dismissed. Other jurisdictions treat these motions somewhat differently: New York courts do not apply independent business judgment, and do not extend their inquiry past the three fundamental questions of independence, good faith, and reasonable investigation,[187] while North Carolina courts apply independent business judgment in all derivative cases, not just those in which demand is excused.[188] Exploring these distinctions among state courts is beyond this Article's scope. In any event, special committee investigations and directorial power to dismiss derivative suits are now a well-established feature in intra-corporate litigation.

The antitrust hypothetical used earlier to describe a deliberate act of corporate deviance by members of a corporate control group can illustrate how a special litigation committee would be involved in a corporate deviance derivative suit.[189] After Western Flight is fined for antitrust violations, imagine that a shareholder files suit against Western's chief executive officer (CEO), who made the noncompetition agreement. The shareholder asserts a derivative claim and seeks damages from the CEO, alleging that the criminal fine against Western constitutes corporate damage resulting from his illegal conduct. Assume further that Western's state of incorporation would excuse demand in a corporate deviance derivative suit and would not apply the net-loss rule to bar the claim as pleaded.

Western's board of directors designates three new directors to fill three empty seats on the board, and appoints them to a special litigation committee to investigate the antitrust incident. The board also names a retired state supreme court justice as special counsel to the committee. After several months' investigation, the committee files a long and detailed report that recommends against the derivative suit as contrary to the corporation's best interests. The committee bases its recommendation on three factors: the territorial allocation pact was a first violation, and no other illegal activity was uncovered by the com-

184. *Zapata,* 430 A.2d at 788.
185. *Id.*
186. *Id.* at 789 (emphasis added).
187. *See* Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).
188. *See* Alford v. Shaw, 320 N.C. 465, 358 S.E.2d 323 (1987).
189. *See supra* notes 51–52 and accompanying text.

mittee's investigation; Western suffered adverse publicity during the criminal prosecution, and wishes to limit future adverse publicity that necessarily would accompany further corporate litigation; and Western did not lose money during the anticompetitive conduct because the fines imposed did not exceed gains attributable to profits made while the illegal policy was in effect.[190]

On these imaginary facts, it is quite possible that the court would grant the corporate motion to dismiss the derivative suit. The corporation probably has met its burden of showing the litigation committee's independence, good faith, and reasonable investigation; in jurisdictions following New York's approach, this would be enough to ensure dismissal.[191] But even if the court were to apply its own independent business judgment, it is likely, in these invented circumstances, that a court also would conclude that pursuing the derivative claim is not in the corporation's best interests. Admittedly, the misconduct was a species of anticompetitive behavior, and thus violated fundamental national policies that favor a competitive market economy; however, the investigation discovered no recidivism or continuing violation. Moreover, the hypothetical as written provides no basis to contradict the committee's finding that pursuing the claim would yield no net corporate financial benefit.[192]

190. This last assumption is the largest, and corresponds least to reality. The hypothetical describes anticompetitive conduct by horizontal competitors, which is a per se violation of federal antitrust laws. The fines and civil damages (after trebling) often are significant in these cases and could reach well into the hundreds of millions of dollars. If the losses were that large, it becomes less likely that a special committee would recommend dismissal. Moreover, judges should be less willing to permit dismissal when the corporate losses are so great, for two reasons. First, the corporate compensation interest is significant when large losses are involved; second, the committee's willingness to dismiss a lawsuit when the damages are so large would tend to undermine the credibility of its recommendation against pursuing the corporate claim.

This assumption also oversimplifies the hypothetical by avoiding the difficulties already described in determining corporate loss. *See supra* notes 156–77. Because large corporate losses probably would exceed the gains obtained from a particular violation, this assumption highlights the importance of the ALI's transactional limitation in its version of the net-loss rule. *See infra* notes 235–45 and accompanying text.

The purpose of this hypothetical discussion is to illustrate the power contained in the special litigation committee device in a relatively low-stakes corporate deviance derivative suit. By implication, the hypothetical also foreshadows subsequent discussion of the ALI's adjustments to existing doctrine in corporate deviance cases.

191. There is some question whether New York would decide *Auerbach* the same way today. It was the earliest of the state law trilogy of special litigation committee cases. *See* Joy v. North, 692 F.2d 880 (2d Cir. 1982) (Judge Winter, writing for the court, predicts that Connecticut would adopt Delaware's approach in *Zapata* rather than New York's in *Auerbach*), *cert. denied*, 460 U.S. 1051 (1983).

192. *See supra* note 190.

The committee could strengthen its report and recommendation by endorsing disciplinary action against the CEO, or suggesting a modification of his responsibilities. It would further support dismissal by reporting that a compliance program had been adopted or, if already in existence, had been reviewed in the wake of the illegal activity. But this probably would not be absolutely necessary for obtaining a dismissal. In short, existing common law patterns suggest that the special litigation committee's power to dismiss is undiminished in deviance cases. Within these existing doctrinal patterns, the courts could effectively remove the law compliance component from the duty of care by giving broad deference to special litigation committees, and narrow readings to the existing corporate deviance doctrines.[193]

The corporate deviance derivative suit's special status as one of the rare exceptions to managerial business judgment protection would be substantially undercut by uncritical acceptance of the special litigation committee. If the corporate deviance derivative suit is to survive this procedural development, corporate doctrine would have to reemphasize that corporate deviance cases deserve special attention and must develop rules for managerial dismissal that reflect this favored status. But corporate doctrine should attempt to retain or restore special rules for corporate deviance derivative suits only if it can articulate sufficient reasons to justify different treatment for such suits. Like all derivative litigation, deviance suits can seem to dragoon an unwilling corporate majority into internal disputes it wishes to avoid. On the other hand, granting directors' a barely-restrained power to dismiss derivative suits as "not in the corporation's best interest" helps create the impression that corporate doctrine is unconcerned with law violations by corporate actors. The scarce existing case law has not yet resolved this conflict between corporate governance and corporate deviance.

3. *Are Direct Involvement Cases Different from Failure-to-Supervise Cases?*

The final question about the traditional case law is whether the courts have recognized distinctions between cases in which corporate

193. As will be seen in Section III, the *Principles* address these questions directly. The *Principles* should not be understood, however, as the sole bulwark against the tide of special litigation committee dismissals in deviance cases. Judges themselves would tend to be skeptical about claims that corporate deviance losses are indistinguishable from ordinary corporate losses, and would hesitate to dismiss litigation involving serious criminal law violations. The *Principles* build on this structural tendency inherent in the judiciary and attempt to construct a screening device to aid judges in deciding derivative claims involving criminal misconduct.

fiduciaries were directly involved in illegal activities, and those in which non-fiduciaries engaged in illegal conduct but fiduciaries failed make an effort to discover and prevent the unlawful behavior. The identifiable corporate deviance fiduciary breach cases all were direct involvement cases: a corporate director or officer had performed or participated in the illegalities at issue.[194] Moreover, in *Graham v. Allis-Chalmers Manufacturing Co.,*[195] the single case directly presenting a claim that corporate fiduciaries were obligated to supervise and investigate to prevent illegal activities, the Delaware Supreme Court refused to recognize a duty to inquire. *Allis-Chalmers* arose from guilty pleas by the corporation and four non-director employees to criminal indictments for antitrust violations.[196] After pretrial discovery and pleading amendments eliminated allegations that the directors actually knew, or were put on notice, of the misconduct, the plaintiffs argued that the directors were liable to the corporation in damages because they failed to take action designed to learn of, and prevent, antitrust activity by Allis-Chalmers employees.[197] The Delaware Supreme Court refused to hold that the duty of care included an obligation to investigate and prevent law violations.[198]

Although *Allis-Chalmers* is the only case that clearly presents this issue, it probably is not the most reliable precedent. Corporations now are subject to substantially more numerous general law obligations than were in effect when *Allis-Chalmers* was decided. Consequently, present day failures to monitor law compliance risk larger corporate losses than were predictable in the 1960s. This greater risk means that day-to-day loss avoidance now demands significant compliance monitoring from fiduciaries. Corporate representatives themselves recognize the need for increased monitoring.[199] Moreover, corporate law compliance has become an identifiable managerial subspecialty; it is

194. In Roth v. Robertson, 64 Misc. 343, 118 N.Y.S. 351, 352 (Sup. Ct. 1909), the defendant managing director himself had paid the hush money. In Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305, 306–07 (1947), the defendant directors had made the allegedly unlawful decision to close a profitable factory out of anti-union animus. In Miller v. A T & T, 507 F.2d 759, 761 (3d Cir. 1974), the defendant directors allegedly had approved the decision not to collect unpaid phone bills from the Democratic National Committee.

195. 188 A.2d 125 (Del. 1963).

196. *Id.* at 127.

197. *Id.*

198. *Id.* at 130–31.

199. *See The Corporate Director's Guidebook,* 33 BUS. LAW. 1591, 1610 (1978) ("The corporate director should be concerned that the corporation has programs looking toward compliance with applicable laws and regulations, both foreign and domestic, that it circulates (as appropriate) policy statements to this effect to its employees, and that it maintains procedures for monitoring such compliance."); *see also* Draft No. 4, *supra* note 123, at 48.

far more sophisticated, and yet more readily undertaken, than was assumed by the *Allis-Chalmers* court.[200] Consequently, *Allis-Chalmers* probably is no longer good law, and the fiduciary duty of care probably includes an obligation to supervise corporate law compliance.

It is harder to ascertain whether corporate fiduciary doctrine ought to create significantly different rules for direct involvement and failure to supervise cases. No cases yet decided have done so explicitly, although some judges could attempt to draw distinctions. Courts exercising independent business judgment might be less willing to dismiss direct involvement cases than failure-to-supervise cases when a special litigation committee recommends termination of the lawsuit. Although mens rea and other relative moral culpability concepts would suggest that fiduciaries who fail to supervise are less responsible for corporate deviance than fiduciaries who themselves commit law violations in the corporate name, it is not entirely clear that corporate doctrine should treat supervisory failures less harshly than direct involvement. Supervision and direction of the corporate enterprise are the fiduciary's fundamental task, and whether compensation or deterrence analysis is applied, there seems to be little reason to forgive supervision failures more readily than direct involvement in illegality. Both types of misconduct can damage the firm economically, so

200. *See generally* J. SIGLER & J. MURPHY, INTERACTIVE CORPORATE COMPLIANCE: AN ALTERNATIVE TO REGULATORY COMPULSION (1988). Other discussions of compliance programs and related problems include: W. CARNEY, THE CHANGING ROLE OF THE CORPORATE ATTORNEY (1982); W. COMEGYS, ANTITRUST COMPLIANCE MANUAL (1986); J. DIMENTO, ENVIRONMENTAL LAW AND AMERICAN BUSINESS (1986); MANAGING THE SOCIALLY RESPONSIBLE CORPORATION (M. Anshen ed. 1974); PRACTICING LAW INSTITUTE, SECURITIES ENFORCEMENT INSTITUTE 511–614 (1989); PRACTICING LAW INSTITUTE, ENVIRONMENTAL COMPLIANCE IN A CHANGING LEGAL ENVIRONMENT 431–53 (1983); PRACTICING LAW INSTITUTE, REPRESENTING DIRECTORS, OFFICERS, AND HOUSE COUNSEL OF PUBLICLY HELD CORPORATIONS 135–42 (1981); E. ROCKEFELLER, ANTITRUST COUNSELING FOR THE 1980s 164–68 (1983); M. STEINBERG, CORPORATE INTERNAL AFFAIRS 108–22 (1983); 1 J. VON KALINOWSKI, ANTITRUST COUNSELING AND LITIGATION TECHNIQUES §§ 5.01–.07 (1989); Branson, *Progress in the Art of Social Accounting and Other Arguments for Disclosure on Corporate Social Responsibility*, 29 VAND. L. REV. 539 (1976); Brodley, *Compliance*, in ANTITRUST ADVISER 505–65 (C. Hills 3d ed. 1985); Jaglom, *How to Develop a Corporate Antitrust Compliance Program*, 31 PRAC. LAW., July 15, 1985, at 75; Steinberg, *The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies—Their Influence on Corporate Internal Affairs*, 58 NOTRE DAME L. REV. 173 (1982); Small, *The Evolving Role of the Director in Corporate Governance*, 30 HASTINGS L.J. 1353, 1374–89 (1979); Tucker, *Corporate Compliance and Compensation Problems in Environmental Protection: Implications of United States v. Reserve Mining Company*, 10 NAT. RESOURCES LAW. 555 (1978); *National Institute On Preventative Antitrust*, 48 ANTITRUST L.J. 1 (1979); *Structuring Corporate Compliance Programs for Pollution Control Requirements*, 35 BUS. LAW. 1459 (1980).

neither one nor the other is a greater violation of the fiduciary obligation. In addition, treating supervisory failures less harshly may create a perverse incentive for fiduciaries to avoid investigation of questionable activities. This incentive arises because utter lack of knowledge would preclude any arguable claim of direct participation or tacit approval of illegal activity. The net result of asymmetrical penalties and procedures thus could be less supervision of corporate affairs, as directors and officers "look the other way."

Doctrinal distinctions that facilitate direct involvement cases over failure-to-supervise cases also could result in an inefficient duplication of incentives: Fiduciaries directly involved in corporate misconduct already face some deterrence from the risk of individual criminal sanctions, while criminal liability is relatively less likely in failure-to-supervise situations. Replicating this imbalance in fiduciary doctrine would tend to increase the risk of corporate deviance from inadequate supervision, and is undesirable and unjustified. All told, little would be gained by any extensive disparities in corporate doctrinal rules governing direct involvement and failure-to-supervise cases.[201] Like most other issues in fiduciary breach cases involving corporate deviance, this question is an open one.

D. Summary

Deviance theory and common law development present an interesting and complex picture. Large firms create opportunities for deviance because of their size and information channels, which tend to separate senior managers from those who implement the broad policies managers establish. As one type of large firm, business corporations also suffer from these problems, which are further complicated in the public corporation by the separation of ownership and control. Unprofitable deviance is an ordinary agency cost that shareholders would tend to reduce by familiar means. In contrast, profitable deviance generates little or no agency cost; this disables the agency cost mechanism as a trigger for shareholder concern about profitable corporate deviance. Two consequences flow from this latter observation. First, non-corporate governance remedies, such as the criminal law, would be important social controls on corporate deviance because shareholders would ordinarily have few incentives to control such

201. Disparities between treatment of direct involvement and failure-to-supervise cases also highlight a related problem, which is designing civil penalties for failures to supervise that are sufficiently harsh to encourage adequate supervision. This latter problem is taken up in Section III.

behavior themselves. Second, this shareholder indifference would tend to make fiduciary litigation less effective as a corporate deviance control mechanism, although the plaintiff's corporate bar can provide some deterrent and compensatory force. Few cases report derivative litigation over corporate general law violations, a situation that has left several unanswered questions. The ALI's *Principles* attempt to address these unanswered questions as they undertake a comprehensive statement about fiduciary doctrine.

III. FIDUCIARY DUTY AND GENERAL LAW COMPLIANCE UNDER THE ALI *PRINCIPLES OF CORPORATE GOVERNANCE*

The ALI makes corporate law compliance obligations a prominent feature of its formulations of corporate doctrine. The *Principles* articulate a corporate duty of general law compliance in section 2.01(a),[202] and include law compliance as part of directors' and officers' corporate duties.[203] The Reporters have attempted to clarify some aspects of law compliance fiduciary doctrine, but on the whole, the *Principles* follow established patterns of fiduciary obligation and general law compliance.

A. *The General Statement: Section 2.01(a)'s Corporate Obligation*

Section 2.01(a) states that "whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business . . . is obliged, to the same extent as a natural person, to act within the boundaries set by law."[204] Section 2.01(a) imposes an obligation on the corporation itself,[205] as distinct from a fiduciary obligation owed by corporate officers and directors,[206] although the *Principles'* formulations of the fiduciary obligations do require corporate officials to act in a manner consistent with section 2.01(a).[207] By its own terms, section 2.01(a)'s law compliance obligation is not merely coextensive or redundant to independent compliance duties owed to third parties or the state: the corporation's duties under section 2.01(a) run to the shareholders.[208]

202. *See supra* notes 17–22 and accompanying text.
203. *See infra* notes 219–32 and accompanying text.
204. *See* Draft No. 2, *supra* note 17, at 25.
205. *Id.* at 26.
206. *Id.*
207. *Id.*
208. *Id.* at 27.

Because it has been infused into fiduciary obligation, section 2.01(a) is partially enforced by derivative suits against directors and officers; this Article discusses the *Principles*' rules for corporate deviance derivative litigation in later sections. Shareholder power to enforce section 2.01(a)'s law compliance obligation directly against the corporation itself is, however, a distinct governance device. The *Principles* do permit section 2.01(a) direct enforcement, though the tentative drafts do not describe in detail the shareholders' power to bring section 2.01(a) suits for injunctive relief directly against the corporation.[209] Equally uncertain is the shareholders' power to surrender by agreement their collective right to corporate law compliance and refuse to act as enforcers of general legal obligations.[210] The *Principles* final draft may

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209. This is, at the very least, a predictable inference from the statement that the general law compliance obligation runs from corporation to the shareholders. Direct action would avoid managerial control mechanisms provided by Part VII of the *Principles;* injunctive relief could be useful in forcing installation of compliance programs after a major deviance episode. Damages cannot be obtained for breach of this corporate duty—no harm is done to individual shareholders, and a corporation cannot by its own illegal "acts" justify recovery from itself back to itself.

Comment d to § 4.01(a) states:

> Directors and officers have oversight obligations . . . with respect to the corporation's obligation to obey the law, and as in other duty of care situations, a failure to use the care required by the provisions of § 4.01 will expose the directors or officers to damage actions, either by the corporation or derivatively by shareholders, and to claims for equitable relief (including injunctive remedies against both the directors or officers *and their corporation*).

Draft No. 4, *supra* note 123, at 21 (emphasis added). This reference to injunctive remedies against the corporation would be more helpfully located if placed in the comments to § 2.01(a) rather than buried in the discussion of fiduciary liability and § 4.01. In any event, this corporate § 2.01(a) obligation is a novelty, and its eventual impact is impossible to predict at this time.

210. It in an interesting question whether the shareholders could agree among themselves to surrender their right to corporate law compliance by so stating in a shareholder agreement, or in the corporate charter or bylaws. Such an agreement would not affect the corporation's law compliance obligations to the state or third parties, but would be a shareholder decision to remove themselves from any role as general law enforcers. The comment to § 2.01 acknowledges that § 2.01's profit objective can be modified by shareholder agreement, but does not clearly address shareholder power to modify the obligations and permissions contained in § 2.01(a)-(c). *See* Draft No. 2, *supra* note 17, at 27.

Comments to § 4.01 suggest that shareholders may not reduce a fiduciary's obligation to comply with the law. *See* illustration 2, Draft No. 4, *supra* note 123, at 18 (shareholders may not approve a director's failure to perform official, statutory duties). And § 7.17 (1) precludes a shareholder agreement to limit damages for "a knowing and culpable violation of law." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 9 1989) § 7.17 (1), at 115 [hereinafter Draft No. 9]. Absent some clarifying cross-references, however, it appears that § 2.01's broader language would permit shareholders to agree to abandon their enforcement role altogether.

This question implicates the ALI's model of the modern shareholder. By recognizing a contractual capacity to abandon shareholder law enforcement under § 2.01(a), the ALI would accept institutional investors as "model" shareholders; refusing to permit any contractual limitation on shareholder enforcement of § 2.01(a) would retain individual shareholders (and the plaintiff's corporate bar) as important players in corporate governance. On balance, it appears

resolve these uncertainties; section 2.01(a) caselaw development also may settle these questions. Caselaw refinement of section 2.01(a) suits by shareholders directly against their corporations would be consistent with the Reporters' recommendation that section 2.01 in its entirety be implemented by judicial decision rather than by statute.[211]

Section 2.01(a) does not impose any greater or lesser duty to obey the law than is owed by individuals.[212] Consequently, corporations may invoke concepts of necessity and desuetude when these are appropriate to excuse isolated legal violations.[213] Corporations also may undertake open violations of legal provisions to test their validity or interpretation.[214] The section 2.01(a) corporate obligation is not, however, without its ambiguities about the content of general legal obligations. For example, the comments state that section 2.01(a) should be interpreted to disregard de minimis violations, as well as nonperformance of legal duties in those "isolated cases in which it is widely understood that liability is properly viewed as a price of noncompliance."[215] However, the comments also state that corporate actors should not engage routinely in a practice of disregarding legal obligations, even if willing to absorb liability costs as "user fees" for engaging in the prohibited conduct.[216] These comments leave some interesting problems for judicial development of section 2.01(a), as judges attempt to distinguish between tolerable and intolerable corporate violations of general legal obligations. Nevertheless, the comments and illustrations show that section 2.01(a)'s authors would find few tolerable exceptions to the general law compliance obligation.[217]

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that the latter course (continued importance of the individual investor, and no ability to abandon law enforcement power by shareholder agreement) is more consistent with the *Principles*' overall design.

Comments to § 2.01 do state that the absence of a § 2.01(a) obligation does not determine corporate obligations to the state or to third parties. Draft No. 2, *supra* note 17, at 34.

211. *See* Draft No. 2, *supra* note 17, at 26.

212. This recognition is placed in the language of § 2.01(a) itself. *See supra* notes 17–19 and accompanying text. It is further explained in the comments to § 2.01:

> Section 2.01(a) is based on the moral norm of obedience to law, and is neither intended to suggest that corporations are less law-abiding than individuals, nor to impose on corporations any different obligation to obey the law than that imposed on individuals. Accordingly, the corporation is obliged to act within the boundaries set by law to the same extent as a natural person—no less, but no more.

Draft No. 2, *supra* note 17, at 33.

213. Draft No. 2, *supra* note 17, at 33–34.

214. *Id.* at 34.

215. *Id.*

216. *Id.* at 32–33; *see also supra* note 21.

217. The Reporters denounce a general costs-benefits approach to legal obligation by corporate decisionmakers, *see* Draft No. 2, *supra* note 17, at 32–33 [comment g]; this language indicates the exceptional nature of permissible law violations under § 2.01(a). *Id.* at 34. Also

Section 2.01(a) may be a doctrinal innovation to the extent that it articulates a separate law compliance duty directly enforceable against the corporation itself, though its novelty creates uncertainty about whether it will achieve independent influence as a governance rule. Section 2.01 (a)'s role as an aspirational guide for corporate conduct is not exactly an innovation, but its precise operation is open to question.[218] The *Principles*' comprehensive nature permits just this sort of conservative doctrinal adjustment. The ALI also invokes traditional governance structures, however, by making section 2.01(a) a component of (or backdrop for) the corporate fiduciary duties imposed on directors and officers.

B. Fiduciary Law Compliance Obligations Under the ALI Principles

The ALI's *Principles*' fiduciary law compliance obligation extends to both direct involvement and failure-to-supervise cases. Recall that, under traditional doctrine, corporate fiduciaries' direct involvement in illegal activities is not protected by the business judgment rule and may support an award of corporate damages if appropriately prosecuted.[219] Under the *Principles,* direct fiduciary involvement in corporate illegality also is unprotected. "A director or officer violates his duty to perform his functions in good faith if he knowingly causes his corporation to disobey the law."[220] The duty of good faith is articulated in section 4.01(a) as part of the fiduciary duty of care.[221] Under

pertinent here is illustration 10's 55 m.p.h. speed limit hypothetical, which condemns relatively low-level law violations if undertaken as corporate policy. *Id.* at 36.

218. Section 2.01(a) may simply be a text made necessary by § 2.01's declaration of the profit and gain objectives of corporate activity. As such, § 2.01(a) insures that general corporate objectives of profit and gain are not interpreted as a license to violate the law. Section 2.01(a) also could work as a liability-excusing standard, making clear that shareholders may not sue directors for failing to attempt to make profits even when law violations are necessary to obtain those profits.

Professor Coffee, who drafted Part VII, clearly expects general provisions such as the duty of care in Part IV to function as aspirational standards even if the *Principles* permit only infrequent successful enforcement of the duty under Part VII's rules for derivative litigation. *See* Coffee, *supra* note 21, at 792, 796–99. It is quite likely that he has similar expectations for much of § 2.01(a)'s application. *See infra* notes 321–26 and accompanying text.

219. *See supra* notes 128–46 and accompanying text.

220. Draft No. 4, *supra* note 123, at 21.

221. The section states:

> § 4.01. Duty of Care of Directors and Officers; the Business Judgment Rule
>
> (a) . . . a director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

Id.

section 4.01(a), then, a corporate fiduciary breaches its duty of care by failing to act in good faith, and the business judgment rule does not protect fiduciary decisions unless made in good faith.[222] To be successful in a direct involvement case under the *Principles,* the corporate or derivative plaintiff must establish the underlying law violation as well as the fiduciary's breach of care by its knowing involvement in the illegal activity.[223] The ALI thus expressly adopts the rule of *Miller v. AT & T,* which requires proof of the corporate law violation as part of the claim against the defendant fiduciary.[224]

The *Principles* clarify the uncertain status of failure-to-supervise cases under existing law. As part of their supervisory duties described in section 3.02, corporate directors are affirmatively required to oversee corporate compliance with general legal obligations.[225] This oversight obligation includes, when appropriate, support for law compliance programs.[226] Moreover, the *Principles* expressly declare that section 4.01(a)'s duty of care includes the obligation to make appropriate inquiry into corporate affairs;[227] a fiduciary's failure to exercise oversight or make inquiries may be actionable.[228] Thus, the *Principles* reject *Graham v. Allis-Chalmers Manufacturing Co.* and accept the failure-to-supervise case as part of their law compliance enforcement mechanism.[229] Section 4.01's comments and illustrations

222. Section 4.01(c) states:

> A director or officer who makes a business judgment *in good faith* fulfills his duty under this Section if:
>
> (1) he is not interested . . . in the subject of his business judgment;
>
> (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
>
> (3) he rationally believes that his business judgment is in the best interests of the corporation.

Id. at 6–7 (emphasis added).

223. *See id.* at 22 (comment d to § 4.01(a)).

224. *See supra* notes 147–55 and accompanying text.

225. The section states:

> § 3.02(a) . . . [T]he board of directors of a publicly held corporation . . . should:
>
> . . . .
>
> (2) Oversee the conduct of the corporation's business with a view to evaluating, on an ongoing basis, whether the corporation's resources are being managed in a manner consistent with the principles of § 2.01 . . . .

Draft No. 2, *supra* note 17, at 66.

226. *Id.* at 69.

227. "This duty includes the obligation to make, or cause to be made, such inquiry as the director or officer reasonably believes to be appropriate under the circumstances." Section 4.01(a)(1), Draft No. 4, *supra* note 123, § 4.01 (a) (1), at 6.

228. *See id.* at 21.

229. *See id.* at 47–52. *Allis-Chalmers* is discussed *supra* notes 195–200 and accompanying text.

join section 3.02 in affirming law compliance programs. Under section 4.01, a fiduciary who fails to assure some sort of law compliance system may breach its duty of care, especially when the corporation has a history of law compliance problems.[230] Directors put on notice by past criminal prosecutions could well act "unreasonably" if they fail to install some sort of law compliance device appropriate both to the law violations and the particular firm. However, the *Principles* contain no blueprint or standards for compliance efforts; judges are expected to develop this fiduciary obligation as a matter of common law.[231] Business judgment protection for corporate fiduciaries thus exists to a limited extent in failure-to-supervise suits: decisions about how to supervise, and what resources to expend for supervision, probably will be granted some degree of business judgment protection. Nevertheless, the *Principles* do not provide failure-to-supervise cases with the routine business judgment protection and immunity from liability that is granted to most ordinary business decisions.

In general, then, the ALI's blueprint for fiduciary doctrine's law compliance obligation is that no business judgment protection will be offered for fiduciary decisions to participate directly in illegal activities. Duty of care liability may be imposed in failure-to-supervise situations, although some business judgment protection is extended to particular decisions about how best to achieve internal law compliance. The possibly beneficial role of compliance programs is noted, but not made an unavoidable requirement. Future judicial development, or revised commentary, may clarify how the presence or absence of compliance programs will be treated as a liability factor in failure-to-supervise cases.[232] The tentative drafts' commentary goes to a fair amount of trouble to explain the interrelationships between section 2.01(a)'s general law compliance obligation and fiduciary duties. Despite section 2.01(a)'s obvious aspirational qualities, and the hints of direct action against the corporation, the ALI regards fiduciary obligation as a significant factor in achieving law compliance. Because fiduciary duties typically are enforced by derivative suits, other ALI

230. *See* Draft No. 4, *supra* note 123, at 47–52 (comment to § 4.01(a)(1)-(a)(2)).

231. *See id.* at 9.

232. For example, at a company with a history of prior violations, the utter lack of a compliance program understandably would be a factor in deciding whether the fiduciaries had adequately discharged their duty to supervise law compliance. On the other hand, if a compliance program had been put in place after previous law compliance difficulties, and the program was adequately supported and a reasonably thorough response to the earlier problems, judges probably would tend to treat this law compliance effort as species of protected decision, and could well decide that the duty to supervise had been discharged.

provisions must be examined to see how corporate deviance derivative suits fare under the ALI's general rules for derivative litigation.

C. *The ALI's Net-Loss Rule in Fiduciary Litigation*

As discussed earlier, corporate general law violations may either return profits to the corporation or cause it losses. Illegal conduct that causes corporate losses fits relatively neatly into the traditional derivative suit, in which fiduciaries occasionally are held accountable for collective losses due to fiduciary misconduct.[233] However, when the illegal activities are profitable, the derivative suit's compensation objective diverges or disappears. Derivative suits would provide deterrence in profitable deviance situations, but at the price of permitting a corporate windfall: the corporation would retain its illegal gains as well as any damages that might be recoverable from corporate fiduciaries found to have breached their duties by participating in the illegal activities, or by failing to supervise adequately to prevent the law violations. This windfall problem forced the courts to struggle with damages pleading rules in corporate deviance derivative suits. The courts produced the "net-loss rule" as a solution, and for a time seemed to require that the plaintiff plead and prove that the corporation had not obtained *any* gains from the illegal activities as a condition to derivative recovery against otherwise culpable corporate fiduciaries for law violations.[234] In trying to prevent windfall recovery, however, the common law net-loss rule created the impression that, under corporate fiduciary doctrine at least, corporate crime was tolerable if it had been profitable.

The ALI's *Principles* deal with the "crime does pay" issue by adopting a modified version of the net-loss rule. Section 7.16(c) provides:

> A plaintiff bears the burden of proving causation and the amount of any losses incurred by the corporation . . . as the result of a defendant's violation of a standard of conduct set forth in Part IV . . . . The court may permit a defendant to offset against such liability any gains to the corporation that the defendant can establish arose out of the same transaction.[235]

Section 7.16(c) works three significant changes from the common law versions of the net-loss rule. First, section 7.16(c) partially remits

233. *See supra* notes 111–24 and accompanying text.

234. *See supra* notes 156–77 and accompanying text.

235. *See* Draft No. 9, *supra* note 210, § 7.16(c), at 94. This section was tentatively approved by the ALI at its annual meeting in May 1989. *See Annual Meeting of American Law Institute*, 57 U.S.L.W. 2686, 2687 (May 30, 1989).

the plaintiff's burden of proof by permitting the plaintiff to allege some corporate loss and shifting the burden to defendants to prove ultimate corporate gain from the illegalities.[236] Second, section 7.16(c) makes clear that defendants' power to offset is not unlimited and that they can avoid liability for profitable deviance only at the court's discretion.[237] Finally, section 7.16(c) limits any offset to gains derived from the illegal acts alleged in the complaint, so defendants cannot avoid liability by claiming that gains resulted from other legal or illegal activities.[238]

Section 7.16(c)'s changes in the common law net-loss rule will make it much harder to obtain quick dismissals in corporate deviance cases. Under section 7.16(c), defendants must now assume evidentiary and persuasion burdens. Although they might eventually prevail if permitted by the court to show a net gain to the corporation arising from the illegal activities, the defendants cannot obtain an immediate dismissal on the pleadings merely by pointing to the plaintiff's inability to establish net corporate losses from the illegal conduct.[239] Taken in isolation,[240] section 7.16(c) will increase the chances of a successful derivative prosecution, and consequently will alter the defendants' settlement strategies. Section 7.16(c)'s procedural reworking of the net-loss rule also realigns the twin problems of windfall and deterrence by rejecting those few New York decisions that insisted on windfall avoidance at all costs. Other provisions eliminate any residual doubts about whether corporate damages must be pleaded with specificity.[241]

236. Draft No. 9, *supra* note 210, at 94. Specifically, this pattern is demonstrated by the section's allocation of pleading losses to the plaintiff and permitting defendants to offset by pleading gains.

237. *Id.* The operative language here states that "the court may permit" offsetting by defendants.

238. *Id.* The section's permissive offsetting extends only to those gains the defendant can "establish" as having arisen from the same transaction.

239. Compare the state law cases that insist on a strict net-loss rule. *See supra* note 172.

240. This is a significant condition, because the *Principles* permit corporate special litigation committee dismissals. *See infra* notes 246–64 and accompanying text.

241. *See* Draft No. 8, *supra* note 31, § 7.04(b), at 81, which states that allegations of fraud, bias, or control be pleaded with particularity. The comments to this section suggest that the normal pleading standard is notice pleading, and suggest further that specific pleading is inappropriate where the defendants bear a pleading burden. *Id.* at 86–87.

Specific pleading was a part of the net-loss rule's complicated historical development. Although the widespread shift to notice pleading has made specific pleading an exceptional requirement rather than the commonplace, certain courts are reviving or strengthening specific pleading requirements in an attempt to discourage certain cases. *See* Himelrick, *Pleading Securities Fraud,* 43 MD. L. REV. 433 (1986); Note, *Pleading Constructive Fraud in Securities Litigation—Avoiding Dismissal for Failure to Plead Fraud with Particularity,* 33 EMORY L.J. 517 (1984); Note, *Pleading Securities Fraud Claims with Particularity Under Rule 9(b),* 97 HARV. L. REV. 1432 (1984). Specific pleading of corporate losses seems incompatible with the elements of

But the *Principles* do not describe in detail the kinds of corporate damages that a plaintiff must allege to sustain its burden. The comments state that the plaintiff must prove any "actual loss, including any intangible losses suffered by the corporation."[242] The most coherent interpretation of the *Principles* is that plaintiffs may allege all losses causally attributable to the illegal conduct, whether these be fines, damages, litigation expenses, impaired reputation or goodwill, or losses incurred because the illegal activities were themselves unprofitable as a business matter. In all these circumstances, the past or future corporate expenditures would not be needed except for the corporate actors' failure to comply with the law. Windfalls are avoided by permitting defendants to offset gains derived from the illegal acts if they wish to make the argument.[243]

All told, section 7.16(c) redefines the corporate windfall problem. The new allocation of pleading and proof means that derivative plain-

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a fiduciary breach claim arising from corporate deviance. The plaintiff's obligation to plead and prove the underlying criminal violation should enable the fiduciary defendants to answer the complaint adequately, and should provide sufficient boundaries to discovery requests. Moreover, specific pleading seems pointless given § 7.16(c)'s allocation of the burden of proof between plaintiffs and defendants; if specific pleading retains importance as a control on disfavored claims, § 7.16(c)'s reduction of the defendants' ability to avoid liability would seem to indicate that corporate deviance fiduciary suits are not to be treated with hostility by the courts. On balance under the *Principles,* specific pleading of corporate losses is not the most effective way to further the goals usually identified to justify specific pleading obligations, such as deterring frivolous actions, protecting defendants from reputational injury, conserving judicial resources, or giving adequate notice. *See* Draft No. 8, *supra* note 31, at 85.

242. *Id.* at 104. These comments make no explicit, direct reference to the older cases that refused to consider criminal fines or litigation expenses as recoverable "corporate losses." *See supra* note 170 and accompanying text. These older cases *are* cited in the Reporter's notes, however. These cases are early common law attempts to refine the net-loss rule's pleading burden. Their pleading rules about species of recoverable damages make no sense, however, under § 7.16(c)'s division of the burden of proof, or its transactional limitation on the defendant's power to offset gains.

243. The Exxon Valdez disaster can furnish the basis for a hypothetical discussion on pleading corporate loss under § 7.16(c). Assume that there were $3 billion in clean-up costs, a possible $700 million in fines, plus unascertained compensation payments and reputational damages. These items would be pleaded as losses by a plaintiff alleging fiduciary misconduct. Under § 7.16(c), the defendants would then have to obtain judicial permission to plead offsetting gains. These gains must be limited to the particular transaction, which raises the possibility that gains could be relatively minuscule in comparison to the damages. If the "transaction" is the fateful voyage of the Valdez, the gains might be those from one tankerful of oil. This will be no easy interpretive problem, particularly if the plaintiffs allege that Exxon's cost-cutting measures reduced the company's capacity for compliance supervision. *See* Sullivan, *supra* note 6.

Even more troublesome in the Valdez situation is the underlying basis of criminal liability. *See* Lev, *Hazelwood's Acquittal Clouds the Exxon Case,* N.Y. Times, March 28, 1990, at A19, col. 1; Cushman, *Exxon Is Indicted By U.S. Grand Jury in Spill at Valdez,* N.Y. Times, Feb. 28, 1990, at A1, col. 6; Egan, *If the Exxon Valdez Spill Is a Crime, Whose Is It?,* N.Y. Times, Feb. 11, 1990, at E6, col. 1.

tiffs are not expected to plead and prove facts not readily available to them. The discretionary privilege to offset illegal corporate gains and the new transaction test for legitimate offsets establish that the *Principles* do not unwittingly tolerate illegal gains. Furthermore, losses attributable to illegal acts are no longer de minimis simply because the organization is otherwise economically successful.

Section 7.16(c)'s most problematic aspect will become manifest as judges attempt to develop standards for their discretion to permit or refuse defendants' allegation of corporate gain. The comments affirm that "section 7.16(c) is discretionary with the court with respect of offsets, and no such offset need be permitted that in the court's judgment would frustrate the policy of a statute or other clearly established public policy."[244] Because corporate deviance derivative suits require proof of the underlying law violation as an element of recovery, the courts should permit section 7.16(c) offsets only when persuaded that an offset is compatible with the violated statute or public policy at the root of the dispute. Such compatibility arguably could be found where the corporate losses were relatively small, or where the underlying violation was itself isolated and de minimis. Two additional factors will shape this judicial discretion to offset. One is section 7.16(c)'s own transactional limit on the power to offset. If the plaintiff shows actual losses arising from the corporate misconduct, judicial discretion is not activated unless the defendant is able to claim and eventually prove that gains are attributable to the particular illegality at issue. The other factor is external to section 7.16(c), namely, the directors' collective power to dismiss derivative litigation, which is recognized by the *Principles* and will be discussed in the section immediately following. For now, it is sufficient to note that courts' discretion to permit an offset may affect reviews of the board's decision to dismiss a case, since refusing to permit an offset should greatly increase the size of the potential corporate recovery.

D. Power to Dismiss

As already noted, courts now acknowledge the board of directors' power to dismiss derivative suits deemed not to be "in the corporation's best interests."[245] The *Principles* absorb this development, and propose procedural refinements designed to reconcile the states' divergent approaches. The *Principles'* most noticeable modification is to require demand in all derivative cases, regardless of the nature of the

244. Draft No. 9, *supra* note 210, at 104.
245. *See supra* notes 180-88 and accompanying text.

underlying claim—a shareholder seeking to file a derivative suit must first submit a written demand for corrective action to the board of directors, unless demand is excused in a particular case because of a specific showing of irreparable corporate harm from requiring demand.[246] This change will eliminate collateral litigation about whether demand is excused in a particular case. It also changes the procedural pattern in corporate deviance derivative suits, which had been treated by some courts as "demand-excused" cases.[247] If demand is accepted, the derivative litigation is mooted. If the demand is rejected, the derivative plaintiff may agree and withdraw, or may pursue the litigation. If a plaintiff persists after refusal, the board almost certainly will seek to have the derivative action dismissed, if only to reinforce their earlier determination to refuse the demand.

In section 7.06, the *Principles* explicitly acknowledge the board's power to dismiss derivative litigation "as contrary to the best interests of the corporation."[248] This power is moderated by internal corporate procedures necessary for a successful dismissal motion,[249] and by judicial review of such motions.[250] Before a derivative claim against a corporate fiduciary[251] can be dismissed as contrary to the best interest of the corporation, the *Principles*' section 7.10 requires a corporate determination to forego or dismiss the suit that is based on an adequately informed evaluation[252] by the board or by a committee of two or more directors.[253] The board or committee must be disinterested in the transaction or alleged wrong that is the subject of the shareholder demand, and must be capable as a group of "objective judgment under the circumstances."[254] The board or committee must be assisted by

246. The section states:

§ 7.03 Exhaustion of Intracorporate Remedies: The Demand Rule

(a) Before commencing a derivative action, a holder . . . should make a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective action, unless demand is excused under § 7.03(b). The demand should give notice to the board with reasonable specificity of the essential facts relied upon by the holder to support the allegations made therein.

(b) Demand on the board should be excused only when the plaintiff makes a specific showing that irreparable injury to the corporation would otherwise result.

Id. at 63–64.

247. *See supra* note 179 and accompanying text.

248. *See* Draft No. 8, *supra* note 31, § 7.06 (a) (4), at 102–103.

249. *See* Draft No. 9, *supra* note 210, § 7.10, at 33–34.

250. *See* Draft No. 8, *supra* note 31, § 7.08, at 114–16.

251. In § 7.07, the *Principles* distinguish between true third-party claims (pure business judgment) and claims against corporate fiduciaries. Draft No. 8, *supra* note 31, at 109–110.

252. *See* Draft No. 9, *supra* note 210, § 7.10(a)(1), at 33.

253. *Id.*

254. *Id.*

independent legal counsel,[255] and must prepare a written report in support of the motion to dismiss.[256] These requirements are the expected minimum procedural standards, though the *Principles* permit the reviewing court to accept justified deviations from them in particular cases.[257]

Once the committee finds that continuing the litigation is contrary to the corporation's best interests, the corporate defendants will submit the report in support of a motion to dismiss the derivative suit. Section 7.08 of the *Principles* states that the trial court should dismiss the suit if: (1) the moving party has complied with section 7.10's standards for internal corporate review;[258] (2) the court deems that the corporate determination to terminate the litigation is a reasonable conclusion and is adequately supported so as to be reliable;[259] and (3) dismissal does not permit a defendant to retain a significant improper benefit in circumstances indicating abuse of control, fraud, or unratified conflict of interest.[260] The court may consider developments subsequent to the report's preparation,[261] and should "independently review any conclusions of law upon which the determinations . . . were

255. *See* Draft No. 9, *supra* note 210, § 7.10(a)(2), at 33.

256. *See id.* § 7.10(a)(3), at 33.

257. *See* Draft No. 8, *supra* note 31, § 7.08(a), at 114.

258. *See id.*; Draft No. 9, *supra* note 210, at 213.

259. The court should dismiss if "based on adequately supported determinations that the court deems to warrant reliance, the board of directors or committee reasonably concluded (either in response to a demand or following commencement of the action) that dismissal is in the best interests of the corporation." Draft No. 9, *supra* note 210, § 7.08(b), at 213.

In Draft No. 8, the *Principles* listed four factors in § 7.08(b) to be considered in determining whether dismissal was warranted, any one or more of which would support dismissal:

(1) The likelihood of a judgment in favor of the plaintiff is remote; or

(2) The expected recovery (or other potential relief) from the defendant does not clearly exceed the corporation's probable out-of-pocket costs if the action were to continue against that defendant; or

(3) Before the commencement of the action, the corporation had itself undertaken appropriate corrective or disciplinary action with respect to the subject matter of the action; or

(4) The balance of corporate interests warrants dismissal of the action, regardless of its merits.

Draft No. 8, *supra* note 31, § 7.08(b), at 114–15. In Draft No. 9, the reporters included § 7.08 for reference in discussion of § 7.10, and removed these specific items from the black letter in favor of the language quoted at the beginning of this note. The Reporters opined that the changed language "simply reflects a position long evident in the commentary to §§ 7.06–7.09." Draft No. 9, *supra* note 210, at 212. It is uncertain how these changes will be reflected in the revised commentary presented for final approval. It might be useful to include in the commentary items one to three from the earlier formulation as indications of three nonexclusive but "easy" cases in which dismissal can be found reasonably to be in the corporation's best interests.

260. *See* Draft No. 8, *supra* note 31, § 7.08(d), at 116.

261. *See id.* § 7.08(c)(i) at 115.

based."[262] Most importantly for this inquiry, although the court normally should defer to internal corporate findings as to business matters in duty of care cases, no such deference is required when the misconduct involved a knowing and culpable violation of law by the defendant fiduciary.[263] This does not mean, however, that dismissal of direct involvement suits is categorically inappropriate.

Corporate dismissal procedures have become a dominant and complicated feature of derivative litigation itself, almost to the exclusion of the underlying claims of fiduciary breach. Despite the helpful elimination of disputes over the "demand-excused" question, the *Principles*' reforms do not drastically alter the focus from corporate dismissals of derivative suits, if anything, the ALI may be attempting to intensify this emphasis to force meaningful internal corporate responses to fiduciary misconduct. The ALI also offers clarifications about the objectives served by this procedural device, the factors to be considered in terminating derivative litigation, and the relative roles of internal corporate decisionmakers and reviewing judges. It is clear that these procedures are applicable to corporate deviance derivative suits, and it seems that, with one exception, the corporate power to dismiss claims against corporate fiduciary defendants arising from corporate illegalities is not treated much differently from any duty of care case. The exception is the direct involvement case, where section 7.08(c)(iii) provides for independent judicial business judgment in reviewing the reasonableness and reliability of the decision to dismiss in the corporation's best interests.[264]

What follows is a brief attempt to predict how the *Principles* would affect derivative litigation over corporate deviance. This effort begins with the *Principles*' effect on the decision to initiate a derivative prosecution against corporate fiduciaries, and then evaluates possible corporate responses.

262. Draft No. 9, *supra* note 210, § 7.08 (c)(ii), at 213.

263. Draft No. 9, *supra* note 210, § 7.08 (c) (iii), at 213–14; *see also* Draft No. 8, *supra* note 31, at 115–16.

264. *See id.* § 7.08(c)(iii), Draft No. 8, *supra* note 31, at 115–16; Draft No. 9, *supra* note 210, at 213–14. As a general matter, the *Principles* take a stricter approach to special litigation committee dismissals than either Delaware law (represented by *Aronson* and *Zapata*) or New York law (*Auerbach*), by enunciating detailed procedural requirements for a committee report, and explicit standards for judicial scrutiny. Because of the strong family resemblances among the various states' special litigation committee dismissal procedures, however, there is some risk that the ALI's subtly more demanding approach could be misread as requiring less of reviewing judges than it actually does. This risk is present particularly in section 7.08(c)(iii), which turns on the assumption that judges will be rigorously skeptical of corporate dismissal motions in direct involvement deviance cases.

E. Summary: The Corporate Deviance Derivative Suit under the ALI Principles of Corporate Governance

1. Choosing a Winnable Deviance Case

Under the *Principles,* plaintiffs (or more accurately, the corporate plaintiffs' bar) must respond selectively to corporate deviance episodes. This is so because the ALI provisions, as they "fine-tune" traditional doctrine, continue to recognize the significance of corporate loss as an element of derivative claims by retaining a modified "net-loss" rule; the *Principles* also discount de minimis violations, and acknowledge the board's power to dismiss derivative claims, subject to procedural requirements. From the plaintiff's perspective, the best chances for successful litigation would lie where the corporate conduct violates a relatively clear and important legal obligation, and has resulted in substantial fines or civil liabilities. Because the *Principles* retain a modified net-loss rule, litigating plaintiffs and their lawyers must search for cases with significant corporate damages. And since it may be impossible to predict in advance whether a judge will permit offsetting under section 7.16(c), case selection must emphasize large damages to avoid a complete offset.

Direct involvement cases have the greatest chance to succeed. Failure-to-supervise claims are somewhat less desirable from a tactical standpoint because, unless the corporate deviance constitutes recidivism,[265] supervisory failures simply do not yet have the visceral impact of direct wrongdoing by corporate officials. Furthermore, if shareholders exercised their option under the *Principles* to limit damages for duty of care breaches, damages may be limited in some failure-to-supervise cases.[266] This limitation would discourage derivative plaintiffs from filing failure-to-supervise suits—lower possible damages mean that litigation offers less chance of significant corporate recovery net of litigation costs; early dismissal therefore is more likely after

265. *See infra* Part III.E.2.b.

266. *See* Draft No. 9, *supra* note 210, § 7.17, at 115–16.

It is possible that some failure-to-supervise cases might not be subject to a § 7.17 damages limitation. When recidivism occurs, and the fiduciaries had failed to install reasonable compliance efforts, it might be argued that the liability limitation is ineffective because this failure showed "a conscious disregard for the [fiduciaries'] duty . . . to the corporation under circumstances in which the [fiduciaries were] aware that [their] conduct or omission created an unjustified risk of serious injury to the corporation." *See id.* § 7.17 (3) at 115. This situation is not specifically addressed by the *Principles'* commentary, and would be fact specific. As drafted, it appears that deactivating the liability limitation would be unlikely unless the officers and directors had failed to take any corrective action in response to the first deviance episode—it is theoretically possible that a corporate deviance episode would result in no corrective action at all, but it is improbable for most public corporations in the modern regulatory environment.

investigation and recommendation.[267] Ideally, any derivative prosecution would come after governmental action establishing corporate criminal, or quasi-criminal, liability. Litigation in other circumstances would be possible, but post-conviction suits would fare best under the *Principles* because of the need to establish the underlying violation and to stabilize the amount of corporate damages.[268]

Once the plaintiff selects its case, section 7.03 requires written demand on the board of directors.[269] In almost all fiduciary cases, demand is unavoidable because it would be nearly impossible to show irreparable corporate harm;[270] this would be particularly true if the plaintiff selects the case for large and relatively well-established corporate losses due to existing criminal or civil liabilities, because the existence of a damages remedy for past conduct probably would preclude a finding of irreparable harm. Corporate senior management must then determine how to answer the demand. Although management could elect to pursue claims against their fellow fiduciaries in a direct involvement case, it is simply not probable as a general matter. Management is even less likely to pursue the corporate claim when the demand claims a fiduciary failure to supervise, because the potential defendants would be members of senior management itself. For these reasons, the following sections do not treat a managerial election to sue as part of the corporate response to shareholder demand.

267. The following discussion assumes, therefore, that no such limitation has been adopted.

268. This delay in filing the derivative suit also might reduce the burden of proving the underlying violation, although the *Principles* do not address preclusion problems. Unless the fiduciary defendants themselves were named as individual parties in the prior proceedings, it will be difficult if not impossible to obtain any preclusive effect from the prior judgment. Any preclusive effect might be further reduced by the nature of the prior judgment, because consent judgments or pleas of nolo contendere usually do not support easy preclusion. The mutuality rule, if still in effect in the pertinent jurisdiction, would add further difficulties. Preclusion issues are interesting and difficult, and largely beyond this Article's scope.

It would be possible to use the requirement that the derivative plaintiff prove the underlying violation as a "sorting device" to avoid prosecution of trivial claims. Difficulties (or impossibilities) of proof of the underlying violation would be one business reason that a special litigation committee might recommend against continuing the derivative suit. *See infra* Section III.E.2.

269. *See* Draft No. 8, *supra* note 31, § 7.08, at 63-64.

270. In an ordinary fiduciary breach claim for damages, irreparable harm simply would not be present—the conduct in question is a past event that usually is not a continuing wrong. If injunctive relief is sought against the corporation for ongoing criminal misconduct, however, demand might be excused on an irreparable harm theory under § 7.03(b). *Id.* Direct equitable claims against the corporation itself are discussed briefly *supra* note 209 and accompanying text.

2. Responding to Demand for Corporate Action

A prudent board would attempt to satisfy the *Principles*' explicit procedural requirements for special litigation committee dismissal. To do this, the board appoints at least two non-defendant directors to investigate the demand. Although the entire board could undertake its own investigation if involved directors were excluded from the process, appointing a special committee is a more likely course of action. The special litigation committee reduces claims of "structural bias," and frees the remaining board members from an intense assignment that would interfere with their other corporate obligations. The investigating directors should have no prior involvement with the misconduct, and if possible should have begun their corporate service after the misconduct was discovered. The board also would appoint special counsel to assist in the investigation.

The *Principles* do permit short-form reports, because some derivative claims do not deserve full investigation.[271] A plaintiff who mistakenly asserts a low damages claim in a corporate deviance derivative suit, or one involving de minimis legal violations, would encounter this short-form report, which operates as a form of confession and avoidance. In these circumstances, the corporate response essentially is that "nobody's perfect,"[272] and that no derivative suit is justified.

In making the inquiry and preparing findings, the inquisitors would make the strongest case for dismissal by emphasizing a few basic aspects of the deviance episode. They should attempt to determine the extent of the misconduct within the organization. They should document the amount of harm caused by the misconduct, as measured by identifiable actual and contingent corporate losses. They should also attempt to identify and assess any gains attributable to the misconduct, though this damages assessment is no guarantee of an independent basis for dismissal because section 7.16(c) limits offsets to the particular illegal transaction, and makes offsetting permissive rather than mandatory. The committee or board should estimate the litigation costs and balance them against any proposed corporate recovery. Finally, and perhaps most crucially, the investigation should consider strategies and mechanisms for internal corrective action. All findings

271. *See* Draft No. 9, *supra* note 210, at 37–39 (comment e to § 7.10).

272. No enforcement scheme yet devised has completely eliminated law violations. Prosecutors in democratic societies do not have the resources to prosecute all crimes, and must rely on selective prosecution to deter those actors who need to be deterred. In totalitarian regimes, the objects of law enforcement are more highly supervised, but the regime and its agents frequently become criminal out of zeal to enforce the "rules," such as they are.

must be reduced to writing and will become the basis not only for action by the board but also for judicial review of that decision.

Both the derivative plaintiff and the corporation face assessment risks under sections 7.08's and 7.10's litigation review and dismissal procedures. Both parties must accurately identify the sort of case at issue. Mischaracterizing the law violation or miscalculating the corporate damages can result in a quick dismissal against the plaintiff, or an embarrassing rejection of a corporate motion to dismiss. The net-loss rule's discretionary offsetting provision[273] is something of a wildcard in the analysis, adding further uncertainties for both sides in predicting the judicial response to derivative litigation over corporate deviance. Because section 7.08(c) encourages independent judicial review of corporate legal conclusions relied upon in dismissal reports, the corporate defendant in particular risks miscalculation if it relies on legal arguments to justify dismissal, such as by downplaying the importance of the laws violated, or by predicting net-loss offsetting under section 7.16(c).

The rest of this discussion assumes that the plaintiff has filed suit over a significant corporate deviance episode, one in which the corporation violated an important legal obligation and has incurred large fines or civil damages obligations. Prudent plaintiffs' attorneys would avoid less egregious cases simply because the prospects for recovery are diminished by the likelihood of a short-form report and rapid section 7.08 dismissal, or by the reality that smaller corporate damages mean a lower attorneys' fee award for what would be a great deal of work.

a. Possible Recommendations in Direct Involvement Cases

The committee has two fundamental options in a direct involvement case. Because it is assumed that the committee always would advise dismissal,[274] the difference would be the committee's recommendation about corrective action: either the report has suggested such action or it has not. If the committee report endorses internal corrective action, and its recommendation is adequate, reasonable, and accepted by the full board, the reviewing court might well dismiss the derivative suit. In deciding these cases under the *Principles,* the judges will necessarily develop standards for "adequate" and "reasonable" internal corrections in response to deviance episodes. Internal corrective action has two components—disciplinary action against the corporate defendants

273. *See supra* notes 235–44 and accompanying text.

274. *See supra* text following note 270.

involved in the misconduct and structural modifications, such as compliance programs, to prevent recurrences. Of the two, internal disciplinary action historically has been more rare. Corporate executives frequently have remained in their positions, with powers and salaries undiminished, despite direct involvement in price-fixing or questionable payments. By exercising judicial supervision under section 7.08, willing judges looking for these types of corrective action can use the *Principles* to encourage internal disciplinary measures. This judicial search could increase the deterrent effect on fiduciaries by prodding corporations to impose internal sanctions. However, for some firms, dismissal of the offending fiduciary would not be in the corporation's best interest, particularly if the fiduciary were crucial to the underlying business activities. Other disciplinary measures could be substituted, such as salary cuts or other status-reducing measures.

If the report recommends no corrective action in a direct involvement case, the dismissal recommendation probably would encounter greater judicial skepticism in a section 7.08 review, especially given the assumption that accrued or potential corporate losses are substantial and the illegality is significant. The corporation is, of course, free to forego its financial claims against its fiduciaries. Realistically, large corporate damage awards against corporate fiduciaries directly involved in criminal law violations may be uncollectible: directors' and officers' insurance policies frequently exclude coverage for corporate losses attributable to criminal fines, or for damages attributable to specified illegal acts;[275] and the damages attributable to certain misconduct, for example the billions of dollars in expenditures and potential fines from the recent Alaskan oil spill, may be so large as to be beyond the resources of even a well-compensated corporate fiduciary.[276] However, realism about damages should not excuse corporate refusals to take steps to prevent future criminal law violations. The *Principles* seem to demand that a special litigation committee recommendation to dismiss derivative litigation in a direct involvement corporate deviance case should in most circumstances be accompanied by specific recommendations and statements about internal corrective action, including penalties against those fiduciaries directly involved.

The as yet unasked question here is whether under section 7.08, a judge may deny a corporate dismissal motion when the damages are so

275. *See generally* J. BISHOP, LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE § 8.09 (1981).

276. Executives compensated at levels comparable to Michael Milken's annual half-billion dollars might be able to pay very large fines and still live quite comfortably on the remainder. These individuals are rare enough, however, to be the exceptions that prove the rule.

large, or the violation so egregious, that she concludes that the committee's recommendation, including internal corrective measures, is not "reasonable" and dismissal of the suit is not "in the corporation's best interests." Section 7.08 does not mandate dismissal, in particular because the judge is not required to defer to litigation committee assessments of the significance of the law violation. The *Principles*' designers, here again, are attempting to achieve additional deterrence by means of this reserved judicial power to override corporate decisions to abandon corporate deviance derivative suits. Although judges probably will not often invoke this power, it does exist under the *Principles*' restatement of corporate doctrine.[277]

b. Possible Recommendations in Failure-to-Supervise Cases

Failure-to-supervise suits are, in the main, indistinguishable from direct involvement suits. A special litigation committee report most likely would recommend dismissal, and would include a recommendation about internal corrective measures. Unless the corporation has a history of law compliance problems that puts fiduciaries on notice, both the corporate recommendations and judicial responses would vary little from those made in direct involvement suits. Corrective recommendations will always bolster a corporate motion to dismiss; on the other hand, failure to recommend internal changes or disciplinary action should meet greater judicial skepticism. All in all, however, it may still be relatively easy to obtain a dismissal after the investigation had been completed.[278]

If the firm has a history of compliance problems, the investigatory committee will have to tell a different story in its report. Under the *Principles*, a committee report should recommend internal corrective efforts at a recidivist firm to obtain dismissal immediately after the investigation. If the company already had undertaken a compliance program, or other formal efforts to cope with the earlier deviance episode, the investigation and report should include some evaluation of

277. *See also supra* notes 189–93 and accompanying text.

278. One remaining uncertainty is the precise effect of these dismissal provisions in first-offense, failure-to-supervise cases where the corporate losses are extremely large. If the damages are very large, there might be less willingness by a special litigation committee to forego litigation because of the possibility of insurance coverage for at least some of the losses as a breach of due care not involving direct criminal misconduct by the fiduciary defendants. Furthermore, judges reviewing dismissal motions in these cases probably would be justified in their skepticism about the "reasonableness" of a committee decision to forego exceptionally large potential recoveries. As a consequence, the corporate and judicial proceedings in such cases may be so controverted that dismissal would not be obtained without considerable effort by the corporate control group and its special litigation committee.

existing compliance efforts, and why they did not prevent the most recent misconduct. Even under the *Principles,* however, courts will recognize that compliance programs do not guarantee perfect adherence to all legal standards. Of all the corporate deviance fiduciary situations, repeated law breaking after earlier episodes puts a premium on meaningful promises of internal corrections, and judges should examine recidivist organizations more closely than firms having their first brush with major law compliance problems.

3. The Litigation Pattern Under the Principles

In the abstract, the *Principles*' sections 7.06, 7.08, and 7.10 allow few corporate deviance suits to survive the directors' dismissal motion after special litigation committee action. As a threshold matter, deviance suits will have to allege significant corporate damages resulting from substantial law violations to avoid de minimis dismissals. Even if the claimed misconduct is serious and damaging to the corporation, a careful managerial group most frequently would be able to halt the derivative suit after a reasonable report and recommendation. Suits could survive these dismissal attempts if the corporation had failed to comply with section 7.10's procedural requirements, but these failures would be correctable by supplementation, as provided in section 7.10(b). Otherwise, dismissal would be granted more frequently than not, unless the committee report and recommendations were unreasonable and inadequate because the committee report had improperly discounted the damages involved, the seriousness of the underlying violation, or the need for corrective action.

Of course, the numbers of deviance suits would vary with the observable waves of corporate scandals: some periods would see few deviance suits, while others would experience relatively higher litigation rates. Moreover, the *Principles*' corporate governance rules about corporate deviance probably are more significant for their threat of deviance suits that *might* survive a dismissal motion and review under sections 7.08 and 7.10, than for the numbers of plaintiffs' judgments obtained under their remodelled rules. By modifying the common law net-loss rule in section 7.16(c), and by stating clearly in section 7.08 that judges should not automatically defer to corporate findings about underlying legal assumptions, the *Principles* encourage judges to scrutinize carefully corporate deviance litigation committee reports, and to act to preserve the social objectives embodied in substantive regulation, at least when the corporate deviance is an egregious case. So viewed, the *Principles* deliver on their promise to adopt a deterrence

model of corporate governance rules along with devices to protect corporate compensation interests.

If the *Principles* largely reserve a successful derivative prosecution for the most egregious cases, their mechanisms for lesser corporate deviance situations are not as clearly drawn. It seems fair to say that the *Principles* try to encourage corporate deliberation about internal measures to reduce corporate deviance,[279] albeit by the section 7.10 committee procedure supervised under section 7.08 instead of an underlying damages threat if deliberations are not satisfactorily undertaken or concluded. It is hard to see how corporate deviance derivative suits under the *Principles* will have much incremental effect on these deliberations. Since derivative litigation largely is driven by the plaintiffs' bar, it is not clear just how these external players would have much impact on the internal process. The relatively faint hope of avoiding early dismissal in most threatened derivative suits reduces the chance of litigation success, and lowers the attorneys' expectation of compensation. Counsel's lack of interest probably would persist even if fees generated through dismissal were guaranteed upon a judicial finding that the damages and violations were significant enough that the corporation "received a benefit" by being forced to "think" about the problem as its special litigation committee investigates and reports its findings and recommendations.[280] These cases are infrequent, and the preliminary work to force a special committee report normally would not lead to the substantial billable work involved in

279. This policy of encouraging effective deliberation can be compared to Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the Delaware Supreme Court attempted to encourage a "better" deliberative process than the corporate leadership had undertaken in that case. Improved deliberation and process could be a goal of § § 7.08 and 7.10's procedural standards; arguably, the special litigation committee and the board would have to go through investigation and deliberation to "earn" the right to dismiss the derivative suit, and those activities could affect corporate behavior and decisionmaking. Whether improved monitoring will result, or simply greater expense, is an open question, one recognized by the Reporter who drafted these sections. *See* Klein & Coffee, *supra* note 9, at 138–43.

280. The *Principles* appear to support a fee award when a corporation takes corrective action after a meritorious demand, even as the corporation moves for dismissal of the derivative action. Section 7.18 provides:

> A successful plaintiff in a derivative action should be entitled to recover reasonable attorneys' fees and other litigation expenses from the corporation, as determined by the court having jurisdiction over the action, but in no event should this amount exceed a reasasonable proportion of the value of the relief obtained by plaintiff.

PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 10, 1990) § 7.18, at 155 [hereinafter Draft No. 10]. Illustration No. 1 to this section expressly endorses fee awards when a shareholder demand results in corrective action, even if the lawsuit is dismissed before trial under §§ 7.08 and 7.10. *Id.* at 161–62.

Even under § 7.18, courts will encounter difficulties in establishing the value of the corporate benefit and the amount of a "reasonable" fee. *Id.* at 155–61.

discovery and trial preparation of an egregious deviance case against fiduciaries, or the large settlement and corporate benefit that would justify a large fee award.

In addition, the current debate about charter provisions to "opt out" of the duty of care has a direct bearing on that part of corporate deviance control mechanisms exemplified by failure-to-supervise suits. Under the *Principles* themselves, corporate participants may by agreement limit damages for duty of care breaches (such as failures to supervise) by directors, although the ALI's membership rejected a liability cap provision for corporate officers.[281] Direct involvement suits are expressly excluded from this power.[282] The ALI Project's Reporters have disagreed among themselves about the wisdom of this exclusionary provision,[283] though this difference of opinion may have been resolved by limiting it to directors. Direct claims under section 2.01 for injunctive relief would not be subject either to corporate dismissal powers under section 7.06 or to section 7.17 damages limitations, but this is an as yet undeveloped notion in the *Principles.*

On the whole, then, the ALI pattern presents a mixed picture of fiduciary duty and corporate law compliance. Section 2.01(a)'s clear obligation to comply with general legal provisions is not carried through as an absolutely enforceable component of fiduciary duty. It may be surprising to work through all these provisions, with their careful adjustments to existing doctrine about general violations, only to reach this conclusion about the *Principles.*[284] Inescapably, one is tempted to ask why the Reporters have bothered with all this.

IV. JUSTIFYING A CORPORATE GOVERNANCE APPROACH TO GENERAL LAW COMPLIANCE

As the preceding discussion shows, working corporate deviance through the *Principles*' fiduciary obligation and shareholder enforcement provisions is not exactly quick or simple. Reduced to essentials, the *Principles* address corporate deviance by combining clear articulations of corporate and fiduciary law compliance obligations with a highly selective enforcement mechanism, the derivative suit. Section

281. *See* Draft No. 9, *supra* note 210, § 7.17, at 115–16.

282. *See id.*

283. *See id.* at 116, 139–143.

284. Actually, this result is not particularly surprising because of corporate doctrine's long commitment to managerial autonomy and judicial noninvolvement in most interactions between shareholders and their directors and officers. To the extent that this doctrinal result is disconcerting, the discomfort most probably results from initial or residual expectations that general legal obligations somehow are "different." This is taken up in Section IV.

2.01(a) makes a strong statement of law compliance by corporations,[285] which is carried forward into the directors' and officers' oversight and supervision duties.[286] Nevertheless, the *Principles*' technical requirements for derivative litigation severely constrain enforcement of these duties. Realistically, only significant violations have any chance to serve as the basis for a successful derivative suit. And the directors' power under the *Principles* to dismiss derivative litigation when not "in the corporation's best interest,"[287] though not unlimited,[288] means that suits over egregious deviance episodes still may be dismissed without corporate recovery for significant fines or damages caused by fiduciary misconduct. The ALI's corporate governance law compliance mechanism is not indefensible, but it is far from intuitive or simple.

In fact, the *Principles*' law compliance scheme makes one wonder why the ALI has bothered to deal with law compliance in the first place. After all, nothing in the corporate governance rules could modify potential criminal or civil enforcement by state or federal officials, or limit civil suits by third parties injured as a result of corporate misconduct. Concededly, the *Principles* may include corporate deviance applications of fiduciary doctrine as a matter of history, or to state doctrine as completely as possible. To the extent that the ALI adheres to its usual comprehensive approach, its projects must attempt to address prior doctrine, which includes corporate deviance suits as rare, but interesting, examples of fiduciary case law.[289] These cases are infrequent enough, however, that they might not be absolutely necessary to a clear reformulation of corporate fiduciary doctrine. Moreover, neither historicism nor thoroughness fully explains why the law compliance obligation would be stated so prominently as a corporate and fiduciary duty, and then apparently diluted by the *Principles*' technical provisions.

The ALI's justification for including general law compliance in its corporate governance formulations actually presents two distinct questions. First, why do the *Principles* include any form of corporate obligation regarding general law compliance? Second, why do the *Principles* make this obligation part of fiduciary duties to be enforced by derivative litigation, especially since the derivative suit is a relatively disfavored enforcement mechanism?

285. *See supra* notes 17–22, 204–18 and accompanying text.
286. *See supra* notes 219–32 and accompanying text.
287. *See supra* note 248 and accompanying text.
288. *See supra* notes 249–64 and accompanying text.
289. *See supra* notes 128–77 and accompanying text.

A. *Reconstructing the ALI's Consensus About General Law Compliance as a Standard of Corporate Conduct*

The ALI membership tentatively approved the *Principles*' section 2.01(a) without much comment about its fundamental recognition of a general law compliance obligation for corporate actors.[290] Of course, it is politically unrealistic to expect ALI members to dissent from a general statement that corporations should obey the law. This does not, however, necessarily imply uniformity of opinion among the membership about the *reasons* for including a law compliance obligation in the *Principles.* Given the widely diverging opinions about corporate governance expressed by ALI members and commentators on the *Principles,*[291] it is reasonable to assume that section 2.01(a) was adopted because its general law compliance obligation makes sense from a variety of perspectives.[292] Identifying these perspectives with precision is somewhat problematic: the apparent consensus about general law compliance left a scant record in the ALI deliberations about section 2.01(a). But it is possible to explore the perspectives on law compliance because they are relatively easy to identify from sources other than the record of section 2.01(a)'s tentative approval.

One view of law compliance presumes that legal prescriptions generally are something to be obeyed. This traditional, "jurisprudential" understanding of legal obligations is reflected in the Principles' commentary,[293] and probably explains much of the support for recognizing law compliance as part of corporate governance. Many in the business and legal communities take this view of law, so many ALI members would hold it as well. From a traditional perspective, the alternative position—namely, accepting a fundamental corporate legal standard that expressly or impliedly condones violations of other spe-

290. *See supra* notes 17–23 and accompanying text.

291. *See* Seligman, *supra* note 16.

292. As an historical matter, verifying this pluralism about law compliance appears to be foreclosed: section 2.01's apparently undisputed place in the *Principles* has resulted in a sparse record, which impairs any attempt to determine the details of the ALI membership's attitudes about the role of law compliance in corporate governance. The agreement appears to have been so complete as to have been almost unspoken.

293. *See* Draft No. 2, *supra* note 17, § 2.01 comment g, at 33: "Section 2.01(a) is based on the moral norm of obedience to law. . . ." This norm is variously expressed in Western culture, from Plato's *Crito* onward, in a rich discussion that can only be briefly acknowledged here. Some representative discussions can be found in H. HART, THE CONCEPT OF LAW (1961); I. KANT, *The Metaphysical Elements of Justice,* in THE METAPHYSICS OF MORALS (J. Ladd trans. 1965); E. ROSTOW, IS LAW DEAD? 45–50 (1971) (obligation to obey the law precludes recognition of "right" of civil disobedience); Greenawalt, *Conflicts of Law and Morality—Institutions of Amelioration,* 67 VA. L. REV. 177 (1981); Greenawalt, *A Contextual Approach to Disobedience,* 70 COLUM. L. REV. 48 (1970).

cific legal obligations—would be self-contradictory and absurd. Moreover, a jurisprudential understanding of law and obedience to its commands does not preclude legal sophistication. As reflected in the *Principles,* the general law compliance obligation is not absolute and corporations may seek to influence the content of legal prescriptions just as individuals do. If the law prohibits a desired course of conduct, corporate managers are in no worse position than other individuals whose wills are constrained by legitimate legal commands.

Traditional jurisprudence is an entirely predictable perspective from which to require corporate obedience to general legal norms. Other perspectives, however, also accept legal norms as legitimate boundaries for corporate profit-seeking. For example, those advocating a neoclassical political economy of limited government and free markets view law as declaring the "rules of the game" for the marketplace, and recognize government's institutional role as umpire in enforcing those rules.[294] If this has fewer obvious "moral" overtones than a traditional jurisprudential approach, it nevertheless insists that market participation is conditioned upon a willingness to "play by the rules" and accept law compliance as fundamental. Nor does this view argue only from efficiency concerns about a limited government acting as umpire among utility-maximizing firms: neoclassical language about "playing by the rules" implies shared notions about equity and fair competition. Other, more controversial economically-influenced views of law suggest that the common law itself reflects "gropings towards efficiency."[295] From this perspective, legal violations would risk inefficiency, and should not be encouraged.[296] It is distinguishable from the older, neo-classical approach by the relative absence of express language stating equity concerns about "fair play" or "fair competition." Neither economic approach encourages law violations, however: under both economic visions of law, no less than traditional jurisprudential views, disobeying the law is an attempt to escape or disregard the basic order of the "good society."[297]

From yet another perspective, business acceptance of law compliance as a general obligation is explained by the close and generally amicable relationship between the business community and govern-

294. *See* M. FRIEDMAN, CAPITALISM AND FREEDOM 15 (1982).

295. *See* R. POSNER, *supra* note 25, at 21; *see also id.* at 22–26.

296. *See id.* at 397–98.

297. One distinguishing feature of the economic perspective is that it measures the good society by efficiency and freedom, both of which are organized primarily by means of the marketplace. *See* Friedman, *supra* note 294. For a somewhat more critical discussion of the claims of a market society, see K. POLYANI, THE GREAT TRANSFORMATION (1944).

ment. This relationship exists despite adversarial rhetoric. Business influence in the law-making process means that, as a general matter, business groups would not be hostile to recognizing the role of law, though specific disagreements frequently surface. From business's vantage point, government regulators, at worst, are familiar adversaries subject to political control; at best, government agencies do much to support business interests. Moreover, to the extent that law does declare the "rules of the game," the law serves to reduce business worries about certain marginal competitors. By outlawing certain types of conduct, government assists those firms that have committed their resources to "lawful" activities. Those firms unable to obtain access to "legitimate" means of competition because of scarcity face the additional barrier of legal sanctions and the possibility of prosecution for noncompliance. From this perspective, the law compliance obligation in section 2.01(a) is noncontroversial because the process of law-making itself generally is subject to great influence or control by the business community.

Finally, the general law compliance obligation makes sense to those who are skeptical of a corporate actor's ability to achieve utility maximization by acting contrary to legal norms. Prosaic observations about any attempt to profit by deviance feed this skepticism. First, it is axiomatic that the corporate manager thinking about profiting by deviance cannot accurately assess the social cost its deviant behavior will impose on others. The cost-benefit analysis is limited to a balancing of the corporation's *own* costs and benefits from the proposed course of conduct. Thus, while a corporate manager might be able to identify opportunities for profitable deviance, there is no guarantee that overall social utility will be enhanced by the proscribed conduct. Second, even in computing its own costs and benefits, the corporate manager faces serious miscalculation risks. Valuation problems are notoriously difficult.[298] And to the extent that the cost/benefit calculation involves a prediction about what the corporate manager's competitors will do, or how enforcement agencies will respond, it is entirely possible that the corporate manager's calculation will overstate the possible returns available from undertaking the deviant course of conduct.[299]

298. *See* Polinsky, *supra* note 87, at 123–26.

299. This is so because the corporate manager acts within a social system of actors that include competitors, customers, and regulators. Under the trucking-firm hypothetical, *see supra* note 27, it is clear that the trucking-firm manager may at least *capture* customers by undertaking willful speeding. Until its competitors and the regulators "notice" the deviance, and respond accordingly, the deviating manager's firm will capture customers interested in quicker delivery

From this skeptical perspective, then, a legal prohibition issuing from a legislature or administrative agency is entitled to respect and obedience because it means one of two things. A prohibition can issue because the state has assessed the predictable social costs of the proscribed conduct and found them to be unacceptably high.[300] Or, a prohibition can be a determination that the benefits to be obtained from the proscribed conduct are relatively uncertain because of the possibility of miscalculation. Either as a known social harm, or as a known risk of social harm, the conduct is prohibited.

These several perspectives, any of which could stand behind the law compliance obligation, are not necessarily mutually exclusive. The individual ALI members who tentatively approved section 2.01(a) might have had any one or more of these viewpoints about law compliance in mind as they considered the provision. In any event, members who might not agree with one another about the reasons for accepting a law compliance obligation nonetheless have managed to agree that such an obligation ought to be recognized as a standard of corporate conduct.

B. Fiduciary Obligation and Shareholder Enforcement

Section 2.01(a) may be pluralistic in its rationales, but it is nonetheless unequivocal. Derivative enforcement of corporate law compliance obligations, however, is less certain under the *Principles.* The ALI does not rely extensively on derivative litigation as a primary mechanism of general law enforcement, but it has not entirely abandoned it either.

1. Reasons to Discount Shareholder Enforcement of General Law Compliance by Corporate Actors

Derivative litigation is an expensive process, both in its direct consumption of resources, and in its power to distract corporate actors from other pursuits. The deterrence benefits from threatened litigation probably are greater than the costs actually imposed by particular

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times. Because of loyalty or bonding effects, these customers will remain with the deviant firm even after it ceases to break speed limits. This "capture effect" is not unlimited, however, because customer loyalty may be diminished if the deviant behavior becomes controversial enough to drive the captured customers to other trucking firms.

300. *See* Polinsky, *supra* note 87, at 82. This notion of "high cost" could work in one of two ways. First, the direct social costs of the prohibited activity might be too high, as would be the case when toxic waste is dumped in the public water supply. Second, although the social costs of the prohibited activity might not be especially high (arguably the case with gambling or prostitution in themselves), the allocation of benefits necessarily goes to the "wrong people," who might use returns from this activity to finance more harmful conduct.

fiduciary lawsuits, but in corporate deviance cases this deterrence usually would be partially duplicated by other threatened prosecutions, whether by regulators or injured parties.

A realistic attitude about the likelihood of derivative enforcement also restrains enthusiasm for the derivative suit mechanism. In most cases, the plaintiffs' corporate bar controls derivative litigation. These lawyers perform a socially useful function by facilitating occasional challenges to corporate misconduct, especially when corporate funds have been redirected improperly by corporate fiduciaries to their own pockets. The plaintiffs' bar carries no special brief for general law enforcement, however. Moreover, fiduciary profiteering is not always present in deviance cases. Instead, deviance episodes frequently are profitable for the corporation itself, which makes it harder to articulate ex post a tangible corporate economic benefit from derivative litigation over corporate deviance.

Shareholders themselves will be even less frequent litigants over corporate deviance episodes.[301] Corporate limited liability for investors insulates public corporation shareholders from any direct threat of criminal or civil liability to the state or third parties. Furthermore, most prudently-diversified institutional and individual shareholders see no significant negative change in their investments' stock market prices because the deviant firm should be but one component in their portfolios. And if the deviant corporation is healthy, and the illegal conduct is profitable, that particular stock price will not drop until market participants learn of the misconduct and begin to assess the likelihood of expensive prosecutions. Most modern shareholders concerned about corporate deviance episodes would not file a fiduciary breach suit as their first course of action.[302] But even if the deviance causes corporate loss, a diversified shareholder in a going business still could find it less risky to bear the distributed loss than to undertake litigation expenses.[303] Hence the modern recognition that the deriva-

301. This may be but another way of saying that it is a mistake to consider derivative litigation to be legitimate solely because it has one shareholder (an "owner" in earlier terminology) attached to it; derivative litigation is legitimized by other factors, such as its deterrent or compensatory functions. Furthermore, derivative litigation must work its deterrent and compensatory functions even though it is relatively rare given the sheer size and numbers of firms that are organized under the corporate form.

302. *See supra* note 29.

303. The passive role of actual shareholders in derivative litigation is not so much a consequence of diversification, *see* Cox, *supra* note 23, at 746–52; rather, it has to do with the problems of collective action described by Professor Olson. *See generally* M. OLSON, THE RISE AND FALL OF NATIONS (1982); M. OLSON, THE LOGIC OF COLLECTIVE ACTION (1965). Since most shareholders hold a minority position, undertaking derivative litigation would confer most of the benefits obtained on others, the "free riders." The plaintiffs' bar and contingency

tive mechanism virtually depends on the plaintiffs' corporate bar. Indeed, to some extent the common law net-loss rule's focus on corporate loss may reflect an older but ultimately unreliable regulatory judgment that shareholder suits, on balance, provide relatively little social benefit in profitable deviance derivative cases.

2. *Reasons to Retain Some Possibility of Shareholder Enforcement of General Law Compliance by Corporate Actors*

Despite these reasons to doubt that derivative enforcement is an effective mechanism for controlling corporate deviance, the ALI has chosen to include the mechanism as part of its corporate governance scheme. As already noted, this might be partly attributable to the nature of the ALI's Corporate Governance Project, and reflect the ALI's concern for historicity and completeness in doctrinal development.[304] The derivative enforcement mechanism, however restrained, also acknowledges the shareholders' traditional place in the corporate conceptual order. Occasional corporate rhetoric describes the shareholders as the "true owners" of the corporation. This description does not accurately reflect current understandings of shareholder function,[305] so mere formalism can be discounted as the controlling explanation. A less naive explanation is that the ALI actually does envision some shareholder role, however small, in corporate governance: no one else among the traditional internal corporate players ultimately can supervise fiduciary performance,[306] and to deny shareholders any power to object to corporate deviance episodes would commit too

arrangements with corporate reimbursement of successful actions address most of these free rider problems. *See generally* authorities cited *supra* note 29.

From a collective, compensation perspective that recognizes the ultimate corporate source for duty of care recoveries, *see* Coffee, *supra* note 21, at 805–07, opting out of the duty of care would make sense even when corporate deviance is involved. If the social utility from these suits is relatively low, shareholders might be willing to avoid drains on the corporate structure from direct and indirect litigation costs from defense; these drains are attributable to another shareholder's miscalculation, either by alliance with the plaintiffs' bar or by underwriting (in the rarest of cases) litigation costs. In failure-to-supervise suits, for example, the fiduciary misconduct is one of management and supervision, just as in ordinary due care situations. However, from a deterrence perspective, duty of care opt-out may not make as much sense. If the conduct is prohibited, there is a social judgment that no overall social benefit can be obtained from the conduct. Unlike ordinary due care liability, there is little chance that deviance liability would create a disincentive to engage in risky, but, on balance beneficial conduct. The *Principles* recognize this, at least partially, by disabling a duty of care opt-out when fiduciaries have been directly involved in illegal activities. *See supra* notes 281–83 and accompanying text.

304. *See supra* note 289 and accompanying text.

305. *See* W. KLEIN & J. COFFEE, *supra* note 9, at 98–102.

306. This is so because the other traditional corporate roles are filled by directors and officers, themselves the corporate fiduciaries charged with maintaining law compliance.

heavily to an "investor model"[307] of the modern corporate shareholder. In this view, even limited shareholder enforcement powers can work to limit deviance, along with other mechanisms of corporate control.

Derivative enforcement also would be efficacious in particular deviance situations, despite its unreliability if it were the sole mechanism for encouraging law compliance. The *Principles* expressly adopt a pluralistic approach to controlling corporate behavior, and acknowledge that corporate governance doctrine works with other social controls, notably the labor, product, capital and corporate control markets.[308] Consequently, it is a mistake to assume that the ALI expects all its mechanisms to apply in every situation. The corporate deviance derivative suit must be applied as appropriate, such as to egregious law violations involving large damages, which already have been described.[309]

The deviance derivative suit also would be useful when the corporation has been put into severe financial distress, in part by deviant behaviors that have cost the corporation substantial sums of money. In receivership or straight bankruptcy cases, especially, the ultimate risk bearers would benefit from an increased ability to seek corporate compensation from managers who contributed to corporate insolvency by illegal conduct. When fiduciaries directly cause the corporation illegality losses, or fail to supervise to prevent such losses, most of the reasons for discounting shareholder enforcement do not apply. An insolvent corporation means that it no longer is in the corporation's best interest to "forgive" the illegality losses. Instead of relying on a future income stream to offset any damages, the insolvent corporation's "interest" would be to recover as much as possible to pay off creditors or begin a restructured business. In insolvency, the plaintiffs' corporate bar would not be the sole actual protagonist; instead, the creditor and insolvency bars would play a greater role. Moreover, shareholder "exit" from this sort of situation is not necessarily more "rational" than litigation: the market price of this troubled stock would be heavily dependent on the likelihood of assembling as many corporate assets as possible for distribution or restructuring. Corporate deviance derivative suits may improve the stock price of distressed corporations by increasing the corporate asset pool. This particular application is tied to the corporate compensation interest, and has

307. *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976); *see also* Ryan, *supra* note 107, at 171–82.

308. *See supra* notes 10–11, 109–10 and accompanying text.

309. *See supra* notes 265–73 and accompanying text.

been reported in the caselaw.[310] It also might be appropriate when the business cycle turns downward. The 1990s promise a winnowing of the heavy deal-making activities in the 1980s, and may also bring to light further financial scandals. If unsuccessful business deals can be tied to illegal activities by corporate participants,[311] compensation suits over corporate deviance could play a role in assembling corporate assets for the next business upsurge.

C. *Interpreting the ALI's Law Compliance "Text"*

By balancing the apparent consensus favoring corporate general law compliance against the limitations of a shareholder enforcement mechanism, the *Principles* have delivered an intriguing and tension-filled statement about corporate deviance. In so doing, the *Principles* take a stance that is largely, but not exclusively, aspirational in tone and character, at least with regard to all but the most egregious corporate deviance episodes. The *Principles* articulate a clear law compliance obligation[312] and take steps to encourage preventative or corrective measures,[313] but do not rely much on derivative enforcement as law compliance "insurance." Viewed entirely from a skeptical, instrumental perspective, this approach can seem to be little more than an empty doctrinal exhortation to "play fair." A skeptical reaction to the *Principles* is a defensible one, particularly since the ALI provisions depend heavily upon judicial implementation; the *Principles*' impact cannot be fully assessed until after judges have time to respond to the ALI's doctrinal rehabilitations.

In the meantime, other, more sanguine interpretations are possible. Admittedly, the *Principles*' blend of pragmatic idealism creates some conflicting overtones in the tentative drafts: the broad language about the general law compliance obligation and fiduciary duties in Parts II, III and IV can create a misleading impression about corporate deviance derivative suits if not read in connection with Part VII's technical provisions governing shareholder litigation. If utterly unenforceable by some corporate actor, however, section 2.01(a)'s general obligation and its insertion into fiduciary duty would become a "phantom," easily disregarded as a meaningful corporate governance principle, even in aspirational terms.

310. *See* the liquidation cases cited *supra* note 169.

311. This doctrine may have some application during the economic shaking-out that will follow the savings and loan scandals, the HUD problems, Operation Ill Wind's effect on defense contracting, and Drexel Burnham's insolvency. *See supra* notes 3–4.

312. *See supra* notes 17–22, 204–18 and accompanying text.

313. *See supra* notes 225–38, 279 and accompanying text.

This is a partial explanation of the ALI's somewhat ambiguous statements about law compliance. Another partial explanation is that the *Principles'* tentative drafts have been prepared by three different Reporters across a period of several years. The gains from hybrid vigor may be slightly offset by differences in authorial tone during the interim periods, but this should dissipate as the drafts are combined into final form over the next several years. The Reporters have not always agreed, especially about the implications of a "soft" contractual model of the corporation.[314] Working out the tensions between the firm declarations of duty and the much less certain shareholder enforcement provisions may bring some disagreements to light as final consolidations are made.

The uncoordinated doctrinal development of the general compliance obligation and the derivative suit mechanism also may have added tension to the drafts. Corporate deviance derivative suits are rare, and have worked out the fiduciary obligation regarding law compliance mostly by means of the *Roth-Allen-Miller*[315] line of authority, which has issued at long intervals since the beginning of the twentieth century.[316] Derivative enforcement doctrine, however, has changed drastically during the last fifteen years: several prominent cases in more than one influential jurisdiction have reworked the rules applicable to nearly every derivative suit.[317] This developmental imbalance between the general law compliance standard of conduct and one of its enforcement mechanisms may have something to do with the *Principles'* complexity regarding law compliance.

Another way to read the *Principles'* statements about general law compliance begins with the notion that the Corporate Governance Project is an attempt to generate a unified textual statement about corporate governance doctrine at the beginning of the twenty-first century. Although it is possible to read the law compliance obligations as a distinct aspect of corporate fiduciary duty, it also is useful to consider these statements as textual signals about other significant aspects of fundamental corporate doctrine. The clearest example is section 2.01(a), which uses general law compliance to temper the *Principles'* declaration of profit-seeking and shareholder gain as the primary cor-

314. One small example of possible disagreement already has surfaced over the question of whether shareholders can elect to opt-out of the power to enforce the duty of care against corporate fiduciaries in most applications. *See supra* notes 281–83 and accompanying text.

315. *See supra* notes 128–46 and accompanying text.

316. *Roth* was decided in 1907, *Allen* in 1947, and *Miller* in 1973.

317. *See supra* notes 180–92 and accompanying text.

porate objective.[318] Another example is the relationship between the general law compliance obligation and the *Principles*' recapitulation of the business judgment standard, which limits judicial review of corporate decisionmaking. This standard mirrors the United States' economic system of private ordering largely unfettered by direct governmental interference in business. The business judgment standard is remarkable as a recurring judicial refusal to inquire into the vast majority of corporate business decisions, which allocate significant economic resources and affect the welfare of many. In these circumstances, the law compliance language declares one boundary of judicial neutrality and of legitimate business activity: judges will take a hard look at business decisions when the alleged misconduct involves general law violations. The *Principles*' law compliance language thus defines institutional roles. It also sends a subtle signal that, despite corporate governance's overwhelming concern with process,[319] at some delicate points a process orientation must give way to concern about the results of corporate behavior.

Finally, any discussion of the *Principles*' general law compliance rules must assess them as aspirational standards and consider their potential influence on corporate fiduciary behavior. To be truly meaningful, an aspirational standard must have some ex ante effect on business decisions. In making decisions, corporate managers react to information presented to them. Admittedly, these managers "see" only an incomplete picture of the current situation and the likely effects of the decision about to be made, which explains why the concept of "bounded rationality" has such significance in organizational theory.[320] Managers evaluate data by means of decisional standards. One crucial standard linked to organizational survival is the need to obtain corporate profit as a result of business decisions.[321] Managers have some discretion in their choices, however, because several profitable courses of action frequently may be pursued at any given time. Moreover, because uncertainties abound, an ex ante decisional standard that demands the *most* profitable course of action is not as useful as it might appear in the abstract. In short, managerial discretion exists and is unavoidable.

In this discretionary realm, once the decisional minimum of profitability is established, managers will need to supplement their deci-

318. *See supra* notes 17–19 and accompanying text.

319. *See* Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97 (1989).

320. *See supra* notes 67–68 and accompanying text.

321. *See supra* notes 75–84 and accompanying text.

sional standards. One supplementary standard is managerial self-interest, which is problematic only if that interest diverges from the institutional interest.[322] Another, more general standard deeply embedded by socialization is to identify "the right thing to do under the circumstances." This is an extensive and flexible standard.[323] The corporate managers using it are dealing with what might be called "moral maps" for making decisions.[324] Because the profitability standard does not fully eliminate managerial discretion, corporate managers invoke these maps far more frequently than many of them would admit. These moral maps can be illusory. By invoking moral language, a decisionmaker frequently can persuade itself that its decision is the right thing to do; this self-persuasion is suspect because of rationalization processes, by which humans convince themselves that what they *want* to do is the "right thing to do."

Section 2.01(a)'s aspirational standard can have influence as a corrective to corporate managers' invocation of rationalized moral maps. Legal obligations are not coextensive with morality, but general legal prohibitions frequently do indicate that among profitable courses of action, some avenues may have been marked off by social decision as illegitimate, even if profitable.[325] Section 2.01(a) operates as a reminder that profitability is not decisive (because of residual managerial discretion), and that rationalization processes cannot justify all managerial preferences. The law compliance obligation shapes the managerial response, in a given situation, as the manager makes bounded choices among several opportunities presented in a complex milieu. It reinforces legal standards as a decisional norm, and for most managers will connect to the trained impulse to respect the law, which is a fundamental characteristic of most moral maps among those socialized in the United States. Section 2.01(a) thus reinforces existing moral maps. Not all corporate decisionmakers would need this influence, or would be susceptible to it, so the aspirational component of the *Principles* is not a complete solution to corporate deviance.

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322. When such divergence occurs, managerial self-interest no longer supplements a decisional standard in choosing among profitable alternatives. Rather, upon this divergence, managerial self-interest conflicts with maximum corporate profits.

323. Making an organizational profit usually is part of "the right thing to do," and will not be separately considered because it has been treated as the typical minimum qualification for a business decision. Also, the concept is flexible enough that it encompasses more specific conflict standards: for example, acting in self-interest can be regarded as the "right thing to do," as moral arguments constructed from *The Wealth of Nations* demonstrate. *See* A. SMITH, *supra* note 47.

324. I am indebted to my colleague Dennis Honabach for a fruitful discussion about moral maps as they might apply to § 2.01(a)'s aspirational function. The standard caveats apply here—all errors are my own.

325. *See supra* notes 293–300 and accompanying text.

Because other control mechanisms exist outside of corporate governance doctrine, however, section 2.01(a) need not aspire to completeness, and does not attempt to function as the ultimate answer to corporate deviance.

V. CONCLUSION

The ALI *Principles* recognize general law compliance as an important value in the conduct of corporate affairs, but do so without utilizing enforcement mechanisms that grant shareholders or the plaintiffs' bar a roving commission to police general law compliance by other corporate actors. Some might denounce this approach as cowardly—one could argue that general law compliance is so important that shareholder interests *must* be given uncontrolled authority to do something about corporate deviance. From this point of view, the ALI's failure to "unleash" derivative enforcement reflects a lack of conviction about the seriousness of the corporate deviance problem. On the other hand, it is possible to assert that general law compliance is not a corporate governance matter at all. To these observers, the ALI falters by refusing to eliminate general law compliance language from its corporate governance standards. In both views, the *Principles* have collapsed into muddled compromise about corporate deviance and corporate governance.

An alternative explanation of the ALI approach is to recognize that corporate deviance is a special sort of corporate law problem, one that reveals doctrinal boundaries. From an external point of view not concerned solely with the utility and internal consistency of corporate governance mechanisms, it appears reasonable to expect that corporate governance doctrine should "do something" about corporate deviance. A basic social premise is that corporate actors should not make use of their corporate situations to profit by violating the large and small social agreements reflected in general laws and regulations. How this expectation fits into corporate governance standards is less clear. It is one thing to say that corporate governance mechanisms should do nothing to encourage law violations, but quite another to suggest that these mechanisms can be used effectively to discourage law violations. To be sure, external observers can be influenced by commonplace, if outdated, rhetoric about the shareholders' supposed status as broadly dispersed individuals who are the "true owners" of the corporate enterprise; this rhetoric could create expectations that shareholders are ordinary, law-abiding citizens who somehow would be reliably active in reducing illegal corporate conduct. The modern

institutional investors' dominance in the equity markets shatters this rhetoric, as do current understandings of corporate order, most of which reject a naive ownership model.

Nonetheless, external hopes for shareholder response are more justified if illegal corporate misadventure causes corporate loss, or creates the risk of such loss. One way or another, shareholders are highly sensitive to corporate losses, and may take a variety of steps in response to significant losses. If the corporate deviance were profitable, however, institutional shareholder activity might not be triggered in any but the most spectacular cases, which would also have brought the scrutiny of other law enforcers.[326] This realism about corporate governance and corporate law compliance is not comforting to external observers. Profitable deviance by corporations is a recurring social bogeyman, and brings to mind Progressive and Populist images of giant corporations tearing at the social fabric while pursuing profit at all costs. By itself, corporate governance doctrine cannot dispel this collective external nightmare. Corporate governance doctrine is a complex but limited set of rules that are part of the larger social controls on corporate activities. Its limitation is the fundamental corporate reality that shareholders have limited ability to influence the day-to-day conduct of corporate affairs. By no means are shareholders powerless; but the power they exert is not the power of on-site supervision and detailed decisionmaking.

This doctrinal boundary is further illustrated by considering whether corporate losses caused by deviant behavior somehow are different from ordinary corporate losses. The divergence between internal and external points of view provides one answer. To an external point of view, these losses have distinctly different characters. Ordinary corporate losses are "part of the game" and are a matter of concern but are left with some confidence to market mechanisms. Deviance-caused losses are different because they involve law violations, which are problematic whether the corporation makes or loses money from the illegality. To internal corporate players like shareholders and managers, however, losses are losses, and are to be avoided whenever possible because they reduce corporate profit and shareholder gain. Deviance-related losses thus are doubly negative when considered from both internal and external perspectives.[327] This

326. Eventually, however, the plaintiffs' bar would become active once large fines or judgments were imposed, and would argue against offsetting deviance-related gains and corporate losses. Judicial application of § 7.16(c)'s net-loss rule would then become critical.

327. To continue this line of analysis, profitable lawful conduct would be double-positive—both lawful and profitable—and not a matter of concern. There are two combinations of mixed

may partially explain why these losses are treated differently by corporate doctrine, which removes business judgment protection in certain cases.[328]

In the main, the *Principles* reflect an internal point of view, which is predictable since they are being drafted and criticized by corporate law specialists. In contrast to external expectations of shareholder ownership as a corporate deviance control, the internal approach is a subtle mélange of situational, sparse applications of the litigation mechanism and section 2.01(a)'s delicate influence on corporate managers' "moral maps" as they decide among various profitable courses of conduct. But the ALI's version of corporate governance doctrine is not utterly self-contained. Section 2.01(a) discloses one boundary of corporate governance, by refusing to reduce modern doctrine completely into technical problems of intracorporate process. The general law compliance obligation works to remind internal players that results *do* matter in the real world. This obligation, and the corporate deviance problem itself, fix a boundary for corporate governance doctrine. They mark a point where internal governance rules meet fundamental social standards in the form of general legal obligations. At such a point in the universe of legal concepts, it is unlikely that either internal or external approaches would be independently satisfactory.

positive-negative. One group is lawful losses, which typically are not a corporate governance issue nor an external issue, and are left to market mechanisms and social stigmatizations attached to failure. The other is illegal profits, which are a major external issue but a weak internal problem because of the internal mechanism's fundamental concern with profits.

328. *See supra* notes 128–46 and accompanying text.