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## ARTICLES & ESSAYS

### ON LEAVING CORPORATE EXECUTIVES “NAKED, HOMELESS AND WITHOUT WHEELS”: CORPORATE FRAUD, EQUITABLE REMEDIES, AND THE DEBATE OVER ENTITY VERSUS INDIVIDUAL LIABILITY

*Donald C. Langevoort\**

Former SEC Chairman Richard Breeden once famously threatened that his agency would pursue wrongdoing corporate executives so as to leave them “naked, homeless and without wheels.”<sup>1</sup> Yet it has not always been so clear that executives are the primary focus of securities enforcement in financial misreporting cases, even when they are its main architects. Their companies often seem to be the real targets. In reports about private securities litigation, settlements (and the rare judgments after trial) in fraud-

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\* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center. Thanks to Bill Bratton, Hillary Sale, Larry Hamermesh, Donna Nagy, Mark Kreitman, and faculty and students in presentations at Georgetown, Fordham, and the University of Connecticut Insurance Law Symposium for helpful comments; to David Becker for helping me with the title quote; and to Aslynn Johnson and John Huffman for excellent research assistance.

1. Meyer Eisenberg, *Enforcement Issues and Litigation*, 21 SEC. REG. L.J. 421, 421-22 (1994). The reference was to pursuing insider traders, but has taken on a broader connotation in SEC lore. *See id.*; SEC. & EXCH. COMM’N, ROUNDTABLE OF SEC CHAIRMEN 12-13 (2004), [http://www.sechistorical.org/collection/oralHistories/roundtables/SECChairmen/chairmen\\_060204Transcript.pdf](http://www.sechistorical.org/collection/oralHistories/roundtables/SECChairmen/chairmen_060204Transcript.pdf).

on-the-market lawsuits are almost always paid directly by the company or out of its directors' and officers' ("D&O") insurance coverage, for which the company pays the premiums, rather than by the officers or directors charged with the fraud.<sup>2</sup> In SEC enforcement actions, headlines frequently tell about the heavy civil penalties imposed on issuers. To be sure, there have been noteworthy criminal prosecutions of individual executives<sup>3</sup> and well-publicized individual settlements in a few private class actions.<sup>4</sup> Since 2002 especially, the SEC has clearly been more aggressive in seeking remedies against individual executives, and even companies themselves appear more willing to try to recoup payments they have made to dishonest managers.<sup>5</sup> But it is still too early to say whether there really has been a shift in emphasis, much less a coherent policy behind the "company versus individuals" decision when sanctioning corporate fraud.<sup>6</sup>

To academics, the appropriate role of enterprise liability in securities litigation is hardly a new issue—it has been debated at

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2. For a now somewhat-dated study, see FREDERICK C. DUNBAR ET AL., NERA REPORT—RECENT TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SECURITIES CLASS ACTIONS? 9 (1995) (concluding that 68.2% of settlements are paid from insurers, 31.4% from the company, and only 0.4% from individual defendants). There have been some recent cases with large contributions by major company executives (often controlling shareholders), but these seem to be limited to situations where the company is insolvent and the insider is under indictment, so that contributing to the settlement fund may largely be an effort to gain leniency. See John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1551–53 (2006). A good example of the standard practice is the *Cendant* litigation, which prior to *Enron* and *Worldcom* was the largest securities fraud settlement. *In re Cendant Corp. Litig.*, 264 F.3d 286 (3d Cir. 2001). The company paid \$2.85 billion of the \$3.18 billion settlement, with no individual contribution. *Id.* at 288. An attack on the fairness of the settlement was rejected. *Id.* at 292–293; see Coffee, *supra*, at 1568.

3. See Kathleen Brickey, *In Enron's Wake: Corporate Executives on Trial*, 96 J. CRIM. L. & CRIMINOLOGY 397, 420–33 (2006).

4. See Coffee, *supra* note 2, at 1551.

5. These efforts are difficult, however. See Phred Dvorak & Serena Ng, *Check, Please: Reclaiming Pay from Executives is Tough to Do*, WALL ST. J., Nov. 20, 2006, at A1; Joann Lublin & Scott Thurm, *How to Fire a CEO: More Bosses Are Getting the Boot, But It's Harder to Sack Them Without Paying for the Privilege*, WALL ST. J., Oct. 30, 2006, at B1, B3.

6. A study by Karpoff, Lee, and Martin indicates that from a review of cases brought from 1978 to 2006, some \$1.8 billion in fines was assessed against senior executives in financial misreporting cases, along with some \$8.64 billion in disgorgement. Jonathan M. Karpoff et al., *The Consequences to Managers for Financial Misrepresentation*, J. FIN. ECON. (forthcoming) (manuscript at 32, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=972607](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972607)). This shows a considerable targeting of individuals, but probably nowhere near the level of aggregate gain from such misconduct. Individual executives also suffer in other ways, including a high probability of job loss and drop in stock value of their securities holdings.

length for some time.<sup>7</sup> What is most notable is how many scholars from across the ideological spectrum have now joined the doubters of enterprise liability, at least with respect to private securities litigation.<sup>8</sup> For some time, critics of private securities litigation were concerned almost exclusively with the potential for strike suits, painting class actions as a form of plaintiffs' lawyer-driven extortion, regardless of at whom they were targeted.<sup>9</sup> That argument, though expressing a legitimate concern,<sup>10</sup> was probably overstated, and the reforms proposed as a result of it threatened good private lawsuits as well as bad ones.<sup>11</sup> But this debate obscured deeper questions of whether and how much investors really benefit, even from meritorious cases, given how the litigation system is currently structured. Much of this relates to the centrality of enterprise liability, which effectively causes some investors to shoulder the lawsuits' burdens while others receive payouts. The SEC, too, has shifted with respect to its enforcement actions, recently acknowledging that the justification for enterprise liability in the form of civil penalties against corporate defendants is not self-evident, and thus adopting a new policy for deciding whether the company itself will be penalized at all.<sup>12</sup>

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7. See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1504 (1996); Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theories and Evidence*, 1992 U. ILL. L. REV. 691, 692 (1992); Donald C. Langevoort, *Capping Damages for Open Market Securities Fraud*, 38 ARIZ. L. REV. 639, 653-57 (1996); Adam Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 947-59 (1999). The issue is, of course, important beyond securities litigation. *E.g.*, Alan Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1278-80 (1984).

8. For the most recent contributions to the literature, see Coffee, *supra* note 2, at 1561-66; Larry Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 143-47 (2006); Richard Booth, *Who Should Recover What for Securities Fraud?* 30 (Univ. Md. School of Law Legal Studies Research Paper Series, Paper No. 2005-32, 2005), available at <http://www.ssrn.com/abstract=683197>.

9. See Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1490-93 (2006); see also Coffee, *supra* note 2, at 1536 n.5.

10. For a good overview of the evidence, see Choi & Thompson, *supra* note 9, at 1490-93; Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1469-74 (2004).

11. See, *e.g.*, James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 523-24 (1997); Elliot Weiss & Janet Moser, *Enter Yossarian: How to Resolve the Procedural Catch-22 that the Private Securities Litigation Reform Act Creates*, 76 WASH. U. L.Q. 457, 458-60 (1998). Many commentators who believe that securities fraud requires aggressive deterrence were thus led to oppose reform.

12. Press Release, Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), <http://www.sec.gov/news/press/2006-4.htm> [hereinafter SEC Statement]. The debate also occurs in the criminal context, where many have discussed whether corporate criminal liability plays a useful role. See, *e.g.*, John C. Coffee, *No*

All of this is interesting and important, though background for my main interest in this Article. To the extent that we were to shift away from our current emphasis on corporate liability, are we satisfied with the available tools for going after the executives who were complicit in the fraud? After all, enterprise liability evolved as a solution to the problems associated with sanctioning individuals. Now that we have more doubts about the efficacy of that solution, we should revisit the law and theory of individual liability to see if there are changes we should make there.

My view is that enterprise liability can and should be pared back, but that the legitimacy of the underlying policy requires that we see to it that executives who are responsible for corporate fraud or misreporting at the very least forfeit most or all of the immense wealth obtained as a result of their control over the firm during the time of the wrongdoing. Hence, my attention in this Article is on equitable remedies—especially rescission and restitution—as underutilized tools in securities fraud enforcement. As we shall see, equitable remedies have the appeal (from the plaintiff's or enforcer's perspective, at least) of making a culpable state of mind—i.e., *scienter*—far less important, thereby easing what is almost always the moving party's heaviest evidentiary burden. When there is real culpability, a predictable penalty on top of that as a deterrent would be good, too, although we must be wary of being too punitive with respect to managers who acted in good faith in trying to benefit the company and its shareholders. The line between fraud and savvy competitive behavior (or poor judgment) is a blurry one in a business world hardly characterized by confessional candor.<sup>13</sup> This Article takes inventory of current law to see how close to the restitutionary objective we are and what changes might be helpful.

Dishonest executives are undoubtedly subject to serious sanction; the question is only how and by whom those executives are sanctioned. There are many potential sources of sanction: federal and state, civil and criminal, private and public, or legal and extra-legal.<sup>14</sup> Even just a survey of these possibilities would be lengthy, and that is not the goal of my Article. Instead, I focus on comparing and contrasting two main sources of equitable remedies. One is federal securities regulation, via both private and public enforcement. As to SEC enforcement, the question is less one of law than of will and resources, which leads naturally to the role of private lawsuits against officers and other executives as a

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*Soul to Damn, No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 434–48 (1981).

13. See Donald C. Langevoort, *Technological Innovation and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 31–32 (2004); see also *infra* note 51 and accompanying text.

14. On nonlegal sanctions, see Karpoff, *supra* note 6, at 32; see also *infra* note 42 and accompanying text.

supplement to the SEC. Here, the problem of executive liability is quite interesting and problematic along a number of dimensions.

The other main source of equitable remedies is state law, particularly in Delaware, the leading state of incorporation for large firms. It may seem obvious that dishonesty is a form of breach of fiduciary duty and that riches tainted by the wrongdoing should readily be disgorged under state law. But what if executive compensation contracts are written in such a way as to limit the circumstances in which the executive can be terminated “for cause” and is required to forfeit compensation?<sup>15</sup> Or what if the board of directors decides, as a matter of business judgment, to settle with the executive in a way that seemingly leaves substantial “ill-gotten” wealth in the executive’s possession? I only want to evaluate the state of the law here, and also suggest that how Delaware law eventually answers these questions says something about whether and how federal law should be redesigned.

#### I. BACKGROUND: ENTERPRISE LIABILITY UNDER FEDERAL LAW

There are, of course, many different forms of executive misconduct—commonly, they fall into the categories of breaches of care, loyalty, and candor, and may be characterized by various states of mind, from malice to simple negligence. Obviously, fraud (i.e., intentional or reckless deception) is the most notorious form of misconduct. Although fraud fits easily enough into the duty of candor category at state law,<sup>16</sup> most of the litigation about fraud takes place in federal court under the federal securities laws.<sup>17</sup>

There are many reasons for this bias toward federal litigation, but the strong embrace of enterprise liability at the federal level<sup>18</sup> is surely a significant factor. Although there are interesting questions beyond the scope of this paper about how well the doctrine of *respondeat superior* fits with the text and structure of the securities laws’ principal antifraud provision, Rule 10b-5,<sup>19</sup> courts have largely assumed that when an executive speaks or acts fraudulently within the scope of his or her authority and in a manner at least partially meant to benefit the corporation, the corporation is jointly and severally liable.<sup>20</sup> Thus, both private plaintiffs and the SEC

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15. See David Leonhardt, *Watch It: If You Cheat, They’ll Throw Money*, N.Y. TIMES, June 9, 2002, at B1.

16. See *Malone v. Brincat*, 722 A.2d 5, 11 (Del. 1998).

17. See Robert Thompson & Hillary Sale, *Securities Fraud as Corporate Governance: Reflections on Federalism*, 56 VAND. L. REV. 859, 909–10 (2003).

18. *Id.* at 864.

19. See generally Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1326–32 (1997).

20. The more difficult question tends to be whether the corporation is liable for fraud when the person responsible for the misstatement was not aware of the truth but some other corporate employee was, or—even harder—when no

commonly name both the company and the potentially responsible executives and directors as defendants.

The controversy is that any financial sanction that is imposed on the corporation in a respondeat superior environment is borne in the first instance by the company shareholders, whom we generally think of as victims, not wrongdoers. This double victimization is not inevitably so. There are many cases, such as when fraud permits the company to acquire another with overvalued assets, where shareholders are clear beneficiaries of the fraud. However, financial misreporting usually has at least a partial element of greed or foolishness to it so that the shareholder victimization label is often apt, leading to concern about the fairness and efficiency of enterprise liability.

The resulting debate focuses on both compensation and deterrence. In private litigation, the result of a judgment or settlement is that investors who bought or sold during the period of the fraud will recover for the losses caused by the revelation of the truth.<sup>21</sup> In situations where the company itself is not buying or selling in the marketplace (as opposed, for example, to a Section 11 case for a registered public offering under the Securities Act or to issuer repurchase activity),<sup>22</sup> the investor's loss is not the company's gain; instead, other investors pocket the gain. The other investor might be an executive in on the conspiracy, making it essentially an insider trading case, but it is much more likely that the counterparty was simply someone lucky enough to be on the right side of the trade. Scholars going back at least to Easterbrook and Fischel's classic analysis<sup>23</sup> have pointed out that the *net* social harm from corporate fraud, therefore, is much less than is evident at first glance because of these offsetting gains to innocent parties, which the law makes no effort to take away.<sup>24</sup>

That does not mean that the unfortunate victims do not deserve compensation. However, if we assume that the company is forced to pay that compensation, directly or via the insurance policy it has purchased for its officers and directors, then the compensation is

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single corporate employee knew the truth, but their collective knowledge would have revealed it. See, e.g., *Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 363–66 (5th Cir. 2004); Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187, 1226–30 (2003).

21. See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 344 (2005) (analyzing the loss causation element of Rule 10b-5 claims following the passage of the Private Securities Litigation Reform Act).

22. See Langevoort, *supra* note 7, at 662–63; Booth, *supra* note 8, at 20.

23. Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 651–52 (1985); see also Dennis Karjala, *A Coherent Approach to Misleading Corporate Announcements, Fraud and Rule 10b-5*, 52 ALB. L. REV. 957, 963–64 (1988); Paul Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 628–29 (1992).

24. Mahoney, *supra* note 23, at 646–48.

largely a form of pocket shifting.<sup>25</sup> Investors find themselves either payors or payees (and in some cases both), depending on when they bought or sold the company's stock. Research has shown what common sense suggests—that the filing of a class action lawsuit against a company leads to a drop in the stock price of the company separate and distinct from any news it conveys about the wrongdoing.<sup>26</sup> Current shareholders understand that they will be net losers as a result of the suit, both in terms of money paid out and legal expenses incurred.<sup>27</sup>

Pocket shifting notwithstanding, compensation still may be good policy if the claims of harm are compelling enough. Pocket shifting, after all, is the nature of insurance, and society might wish to use enterprise liability as an insurance device for investors. Here we come to a second point that many commentators have emphasized.<sup>28</sup> On average, an investor has roughly the same likelihood of being the lucky beneficiary of a fraud as its victim.<sup>29</sup> For diversified, active investors, the gains and losses will thus tend to net out over time, meaning that the need for insurance for those

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25. Obviously, this result leaves open the question of whether third parties—e.g., accountants, lawyers, investment banks—should be subject to suit, since there is less pocket shifting going on there and the case for deterrence is stronger. I believe that issuer and third party liability issues differ, though there is a case for capping damages in both situations. In particular, leaving third parties open to the full measure of damages while seeking to protect issuers raises the likelihood that, through indemnification provisions or other risk-shifting techniques, the third-parties' liability will indirectly be pushed back to the issuer.

26. See ANJAN THAKOR, U.S. CHAMBER INST. FOR LEGAL REFORM, *THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION* 5 (2005); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 67–68 (1991); see also Janet Cooper Alexander, *The Value of Bad News in Securities Class Actions*, 41 UCLA L. REV. 1421, 1435 (1994). On investor anticipation of such losses, see Amar Gande & Craig Lewis, *Shareholder Initiated Class Action Lawsuits: Shareholder Wealth Effects and Industry Spillovers* 5 (Working Paper Series, 2007), available at <http://www.ssrn.com/abstract=891028>. Plenty of evidence supports the inference that investors as a whole see restraints on private securities litigation as useful, not threatening. See, e.g., Marilyn Johnson et al., *In re Silicon Graphics, Inc.: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 794 (2000); see also Joseph Grundfest & Adam Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 676–77 (2002).

27. See Johnson et al., *supra* note 26, at 802; Gande & Lewis, *supra* note 26, at 10.

28. See Arlen & Carney, *supra* note 7, at 698–700; Langevoort, *supra* note 7, at 648–50; Mahoney, *supra* note 23, at 635. For an empirical demonstration, see ANJAN V. THAKOR, U.S. CHAMBER INST. FOR LEGAL REFORM, *THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION* 4 (2005), available at <http://downloads.heartland.org/18331.pdf>.

29. The difference reflects trading by the company itself or by insiders with knowledge of the fraud.

losses lessens. Moreover, if we assume a highly efficient market, the residual risk will be priced *ex ante*,<sup>30</sup> so that compensation for the average amount of fraud would be built into stock prices. There is less need for insurance then, especially if it comes—as it does—with high premiums in the form of attorneys' fees and other litigation costs borne by shareholders.

Still, not all investors are active or diversified, and bad luck as a result of corporate fraud will predictably befall even some who are, in ways that are not washed away. There will always be some investors who did rely and suffered losses well in excess of any compensation they got outside of litigation. Even here, however, we should be cautious. Inactive investors are far more likely not to have traded during the class period, but rather to be among those company shareholders who simply suffer the costs of the lawsuit (many investors who feel aggrieved when the revelation of fraud causes a large stock price drop have no standing to sue because they bought before the fraud).<sup>31</sup> But in the end, therefore, we have to admit that there will be some compelling cases where recovery, even in an insurance-like system, seems warranted. In the *Enron* litigation,<sup>32</sup> for example, much was made of many current and former company employees whose retirement savings were heavily concentrated in Enron stock.<sup>33</sup> Their claim for just compensation seems persuasive.<sup>34</sup> The question is whether, even for this remaining group, the insurance “product” created by private litigation-driven enterprise liability is a particularly attractive one.

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30. I am skeptical that market prices decrease the risk of fraud in a careful fashion, though there is no doubt that the risk premium does reflect, in part, the fear of deception. See generally Donald C. Langevoort, *The Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 182–83 (2002). My guess is that this varies widely based on investor sentiment.

31. And it is quite possible that much of the public support for private securities litigation comes as a result of the erroneous assumption that the law does compensate all these victims. An interesting feature of the litigation landscape is how often institutional investors do not even bother to collect the money owed to them as a result of settlements, which says something—although it is not clear exactly what—about how institutions view the need for compensation. See James D. Cox & Randall Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 412–13 (2005).

32. See generally *In re Enron Corp. Secs., Derivative & “ERISA” Litig.*, 284 F. Supp. 2d 511 (S.D. Tex. 2003) (denying in part a motion to dismiss claims brought by participants in three employee pension plans under ERISA for a breach of fiduciary duty against their employer).

33. *Id.* at 555–59.

34. One problem with this, however, is moral hazard: as a matter of policy, investors should diversify and be careful—it thus seems counterintuitive to give compensatory priority to those who are not. See David Hoffman, *The “Duty” to be a Rational Shareholder*, 90 MINN. L. REV. 537, 548–49 (2005).



It delivers at best only five to ten cents per dollar of alleged losses (often less), compensates far too many investors who do not have the same claim to compensation, and comes at a very high price tag that eats up fifteen to thirty percent of the claims in plaintiffs' legal fees and costs plus arguably even more in indirect costs (particularly defendants' legal fees and costs).<sup>35</sup> Were this sold as an insurance product, consumer-protection advocates might well seek to have it banned as abusive because the hidden costs are so large. Conceding that some mechanism should exist to compensate these sufferers, it is far from clear that the appropriate mechanism is the current system.

The foregoing argument is commonly met with the response that whatever its defects as a compensatory device, private securities litigation effectively *deters* securities fraud.<sup>36</sup> From a deterrence standpoint, enterprise liability is attractive because responsibility for fraud is often diffused among many participants.<sup>37</sup> The threat of enterprise liability essentially instructs the firm to take precautions (selection of managers, design of incentives, internal controls, etc.) to reduce the system-wide fraud risk. It also permits a more risk-neutral entity to assume this task, as opposed to risk-fearing individual executives who might thus be excessively cautious.<sup>38</sup>

The problem is that executives themselves will not be deterred from misconduct when their personal gain from perpetrating or concealing the fraud exceeds the impact they would suffer should the corporation have to pay. As Arlen and Carney have shown, a sizable portion of corporate fraud comes when executives fear that discovery of the truth will cost them their jobs, reputations, and perquisites, and thus have a strong incentive to delay discovery so that they can remain in control longer and hope for some good fortune that will turn things around.<sup>39</sup> Even if much of this is also intended to benefit the company (e.g., keeping creditors or customers from exiting in a way that would harm the company or even threaten its survival), the rational response is to take the risk of some future lawsuit rather than bring on certain immediate harm. Psychologically, the tendency of corporate executives (and corporate cultures) to be overconfident about their chances of avoiding harm only increases the likelihood of their misrepresenting

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35. See generally *In re WorldCom, Inc. Secs. Litig.*, 315 F. Supp. 2d 527, 538 (S.D.N.Y. 2004).

36. See Eric Helland, *Reputational Penalties and the Merits of Class Action Securities Litigation*, 49 J.L. & ECON. 365, 365 (2006).

37. See Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 866–67 (1984).

38. See, e.g., A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239 *passim* (1993).

39. Arlen & Carney, *supra* note 7, at 694.

the truth.<sup>40</sup>

An alternative deterrence story is that, while executives might well be subject to temptation or cognitive bias, outside directors will not, and they will insist on rigorous monitoring and internal controls to avoid large-scale enterprise liability.<sup>41</sup> There are two main responses here. One is that the company clearly suffers from the *marketplace* discovery of the fraud at a level substantially in excess of even the most sizable fines.<sup>42</sup> If the directors are sufficiently motivated, this reputational exposure (without the need for additional legal penalty) would seem to be ample to put them to work.<sup>43</sup> The other response is that the assumption of sufficiently motivated and knowledgeable outside directors is questionable, at least historically.<sup>44</sup> The Sarbanes-Oxley Act of 2002 was essentially a response to the perceived inadequacy of “gatekeeper” involvement of the sort provided by outside directors on audit committees, notwithstanding decades of enterprise liability risk.<sup>45</sup> There are open questions about whether Sarbanes-Oxley will create the necessary incentives.<sup>46</sup> If it does, then the deterrence-based argument for private litigation enterprise liability exposure weakens; if not, then it may just prove the futility of the effort. One might argue that enterprise liability *plus* Sarbanes-Oxley’s enhancements offer the right mix, and we cannot rule that out entirely. But it is still a speculative case, suggesting caution before embracing the expensive current system. My prediction would be that enterprise liability’s deterrence value actually is positive, but not all that large when other influences on director behavior are considered. That, however, brings us back to the same point made earlier about compensation: because the current private litigation system is so cumbersome and expensive, it may be hard to justify under its current design even if it does produce some benefits, giving

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40. See Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harm)*, 146 U. PA. L. REV. 101, 139–41 (1997).

41. To this we should add other company executives not in on the fraud, but in a position to blow the whistle on it.

42. See Jonathan M. Karpoff et al., *The Costs to Firms of Cooking the Books*, J FIN. & QUANTITATIVE ANALYSIS (forthcoming) (manuscript at 1–2, available at <http://www.ssrn.com/abstract=652121>). This includes a reputational penalty above and beyond either the value-relevance of the revealed information or the effects of lawsuits and government enforcement. *Id.*

43. For the portion of actions viewed by the market as meritorious, directors themselves pay a reputational penalty. See Helland, *supra* note 36, at 366.

44. Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885, 887–89 (1999).

45. E.g., Jill Fisch & Caroline Gentile, *The Qualified Legal Compliance Committee: Using Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 519–20 (2003).

46. *Id.* at 566–82.

us reason to look for something better.

The enterprise liability debate is not limited to private securities litigation. Under prodding from two of its commissioners, the SEC issued a policy statement in January 2006 describing how it will decide whether to seek fines against the company as opposed (or in addition) to the individual wrongdoers,<sup>47</sup> acknowledging that large fines against companies—notwithstanding their publicity value for the SEC's enforcement program—may sometimes hurt investors more than help them. The SEC's policy statement lists a disparate group of factors that will be considered.<sup>48</sup> The principal factor is whether the company benefited from the violation, which the Commission describes in terms of a desire to avoid unjust enrichment.<sup>49</sup> That point is well taken, though if such benefit can actually be demonstrated, then disgorgement, as opposed to a penalty, would seem to be the natural move.

That issue brings up an intriguing conceptual question about the SEC's approach—should the right standard be actual benefit, or instead, whether the perpetrators *intended* to benefit the company (at least in part) by their conduct? The latter standard is the one used in agency law (*respondeat superior*)<sup>50</sup> and works from the following logic. If managers engage in some risky course of deceptive conduct meant to benefit the company and it succeeds, the shareholders are enriched and keep the gains. Assume now that the scheme fails, either because the bet did not pay off or because the deception was exposed, so that no actual benefits were generated. In terms of deterrence, one would presumably want to penalize the company then as well, lest the shareholders be left with the gains when the deception succeeds but no penalty when it fails.

Buying into that idea, however, creates fairly broad corporate liability exposure because, as noted earlier, most financial reporting frauds (certainly *Enron* and *Worldcom*, for instance) are intended to benefit the company and its shareholders, at least in part.<sup>51</sup> The question is whether we really expect good deterrence as a result of a

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47. SEC Statement, *supra* note 12; see Ralph Ferrara et al., *The SEC's Newly Announced Standards for the Imposition of Corporate Monetary Penalties: An Overdue Step Toward Predictability*, 38 SEC. REG. & L. REP. (BNA) 170, at 170 (Jan. 30, 2006) (suggesting that the SEC's approach should apply to how big the corporate fine is, as well as to whether there is a fine in the first place).

48. SEC Statement, *supra* note 12.

49. *Id.*

50. Peri Nielson & Claudia Mann, *Securities Enforcement: Company Liability After the Sarbanes-Oxley Act*, 18 INSIGHTS 1, 2 (2004), available at <http://www.wsgr.com/PDFSearch/Insights1004Nielsen.pdf>.

51. See Langevoort, *Technological Innovation*, *supra* note 13, at 10; Baruch Lev, *Corporate Earnings Management: Fact or Fiction?*, 17 J. ECON. PERSPECTIVES 27, 36 (2003). This is not to say that greed does not play a role as well. Note that if greed is the only motivation, then traditional *respondeat superior* principles would say that there is no vicarious liability at all.

threat like this, which brings us back to our earlier discussion. The Commission's choice of an actual benefit, rather than an "intent to benefit" standard,<sup>52</sup> presumably reflects some doubts about respondeat superior theory as a deterrent device. If so, then it really might just be a redundancy for disgorgement, perhaps just seeking to avoid the need to prove the actual amount of the benefit as is required when disgorgement is sought in court.

On the other hand, the Commission expands the corporate penalty threat by making difficulty of detection, scope of the fraud, and the "need to deter" the type of offense additional factors in the analysis.<sup>53</sup> It is hard to see how or why these should be important factors if we think that shareholder liability generally produces little deterrence in the first place. Conversely, if we have more faith in the deterrence possibility, then the Commission's choice of the actual benefit standard is open to criticism, especially if that is the dominating factor.

Other factors on the list turn to compensation, insofar as the "fair funds" provision of Sarbanes-Oxley directs the SEC to find the victims of the fraud and use both disgorgement and penalty amounts to distribute fair shares in compensation.<sup>54</sup> This provision is a useful item to consider, but is limited in two respects. First, as noted earlier, the theory behind identifying who is injured by fraud is hard—are active, sophisticated traders to be put in the same place as undiversified retail investors (in which case, institutional investors get the overwhelming amount of the fair funds proceeds)? If not, how are the priorities to be set? Second, there is the problem of identifying the tens of thousands of potential victims and assessing their claims, which is a very costly process and one likely to eat up a large portion of the amount to be distributed unless very arbitrary determinations are made.<sup>55</sup> The Commission obscures all of these practical issues by simply saying that the desire to compensate victims will be part of the corporate penalty determination.

A final cluster of factors on the SEC's list looks at whether the company behaved appropriately *after* discovering the problem, i.e., remediation and cooperation with the Commission and other enforcers.<sup>56</sup> This consideration is important, but is meant at least partly as a hammer vis-à-vis the board of directors, and is controversial as a result.<sup>57</sup> If directors let company officials and

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52. SEC Statement, *supra* note 12.

53. *Id.*

54. *Id.*

55. See GOV'T ACCOUNTABILITY OFFICE, REPORT NO. 05-760, SEC AND CFTC PENALTIES: CONTINUED PROGRESS MADE IN COLLECTION EFFORTS, BUT GREATER SEC MANAGEMENT ATTENTION IS NEEDED 11 (2005).

56. SEC Statement, *supra* note 12.

57. Robert S. Bennett et al., *Internal Investigations and the Defense of Corporations in the Sarbanes-Oxley Era*, 62 BUS. LAW. 55, 80–83 (2006).

their lawyers fight the SEC's claims against the executives too hard, their decision may lead directly to a corporate penalty. But sometimes the SEC is wrong in its suspicions, so that a vigorous corporate-funded defense of (and by) company executives is justified.<sup>58</sup>

My sense, then, is that the SEC's 2006 policy statement is born of the same conceptual difficulties that we struggle with in the private securities litigation area. It is a good starting point for constructive deliberation, but highly indeterminate and unsatisfying. Both the deterrence and compensatory questions embedded in the guidelines are more difficult than they seem at first glance, and there really are no obvious rules of thumb for when sanctioning the corporation is good policy in the absence of better-grounded assumptions about deterrence and compensation.

## II. A SECOND LOOK AT INDIVIDUAL EXECUTIVE LIABILITY

The preceding discussion of the problems associated with enterprise liability takes us to the obvious question: how much could we gain by diminishing the liability threat to the corporation and its shareholders, and instead making it so that the individual executives who participated in the fraud are the primary, and maybe only, targets? If we do so, do we also need to improve the legal framework for individual liability?

With respect to private securities litigation, these questions have been obscured because of the impression that individual liability could never support full (i.e., often multi-billion dollar) compensation for the fraud's victims. Thus, enterprise liability is a practical "deep pocket" necessity on compensatory grounds, whatever its conceptual flaws. But as we have seen, the compensatory case, though strong in certain instances, is weaker than assumed. It does not require the inflated liability exposure created by the current fraud-on-the-market system and could be aided considerably by prioritizing distributions to those more deserving than others. Once we shift primary attention to deterrence, the amount of liability exposure could be a good bit smaller and presumably still have a sharp bite, so long as it is well-targeted. The remainder of this Article will address whether this shift is practicable.

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58. This was the basis for Judge Kaplan's decision in *United States v. Stein*, 435 F. Supp. 2d 330, 352–58 (S.D.N.Y. 2006), criticizing prosecutors for pressuring the company not to advance expenses to executives, by using the leverage of threatened prosecution of the corporation. Recently, the Department of Justice has revised its policies on this aspect of cooperation via the so-called "McNulty" Memo. Memorandum from Paul J. McNulty on Principles of Federal Prosecution of Business Organizations to the United States Attorneys, Department of Justice 19 (Feb. 7, 2007), available at [http://www.usdoj.gov/dag/speech/2006/mcnulty\\_memo.pdf](http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf).

The next step in the analysis is to look at the existing legal regime with respect to individual liability to assess its current status and future potential. Most discussions treat fraud-based liability, whether enterprise or individual, as a federal securities law issue.<sup>59</sup> But this is not necessarily so. Intra-corporate fraud and breaches of the duty of candor vis-à-vis company stockholders create state corporate law liability as well (and often state securities law liability), and some federal courts have suggested that state law ought to have primacy with respect to those frauds that are essentially instances of corporate mismanagement.<sup>60</sup> So, perhaps the better place to start in assessing executive liability exposure is with respect to state law, particularly that of Delaware.

### III. STATE LAW ON EXECUTIVE LIABILITY

There are two versions of executive “dishonesty” to consider, and one is considerably easier than the other. The easier one is when an executive is actively involved in creating material misimpressions on the part of the board or company shareholders, or fails to speak when there is a duty to do so.<sup>61</sup> If deliberate, this can easily be seen as a breach of the duties of candor, loyalty, and/or good faith. The harder questions arise when the fraudulent scheme is designed and executed by subordinates without active involvement by the executive. Here, the questions largely turn on the executive’s state of mind: was there knowing encouragement of or acquiescence in the fraud, conscious or reckless disregard, simple negligence, or no fault at all? Absent bad faith or something akin to gross negligence, this inquiry touches on the legal question of whether executives (as opposed to corporate directors) have the full protection of the business judgment rule, a topic that has recently generated a lively scholarly debate.<sup>62</sup>

Let us put aside the hard questions for a moment and assume

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59. Thompson and Sale, *supra* note 17, at 887, 889.

60. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 478–80 (1977); *Field v. Trump*, 850 F.2d 938, 947–48 (2d Cir. 1988). For doubts about whether this is a useful line to draw, see Donald C. Langevoort, *Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 463–64 (2001). See also Thompson & Sale, *supra* note 17, at 863–70.

61. The latter question is interesting in and of itself, but seems reasonably clear (if underutilized) as a matter of state law. See Langevoort, *supra* note 20, at 1199–1205.

62. Compare Lyman Johnson & David Millon, *Recalling Why Corporate Officers are Fiduciaries*, 46 WM. & MARY L. REV. 1597, 1642–43 (2005), and Lyman Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439, 440–41 (2005), with Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 865–66, 876 (2005). See also Deborah DeMott, *Inside the Corporate Veil: The Character and Consequences of Executives’ Duties* (Duke Law Sch. Legal Studies Paper No. 112, 2006), available at <http://ssrn.com/abstract=918524>.

that a senior executive acted intentionally, deceiving both the board and the company shareholders as to the company's financial condition in an effort, at least partly, to hold onto his job and inflated compensation longer than might have been the case had the truth been known. This is bad faith—now, it seems, a breach of loyalty<sup>63</sup>—and damages are a possibility upon an adequate showing of proximate cause, at least in a derivative case. However, an equitable remedy may also be well-suited for this kind of case, which might be easier for plaintiffs to establish a right to in the first instance. The explosion in executive compensation has led to massive pay packages tied to performance, in the form of bonuses, stock options, and deferred compensation.<sup>64</sup> Typically, these incentive provisions are tied either to stock price or accounting measures, either of which would presumably be tainted by the fraud. Isn't there at least a straightforward case for disgorgement of all that wealth?

Black-letter law of contracts and restitution certainly says that there is one. Restitution allows recovery of ill-gotten gains against those who commit a civil or criminal wrong, in order to avoid unjust enrichment.<sup>65</sup> In contract terms, a breach of fiduciary duty would presumably operate as a material breach of the contract as well, giving the victim (the corporation) the right to seek rescission and restitution instead of suing on the contract.<sup>66</sup>

That much is fairly straightforward. What is often ignored about this equitable rescission and restitution option is that it does

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63. See *Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) (noting that a lack of good faith will constitute a breach of loyalty when there is a “sustained or systematic failure to exercise oversight”).

64. For a critical view on this compensation explosion, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* (2004).

65. See RESTATEMENT (THIRD) OF AGENCY § 8.01 (Tentative Draft No. 4, 2005); RESTATEMENT OF THE LAW: RESTITUTION AND UNJUST ENRICHMENT § 43 (Tentative Draft No. 4, 2005). For a sampling of restitution cases against those who did in fact breach their fiduciary duties, see *Phansalkar v. Andersen Weinroth & Co.*, 344 F.3d 184, 197, 211 (2d Cir. 2003) (arguing for an expansive scope of compensation that must be disgorged); *Aramony v. United Way Replacement Benefit Plan*, 191 F.3d 140, 153–54 (2d Cir. 1999) (forcing the former president and CEO to forfeit salary paid during his period of disloyalty); *Bank of Tokyo-Mitsubishi Ltd. v. Malhotra*, 131 F. Supp. 2d 959, 961 (N.D. Ill. 2000) (holding forfeiture of much, but not all, compensation). This issue is also analyzed and discussed in Deborah DeMott, *Disloyal Agents*, 58 ALA. L. REV. (forthcoming 2007).

66. RESTATEMENT OF THE LAW: RESTITUTION AND UNJUST ENRICHMENT §§ 38–39 (Tentative Draft No. 3, 2004). There is a debate about whether “restitution” after rescission for breach of contract refers to avoiding unjust enrichment on the part of the defendant or simply putting the victim back to the status quo ante. See Andrew Kull, *Rescission and Restitution*, 61 BUS. LAW. 569, 574–79 (2006) (describing ALI efforts to make the latter the standard in the new RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT). Even under the ALI's approach, unjust enrichment is the standard if the breach was opportunistic, which it would be in the case of deliberate deceit.

not depend on a showing of intentional or deliberate misconduct by the person subject to the disgorgement claim. Suppose, for instance, that plaintiffs lack evidence one way or the other on culpability, or even that the executive was at most negligent in failing to detect and prevent the fraud. As noted, there is a rich debate over the protection of the business judgment rule to company executives,<sup>67</sup> from which it might be gleaned that their liability *for damages* depends on a showing of bad faith, disloyalty, or perhaps gross negligence. But even when that is so, plaintiffs have a restitutionary alternative.

In *In re HealthSouth Corp. Shareholders Litigation*, Vice Chancellor Strine considered a derivative action seeking rescission and restitution with respect to an agreement between then-CEO Richard Scrushy and HealthSouth to extinguish a \$25 million loan that he owed the company.<sup>68</sup> The consideration for extinguishing the loan was the return of HealthSouth stock of comparable market value that he had purchased with the money.<sup>69</sup> Soon thereafter, accounting irregularities at the company came to light, and the market price of the stock dropped precipitously.<sup>70</sup> Plaintiffs claimed that Scrushy was unjustly enriched by discharging a debt with overvalued stock.<sup>71</sup> The Vice Chancellor granted their motion for summary judgment.<sup>72</sup>

Although there certainly were public allegations of Scrushy's involvement in the fraud (though he was later acquitted of criminal charges in a widely-publicized and controversial trial),<sup>73</sup> plaintiffs in the derivative action made no claim of knowledge or intentional involvement. Rather, they argued that even if he were uninvolved in the wrongdoing, he was still unjustly enriched by benefiting from the overvalued stock.<sup>74</sup> Vice-Chancellor Strine agreed, finding that Scrushy as CEO was "charged with managerial responsibility for

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67. See Johnson, *supra* note 62, at 453–55.

68. 845 A.2d 1096, 1100, 1103 (Del. Ch. 2003); see also Thorpe v. Cerbco, 676 A.2d 436, 445 (Del. 1996) (noting that even if the fiduciary did not profit at the corporation's expense, the profit is still considered unjust enrichment); Hills Stores Co. v. Bozic, 769 A.2d 88, 110–11 n.74 (Del. Ch. 2000) ("Even if [the defendants] can convince me that they had no role in causing any excessive payments to themselves, they still would be unjustly enriched if they received them. Just as someone can't keep a mistakenly excessive tax refund or automatic teller pay out, these defendants cannot hold on to overpayments from the company to which they owed fiduciary duties."). For a brief discussion of *In re HealthSouth*, see Mark Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353, 360 n.36 (2004).

69. *HealthSouth*, 845 A.2d at 1100.

70. *Id.* at 1100–01.

71. *Id.* at 1103.

72. *Id.* at 1110.

73. Patti Bond, *Ex-CEO Scrushy Cleared*, ATLANTA J.-CONST., June 29, 2005, at A1.

74. *HealthSouth*, 845 A.2d at 1099.



overseeing the preparation of accurate and reliable financial statements.”<sup>75</sup> Hence, “[w]hether or not Scrusby breached any cognizable duty in signing those statements, he was undoubtedly unjustly enriched when the company of which he was a fiduciary bought back shares from him at a price inflated by false financial statements he had signed.”<sup>76</sup> Strine said that the same conclusion could be grounded under the law of innocent misrepresentation (or equitable fraud), which is a variant of mutual mistake in contract law.<sup>77</sup>

This is a powerful holding when one considers its implications. To be sure, at issue was an extraordinary loan transaction (of a kind no longer permissible after Sarbanes-Oxley), which made the case easier. But suppose that the board of directors had simply awarded Scrusby some additional incentive-based compensation or renewed his contract at a higher compensation package at a time when the same could be said about the accuracy of HealthSouth’s financial reporting. If the board might have been led to do so by a false sense of company performance, the same equitable remedy would seemingly apply—restitution of the tainted compensation. A recent decision also involving Scrusby by the Alabama Supreme Court, *Scrusby v. Tucker*,<sup>78</sup> does precisely this, citing *HealthSouth* in support of requiring forfeiture of Scrusby’s tainted bonuses: “As between Scrusby and HealthSouth, it would be unconscionable to allow Scrusby to retain millions of dollars awarded to him in the form of bonuses at the expense of the corporation he served as chief executive officer [of] and its shareholders.”<sup>79</sup> Here again, the court said that this result would be so even if Scrusby were entirely uninvolved in the misreporting.<sup>80</sup>

With respect to compensation pursuant to contractual

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75. *Id.* at 1105.

76. *Id.* at 1106.

77. *Id.* at 1106–07. In a subsequent limited liability company case involving claims for damage liability rather than unjust enrichment, Vice Chancellor Strine indicated that notwithstanding *HealthSouth*, plaintiffs should have to show a breach of fiduciary duty by the company official to prevail against that official under an equitable fraud claim, lest the protections of the business judgment rule be too easily lost. *Metro Comm’n. Corp. BVI v. Advanced Mobilecomm Techs. Inc.*, 854 A.2d 121, 163 n.102 (Del. Ch. 2004). *Cf. Shamrock Holdings of Cal., Inc. v. Iger*, No. CIV.A.1330-N, 2005 WL 1377490, at \*7 (Del. Ch. June 6, 2005) (involving a claim for equitable relief).

78. 955 So. 2d 988 (Ala. 2006). The presence of litigation involving Scrusby and HealthSouth in both Delaware and Alabama raises an interesting choice of law question—is the restitutionary alternative based on the internal affairs doctrine, so that the state of incorporation takes primacy—or can the state in which the tainted compensation was paid also plausibly assert subject matter jurisdiction as a matter of contract law? Given the contractual nature of compensation, it is hard to argue that only the state of incorporation has authority here.

79. *Id.* at 1012.

80. *Id.*

agreement between the executive and the company, the issues are pretty much the same. To the extent that the contract was made after the fraud began (even assuming the executive is unaware of it), it is entirely justifiable to employ contract formation defenses, such as mutual mistake or innocent misrepresentation, to set aside the contract and permit restitution by the issuer. One court, in *Miller v. U.S. Foodservice, Inc.*,<sup>81</sup> casts doubt on whether this should be so, but in so doing seems to take an unnecessarily narrow view of the law of mistake. *Miller* suggests that the company (through the actions of the board of directors) assumes the risk that the financials might be misstated in contracting with the executive.<sup>82</sup> But, where one party is better positioned to either spot or prevent the problem, that party is typically allocated the risk, and in the corporate context—as both *HealthSouth* and *Scrushy* emphasize—the CEO is the better-positioned party.<sup>83</sup> Another concern raised in *Miller* is that the remedy seems draconian.<sup>84</sup> But assuming that an executive had acted in good faith, this would not leave him out in the cold. Equity would give him an offsetting quasi-contractual claim against the company for the reasonable value of his services during the time in question, given the truth about the company's performance. However, the difference, the amount returned to the company and its shareholders, could still be considerable.<sup>85</sup> The other contractual setting is where the contract predates the fraud. Here, the role for unjust enrichment in the absence of a showing of culpability is smaller, limited to those portions of the compensation that were determined or otherwise tainted by the inaccurate financial statements.

The unjust enrichment approach seems so easy and straightforward that we might predict that these kinds of cases should become commonplace against executives after companies with which they are associated get caught up in scandal. Indeed, these cases are common, and ongoing litigation now regularly cites these cases in efforts to recoup. The recent options-backdating

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81. 361 F. Supp. 2d 470, 484–85 (D. Md. 2005) (doubting whether restitution should play a significant role where an unbreached contract exists between the executive and the company, notwithstanding severe corporate fraud). *Miller* should be read in light of its primary holding—that the CEO did breach his fiduciary duty and hence, was liable to the company for both restitution and damages on that ground.

82. *Id.* at 484 n.13.

83. On the law of mistake and avoidance in this setting where the executive is complicit, see DeMott, *supra* notes 62 and 65 (comparing U.S. and British cases); Catherine MacMillan, *How Temptation Leads to Mistake: An Explanation of Bell v. Lever Brothers*, 119 L.Q. REV. 625 (2003) (discussing a British case regarding the validity of a severance agreement made before the board was fully aware of the agents' self-dealing).

84. *Miller*, 361 F. Supp. 2d at 485.

85. Also, to the extent that the executive somehow lacked “clean hands,” his offsetting recovery could be reduced or denied entirely.

scandals have been a particularly compelling opportunity to make unjust enrichment arguments. To the extent that *HealthSouth* and *Scrushy* are followed and extended, the state law trend would be important in assessing the law relating to individual as opposed to enterprise liability. So, we should turn to the obstacles to recovery in restitution.

The incentives for derivative plaintiffs to bring the cases seem sufficient. A suit can be brought against the senior management team, which may include a sizable number of executives, and the aggregate amount of compensation subject to disgorgement should be large enough to justify the litigation risk and expenses, especially if state of mind (always the hardest issue) is not a necessary element.<sup>86</sup> Recall that in *HealthSouth*, plaintiffs succeeded on a motion for summary judgment, not even needing to go to trial.<sup>87</sup> To be sure, insurance coverage is not available with respect to an unjust enrichment claim, so that defendants might be highly motivated to defend their wealth aggressively.<sup>88</sup> But the law still seems stacked against them.

The more serious obstacles are twofold. One deals with contractability. In *HealthSouth*, Vice Chancellor Strine observed that there was no contractual impediment to the claim for restitution, because no contractual language addressed the matter in question (the loan forgiveness).<sup>89</sup> *Miller*, by contrast, emphasized the presence of the compensation contract in saying the restitution had no place.<sup>90</sup> Executives often negotiate detailed compensation contracts under circumstances that give them substantial leeway in extracting favorable terms.<sup>91</sup> Such contracts not infrequently limit

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86. There can be questions in terms of personal jurisdiction over the individual defendants, although Delaware's recent change in the law makes it easier to sue high-ranking officers in Delaware court. There is always the option of suing in the jurisdiction where the company's principal offices are located, though that loses the expertise of the Delaware judiciary.

87. *In re HealthSouth Corp. S'holders Litig.*, 845 A.2d 1096, 1110 (Del. Ch. 2003).

88. Although such claims are outside the scope of the standard policy, one cannot simply assume that insurers would not be pressured to find some way to settle such cases within the scope of the policy. For concerns about the relative indifference of insurers to scope questions (particularly the "fraud" exclusion), see Tom Baker & Sean Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1805 (2007). One problem is that issuers have in large numbers obtained insurance policies for their own liability, so that neither they nor the insurers have that much interest in the apportionment question. See *id.* at 1802-03; Coffee, *supra* note 2, at 1569-70.

89. *HealthSouth*, 845 A.2d at 1109 n.27.

90. *Miller v. U.S. Foodservice Inc.*, 361 F. Supp. 2d 470, 483 (D. Md. 2005).

91. See Randall Thomas & Stewart Schwab, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 241 (2006); David Yermack, *Golden Handshakes: Separation Pay for Retired and Dismissed CEO's*, 41 J. ACCT. & ECON. 237, 237-38 (2006).

the ability of the company to terminate executives' employment, except on a very stringent showing of cause, and trigger lucrative severance packages when a termination is without cause.<sup>92</sup> One can imagine a provision that explicitly makes this the limited and exclusive remedy for the corporation in an effort to bar recapture of money already paid under the contract absent cause. Indeed, there are many contractual variations by which executives might seek to protect their compensation against the kind of remedy afforded the plaintiffs in *HealthSouth* and *Scrushy*.

The general rule of contract law with respect to restitutionary remedies for breach is that they can be waived or revised *ex ante*, so long as the limitation is clearly stated and not unconscionable or otherwise in violation of public policy.<sup>93</sup> This rule is subject to an overriding rule of some importance, however: that the contract containing the limitation not itself be tainted by fraud.<sup>94</sup> In another recent and somewhat controversial opinion by Vice Chancellor Strine involving a sale of business transaction, he held that the remedy of rescission and restitution was available to the plaintiffs even though the contract disclaimed such a remedy, because the fraud preceded the making of the contract and thus rendered the whole contract, including the disclaimer, unenforceable.<sup>95</sup> To the extent that the start to the fraudulent scheme preceded the executive compensation contract, the same reasoning might well apply. The same would be true if the contract was tainted by some other procedural defect, for example, if the process by which it was negotiated involved a breach of fiduciary duty as a result of gross negligence.<sup>96</sup>

Assuming not, however, the question turns into one of public policy. Would a limitation of remedy clause essentially guaranteeing that an executive retains extraordinary compensation notwithstanding corporate wrongdoing be a violation of public

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92. See Charles Forelle & Mark Maremont, *UnitedHealth's McGuire Could Leave with \$1.1 Billion*, WALL ST. J., Oct. 17, 2006, at B1. According to this report, McGuire, who left UnitedHealth in connection with an options backdating scandal, had a contract that limited "cause" to either a felony conviction or a repeated failure to remedy a serious problem despite repeated notices demanding that it be cleaned up. *Id.*; see also Lublin & Thurm, *supra* note 5, at B1 (quoting one lawyer as saying that for a board to fire a CEO for cause, "you have to burn the building down or have major, major embezzlement"). On the policy issues raised by termination provisions generally, see Geof Stapledon, *Termination Benefits for Executives of Australian Companies*, 27 SYDNEY L. REV. 683, 683 (2005) (surveying U.S., U.K., and Australian authorities and guidance regarding termination payments).

93. See RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981) (recognizing the rights of parties to revise and limit contractual remedies).

94. *Abry Partners V, L.P. v. F&W Acquisition L.L.C.*, 891 A.2d 1032, 1048 n.26 (Del. Ch. 2006).

95. *Id.* at 1064.

96. See *infra* notes 97–99 and accompanying text.

policy? The answer would seem to depend on the executive's behavior. If the executive was complicit in the fraud and acted in bad faith, the retention of benefits would offend any number of basic principles of corporation law. An ultra-narrow definition of cause or limited remedy provision that essentially immunizes the executive from restitutionary liability for breach of fiduciary duty encourages breach without offering any offsetting justification (risk allocation, etc.). A useful analogy here might be to the law of indemnification, which bars the company from reimbursing officers and directors for fines, judgments, or expenses, unless the board finds that the party seeking reimbursement acted in good faith and in a manner reasonably believed to be in the best interests of the company. By most accounts, this bar cannot be overridden by contract.<sup>97</sup> A contractual override of basic restitutionary principles operates almost identically, and is equally suspect. Arguably, one might extend this principle beyond bad faith to conduct in good faith, but that could not reasonably be thought to be in the company's best interests, which might include recklessness or gross negligence. On the other hand, it would be harder to strike down on public policy grounds a limitation on restitution with respect to innocent or simply negligent conduct. This is more properly a matter of risk allocation, and Delaware's presumption of free contractability regarding the terms and conditions for executive employment is probably strong enough to protect a clause such as this. This is significant, however, because this kind of contractual limitation would alter the incentive structure for litigation—to the extent that plaintiffs are forced to show bad faith or something equivalent to get around the limitations on remedies, their case is more difficult and risky. We could expect fewer such suits, then, to the extent that aggressive contractual protection became commonplace.

But there may be an even larger hurdle if the corporation's independent directors choose not to seek full restitution against the executive and recommend termination of the derivative suit as a matter of business judgment. This gets us into a subject well beyond the scope of this Article. A board might be protective of a senior officer whom they decided not to terminate notwithstanding the scandal, although this is increasingly less common given public relations concerns and enforcement pressure. More likely, at least

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97. See *Waltuch v. Conticommodity Servs. Inc.*, 88 F.3d 87, 92 (2d Cir. 1996) (construing Delaware law regarding indemnification); see also E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 412 (1987). In *In re Cendant Corp. Securities Litigation*, the court rejected a claim that a settlement excluding individual liability operated as impermissible indemnification. 264 F.3d 284, 301 (3d Cir. 2001). My argument here is different: that an actual payment by the company pursuant to contract should, by analogy, be deemed against public policy if it had the effect of enriching the defendant notwithstanding bad faith or lack of corporate best interests.

some senior officials will be terminated regardless of evidence of complicity, assuming the scandal is serious enough. However, the termination will often be on mutually agreeable terms that leave the executive with a large severance package, in essence protecting the wealth created during the period in question. There are many reasons why this might be: loyalty or sympathy for the executive who has been forced out because of media, investor, or regulatory pressure is one possibility; the more likely reason is to avoid the expensive, messy publicity and liability risk associated with litigation against the executive over whether the termination was permissible, who else was at fault, and so on.

Assuming that demand is not excused or the special litigation committee is composed of sufficiently independent directors, there are significant, though not necessarily insuperable, hurdles. In terms of the thoroughness of the investigatory process, one interesting question is whether the reviewing directors were sufficiently aware of and considered the potency of the restitutionary remedies that cases like *HealthSouth* afford the corporation, so that if it was foregone, they could plausibly explain why. (In a demand-excused case, this would be an explicit inquiry.)<sup>98</sup> A conclusion, after thorough investigation, that litigation against the executive would be difficult, risky, and counterproductive to the corporation's need to "move forward" from its troubles would probably receive deference. But if the Delaware chancery judges were so inclined, they could breathe more life into the restitutionary threat by taking a hard look at cases where the board allows an executive to walk away substantially enriched, notwithstanding plausible allegations of misconduct.<sup>99</sup>

In sum, Delaware law affords the corporation considerable ability to seek rescission and restitution for breach of contract in the form of breach of fiduciary duty, thereby putting the individual executives at risk with respect to their incentive compensation. But there are practical questions about the incentive structure for aggressively pursuing equitable remedies via a derivative suit. So, while this is potentially fertile ground for remedial action against individual executives complicit in (or benefiting from) fraud, Delaware law requires further articulation to see just how great the potential really is, and in the absence of evidence that the Delaware chancery judges will encourage efforts to seek disgorgement, the more likely remedies will be federal, not state remedies.

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98. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981).

99. In *Desimone v. Barrows*, 924 A.2d 908, 950–51 (Del. Ch. 2007), Vice Chancellor Strine refused to consider evidence that the directors in a stock options backdating case had not been aggressive enough in pursuing the individuals accused of wrongdoing in assessing whether demand is required or excused.

## IV. FEDERAL LAW

A. *Private Lawsuits*

Corporate liability is a derivative of individual liability; by and large (with a few exceptions), courts have rejected the idea that there can be enterprise liability under Rule 10b-5 without a showing that at least one natural person acting within the scope of his or her authority was primarily liable.<sup>100</sup> In that sense, individual executive liability is the starting point under federal law, and the key issues in private litigation focus on executive culpability. For our purposes, that means that sanctioning individuals upon a determination of culpability should be fairly straightforward.

There are, however, notorious obstacles even if we assume that plaintiffs can demonstrate materially false statements or omissions. Cases under Rule 10b-5 require a showing of scienter (knowledge or recklessness), and Congress has made bringing a case more difficult by requiring a showing by the plaintiff of facts giving rise to a strong inference of scienter before discovery can begin.<sup>101</sup> Courts recently have become much stricter in requiring plaintiffs to make this showing with respect to each individual executive charged with responsibility, rejecting “group pleading” efforts to assert that executives are presumed to know what other members of the control group know.<sup>102</sup> This difficulty is avoided if the company made a registered public offering of securities during the time of the misconduct with respect to executives who signed the registration statement, because Section 11 lawsuits under the Securities Act merely require a showing of lack of due diligence on the executive’s part.<sup>103</sup> Also a potential obstacle is the requirement that any person sued under Rule 10b-5 in a private lawsuit be a “primary” violator.<sup>104</sup> In some circuits, this requirement means that the filing or publicity alleged to be fraudulent must identify the individual as at least partly responsible for its production, so that behind-the-scenes

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100. See *supra* note 20 and accompanying text.

101. See William S. Lerach & Eric Alan Isaacson, *Pleading Scienter Under Section 21D(B)(2) of the Securities Exchange Act of 1934: Motive, Opportunity, and Recklessness and the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 893, 896 (1996). This requirement was analyzed by the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007).

102. See *Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 365 (5th Cir. 2004); William O. Fisher, *Don’t Call Me a Securities Law Groupie: The Rise and Possible Demise of the “Group Pleading” Protocol in 10b-5 Cases*, 56 BUS. LAW. 991, 1049–53 (2001).

103. Section 11, however, limits non-director executive liability to the signatories of the registration statement, thus excluding most of the senior management team.

104. See Fisher, *supra* note 102, at 1031–33.

actors escape liability.<sup>105</sup> This result may narrow the number of executives against whom the action can be brought, although CEOs and CFOs are less likely to gain much benefit here because signature and (after Sarbanes-Oxley) certification requirements create the necessary attribution with respect to SEC filings.<sup>106</sup> Lesser senior executives plainly benefit from this line of case law. On the other hand, the benefit may be partially overcome to the extent that plaintiffs persuade the court that those executives are part of the control group of the corporation, which makes them presumptively liable unless they acted in good faith and did not directly or indirectly induce the violation.<sup>107</sup>

A third factor in restricting individual executive liability exposure is another product of Congress's reforms in 1995, proportionate liability. To the extent that a defendant acted without actual knowledge of the fraud in a Rule 10b-5 case, joint and several liability is replaced by proportionate fault, wherein the jury apportions to the individual only his share of liability.<sup>108</sup> In a case where a large number of persons may have contributed to the fraud, this can bring down individual liability exposure considerably. With respect to company executives, proportionate liability does not apply in Section 11 cases.

Finally, many courts say that the plaintiff's case must allege something more than mere "corporate mismanagement" against the executives.<sup>109</sup> This requirement is not a problem when the misconduct operates as a fraud on purchasers or sellers of company stock by concealing financially material information, and hence does not apply to accounting scandals. But reckless or disloyal managerial behavior can sometimes be hard to reach under this line of cases if not part of some scheme, the exposure of which caused a significant drop in the price of the company's stock.

Each of the foregoing examples is significant, but not enough that we can say that dishonest executives readily escape liability as a matter of law when there is a significant scandal at the company. Proving that there was in fact a scandal and that any particular executive was dishonest can be hard, but that is not my main concern. Again, proving the scandal and the involvement of at least one executive in its perpetration is normally essential to creating enterprise liability as well.

Instead, the explanation for why settlements in securities

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105. See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 174–75 (2d Cir. 1998); *SEC v. Lucent Techs. Inc.*, 363 F. Supp. 2d 708, 720, 723–24 (D.N.J. 2005).

106. 17 C.F.R. §§ 240.13a-14, 240.15d-14 (2006); see Lisa Fairfax, *Form Over Substance? Official Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 13–15, 18–20 (2002).

107. Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78(t)(u) (2000).

108. Securities Exchange Act of 1934 § 21(d)(6), 15 U.S.C. § 78u-3 (2000).

109. See *supra* note 60 and accompanying text.



actions tend to neglect individual executive responsibility is one of negotiation dynamics. Plaintiffs want the largest sum of money possible, with—until recently in some high profile cases<sup>110</sup>—little care about who was funding it. Because it comes out of their pockets, the individual defendants can be expected to resist personal liability more strongly than the board of directors will resist corporate payment (the board is also aware that amounts paid by executives in a class action settlement may trigger indemnification rights anyway). And both the company and executives will seek substantial participation in the settlement from the D&O insurers, who appear to be quite willing to participate as long as settlement patterns are predictable enough that the costs can be passed on in the form of higher premiums, even though fraud is contractually outside the scope of coverage.<sup>111</sup> Hence, the result mentioned earlier: nearly the entire settlement funding tends to come from the company and the insurers.<sup>112</sup> Individuals are largely ignored, however culpable. Concern about unjust enrichment has not been a significant factor in the resolution of fraud-on-the-market cases.

That may be changing, of course, as plaintiffs' lawyers recognize the risk that investors will come to realize the extent to which they fund the system almost entirely. Again, there is nothing more than difficulty and expense standing in the way of greater individual liability once the underlying fraud is proved, and the difficulty and expense is not preclusive. But it probably does require plaintiffs and their lawyers to act against short-term self-interest by turning down settlement offers that shift responsibility away from the individuals, and that is not something we can predict will happen consistently.

The interesting question is how plaintiffs' behavior would change if we abolished or significantly curtailed enterprise liability, leaving only (or mainly) insurance money and the individual executives' assets on the table. The answer is far from clear. It might be, as we observe in other settings such as medical malpractice, that insurance would become the sole source of funding, which in turn might create a game of chicken regarding the size of corporate D&O insurance policies. Moreover, to the extent that individual assets became more of the target, individual executives could be expected to engage in more aggressive asset protection strategies, raising the cost and risk associated with reaching those assets, and to insist on very strong litigation defense,

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110. See, e.g., Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057–58 (2006); Brooke A. Masters & Kathleen Day, *10 Ex-WorldCom Directors Agree to Settlement*, WASH. POST, Jan. 6, 2005, at E1.

111. See Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629, 1644–48 (1994).

112. See *supra* note 88 and accompanying text. On the insurance problems, see Baker & Griffith, *supra* note 88, at 1820; Syverud, *supra* note 111, at 1634–35.

which is, at least in the first instance, at company expense.

Either of these outcomes might simply reduce the number of private lawsuits (meritorious as well as nonmeritorious) without producing many benefits in terms of compensation or deterrence.<sup>113</sup> On the other hand, it could create sufficient incentive so that more resources would be directed at individual involvement in the fraud. We observe a steady stream of private lawsuits brought under Section 16(b) against executives and large shareholders for disgorgement of short-swing insider trading profits, for example, even though there is neither insurance nor enterprise liability. Admittedly, however, Section 16(b) cases are easier to prove than Rule 10b-5 violations.

### B. SEC Enforcement

The SEC avoids many of the restrictions imposed on private litigants in fraud actions involving company executives. The Private Securities Litigation Reform Act's ("PSLRA") heightened pleading standard does not apply to SEC enforcement actions; indeed, the SEC can avoid having to prove scienter if it is likely to be troublesome by charging the executive with liability under Section 17(a) of the Securities Act, which permits negligence-based actions.<sup>114</sup> Nor does it have to worry excessively about the "primary" liability case law, because it can bring actions against aiders and abettors.<sup>115</sup> The SEC does not have to prove losses either, or be concerned about proportionate liability limitations.

So far as substantive law is concerned, in fact, what is remarkable is the breadth of the SEC's ability to reach individual corporate executives. It is by no means just a matter of antifraud liability under Rule 10b-5 or Section 17(a), but a host of specific rules that reach deeply inside the corporation. For example, Rule 13b2-2 bars not only direct efforts to mislead accountants, but also actions to "coerce, manipulate . . . or fraudulently influence" them with respect to material financial reporting matters.<sup>116</sup> Also, any false or misleading record that an executive puts into the accounting system violates Rule 13b2-1.<sup>117</sup>

Where fraud is alleged, the law's scope is extensive as well. There is no question of the law's ability to reach executives' participation in any fraud influencing the investing public, but as I have described elsewhere, even intra-company frauds are likely

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113. There is evidence that the expected value necessary for plaintiffs' lawyers to bring a class action suit has gone up in recent years, reflecting the increasing cost and difficulty of succeeding. See Choi & Thompson, *supra* note 9, at 1497.

114. See *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980).

115. See *SEC v. Lucent Techs. Inc.*, 363 F. Supp. 3d 703, 723-24 (D.N.J. 2005).

116. Securities Exchange Act of 1934, 17 C.F.R. § 240.13b2-2 (2006).

117. *Id.* § 240.13b2-1.

subject to sanction.<sup>118</sup> If a senior executive omits material information in a presentation to the board of directors, that is considered securities fraud so long as it has the requisite connection to the purchase or sale of securities. For example, board grants of options-based compensation certainly satisfy that standard, so that if there is a causal link between the two (e.g., the presentation created a misleadingly favorable impression that influenced the compensation decision), the SEC could charge the executive with fraud.<sup>119</sup> It is hard to imagine many forms of executive dishonesty that the Commission could not reach as a matter of law.

The Commission's remedial tools are extensive as well, including the ability to seek civil penalties with respect to the violation of any provision or rule, the ability to gain disgorgement of any gains or profits tainted by a violation, and a bar against officers from continued employment in that role at a public company if the violation demonstrates substantial unfitness to serve.<sup>120</sup> Two provisions added by Sarbanes-Oxley underscore the SEC's ability to reach ill-gotten gains. One is the ability to seek a temporary freeze authority over extraordinary payments that the issuer is about to pay to company executives.<sup>121</sup> The other requires the forfeiture by the CEO and CFO of any bonuses and other incentive compensation, plus profits from the sale of securities when the issuer restates its financials because of "material noncompliance . . . as a result of misconduct, with any financial reporting requirement under the securities laws."<sup>122</sup> A plain reading of the statute does not require that the misconduct be the fault of the CEO or CFO, so that executives are at risk simply from being in charge when accounting problems occur due to someone's misconduct. This latter provision is potentially even more potent than the principle announced in *HealthSouth* under Delaware law, because there is no requirement

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118. See Langevoort, *Agency Law*, *supra* note 20, at 1208–10; see also Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1656–57 (2004).

119. This example is of significance in the recent flurry of enforcement activity charging company officials with options backdating and so-called "spring-loading." Where the board is left in the dark, liability should follow; questions are much harder—requiring some sort of theory relating to misrepresentation of executive compensation—if the board is aware of the insiders' benefit.

120. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 817–20 (5th ed. 2006).

121. See *SEC v. Gemstar-TV Guide Int'l, Inc.*, 401 F.3d 1031, 1036 (9th Cir. 2005).

122. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §304, 116 Stat. 745, 778 (2003) (codified as amended at 15 U.S.C. § 7243 (2005)). On private enforcement of this provision, see *infra* notes 132 and 143 and accompanying text. For an argument that personal wrongdoing should be required, see John P. Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005 (2004).

that the compensation specifically be tied to assumptions about the accuracy of the company's financials or its share price, and because it reaches even trading profits made in transactions with third parties.

Given this substantive and remedial breadth, the SEC has the power to leave dishonest company executives "naked, homeless and without wheels," but often the SEC does not, choosing instead to settle cases without impressive sanctions against the individuals involved,<sup>123</sup> leaving the suspicion that executives may have walked away from the settlement table with substantial wealth still in their pockets. This pattern is changing, but it is still worth asking why the Commission might tradeoff sanctions against the company for aggressively sanctioning the individuals. To a large extent, the answer likely mirrors the dynamics in the settlement of private securities litigation. The SEC has too few resources for all the work it is asked to do, and hence seeks settlement rather than continued litigation of its enforcement actions. It is easier to get a board of directors to accept a penalty against the company than it is to get individuals to agree to painful personal sanctions. The corporate sanction avoids the need to attribute fault to any particular individual under circumstances where there is likely mutual finger pointing about who is to blame. For all these reasons, company sanctions are the path of least resistance; the SEC can claim its victory and move its resources to new matters that deserve attention. There is probably a publicity-related reason as well: sanctions against companies can be large enough to grab headlines, which is less likely to occur with respect to individual sanctions, even in the aggregate.

The problem of limited resources affects not only the disposition of cases actually brought by the SEC, but also means that there will probably be many matters that the SEC would investigate if it had the available staff, but simply cannot. This concern over shortage of resources is the standard argument for supplementing SEC enforcement with private rights of action under the securities laws.<sup>124</sup> Deterrence against individual executives is less than it should be if the SEC must forego promising enforcement actions, regardless of its position with respect to individual versus enterprise liability.

## V. POSSIBILITIES FOR IMPROVEMENT

As noted earlier, the impulse to use enterprise liability as a tool

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123. See Coffee, *supra* note 2, at 1536–37.

124. But see James D. Cox & Randall Thomas (with Dana Kiku), *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 897 (2004) (expressing concern that many private actions piggyback on SEC investigations, raising the question of whether they really provide a useful supplement).

is a response to the challenges associated with individual liability. These are daunting problems that do not easily disappear, even if deterrence rather than compensation is made the primary goal. Indemnification, insurance, and asset protection strategies may reduce the pain that the individual executive feels from a sanction *ex post*. There are also the practical problems of assessing individual executive culpability in complex organizations with diffused lines of authority and the fear that if the liability system is made draconian, it will either induce excess caution or lead to demands for greater compensation *ex ante* for the risk of liability.

A focus on unjust enrichment avoids some of these problems, but not all. It also naturally invites the objection that it is too little a threat—that given the problems with detection and litigation incentives, the optimal penalty has to exceed the amount of the gain in order to deter efficiently. I agree and would want the system to create more of a liability threat than simply disgorgement. Keep in mind, however, that executives do face significant threats in addition to this possibility of disgorgement: harm to reputation and livelihood can be considerable;<sup>125</sup> the SEC can always impose penalties and an officer/director bar in addition to disgorgement remedies;<sup>126</sup> and the threat of criminal prosecution with severe jail sentences is always present.

That notwithstanding, I want to turn to some other possibilities for making changes in the legal landscape that might improve the probability that executives caught up in misconduct will lose the wealth gained from being in control during the time of the fraud.

#### A. *Incentives in Private Litigation*

Plaintiffs' lawyers act in an economically rational fashion: they pursue cases that generate the largest net gains, preferably in settlement rather than costly litigation. This tendency produces a bias toward pursuing D&O insurance coverage and enterprise liability, because pay-out decisions are not made by those paying out of their own pockets.

Jack Coffee has made the useful suggestion that this bias be countered by adjusting attorneys' fees in settled and litigated

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125. See Hemang Desai et al., *The Reputational Penalty for Aggressive Accounting: Earnings Restatements and Managerial Turnover*, 81 ACCT. REV. 83, 85 (2006) (reporting that turnover of a high ranking official after a restatement is approximately 60%, compared to 35% when there is no such restatement); Karpoff, *supra* note 42, at 2. Earlier work largely doubted that there was much turnover effect. See Anup Agrawal et al., *Management Turnover and Governance Changes Following the Revelation of Fraud*, 42 J.L. & ECON. 309, 339 (1999). It is possible that recent changes—including the policies of the Justice Department and the SEC to credit companies if they have reacted aggressively to the allegations of fraud and cooperated with investigators—have made terminations more commonplace.

126. See Karpoff, *supra* note 6, at 32–33.

actions so that the lawyers would recover a greater percentage or amount to the extent that the money was paid by individual wrongdoers.<sup>127</sup> The question, of course, is how much greater the bounty payment needs to be to cause a shift? Too great a percentage becomes at least politically troubling to the extent that it shifts more money from defendant to plaintiffs' lawyer, skipping the supposed victims, and tempting a greater number of suits to be brought for their settlement value. At the very least, courts approving settlements would have to be more careful (and work harder) in this setting.

Too small an additional percentage, on the other hand, might leave the lawyers preferring to take advantage of the gross liability threat to the corporation as their main leverage in settlement talks. I have suggested elsewhere that corporate liability be capped, both to bring damage liability closer to the optimal and in order to eliminate this excessive leverage.<sup>128</sup> The hard question is whether such caps would leave in place enough incentive for lawyers to bring meritorious lawsuits. My sense is that the caps could be set in a way that would. Additionally, if a bounty were then added for uninsured and unindemnified recoveries against wrongdoing executives, there would be substantial incentive to exceed the company-funded baseline, notwithstanding the costs.

Without necessarily endorsing it as a reform, one could at least imagine abandoning the fraud-on-the-market presumption of reliance in cases involving nontrading issuers<sup>129</sup>—the key to class actions seeking recovery for corporate fraud—and still retain room for deterrence and restitution. Such a change would eliminate class actions as a remedial device, but still permit large shareholders to bring suit for fraud, either under Rule 10b-5, or, in a case involving false filings with the SEC, Section 18 of the Securities Exchange Act. In such an action, it would be fairly easy (and perhaps already so as a matter of law)<sup>130</sup> to allow restitution as an ancillary remedy on top of whatever actual damages the plaintiffs can show, again with an attorney's fee bounty for successful recovery against company officers. The remainder of the restitutionary amount

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127. Coffee, *supra* note 2, at 1581–82.

128. See Langevoort, *supra* note 7, at 657–60.

129. See *Basic Inc. v. Levinson*, 485 U.S. 224, 245, 250 (1988) (holding that in fraud-on-the-market cases, reliance is a rebuttable presumption). For such a proposal, see Mahoney, *supra* note 23, at 670; see also Coffee, *supra* note 2, at 1582–84. On the difficulties for the fraud-on-the-market theory if one assumes some degree of investor irrationality in the setting of stock prices, see Langevoort, *supra* note 30, at 137; Ribstein, *supra* note 8, at 139–40.

130. See *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 287–90 (1940) (noting that the Securities Act does not restrict relief under its provisions to monetary judgments). Also worth remembering is Section 29(b) of the Securities Exchange Act, which renders contracts made in violation of the Act voidable. Securities Exchange Act of 1934, 15 U.S.C. § 78cc; see COX ET AL., *supra* note 120, at 782–89.

would then be returned to the corporation or transferred to the SEC, as the court directs.

*B. Director Accountability*

As a matter of state corporate law, directors are well positioned to recoup ill-gotten gains from executives who have been unjustly enriched by their activities; the question is whether they have the motivation and incentive to do so. One way of turning up the pressure is to hold the directors more accountable for their decisions. Coffee suggests that the SEC require—in the event of settlement of private securities litigation—a filed statement from the board of directors as to the fairness of the settlement in light of concerns that money simply paid by the company or its insurance carrier hurts, rather than helps, shareholders.<sup>131</sup> This change, too, would be helpful, though its benefits might be small in the predictable situation where the board denies widespread individual executive culpability in favor of a few “rotten apples,” or largely denies wrongdoing altogether and claims that settlement is simply to avoid the costs and burdens of further litigation.

Further leverage here could come from the SEC. One of the factors on its list of whether to penalize a company is the extent of its “remediation” efforts,<sup>132</sup> a vague term that encompasses many possible board responses to what has been uncovered. The SEC could require a commitment from the company that it will seek appropriate restitution from all identifiable wrongdoers and “defer” enforcement action against the company pending its effort to do so. The board would report periodically to the SEC on its progress and receive approval with respect to the settlement or termination of any action against the executives in question. This requirement would also conserve SEC resources, addressing another factor that sometimes leads to a preference for entity, rather than individual, liability.

*C. Derivative Suits*

As just noted, state law holds some promise as a source of restitutionary recovery against executives.<sup>133</sup> Because of the dearth

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131. See Coffee, *supra* note 2, at 1577 (citing *In re Warner Commc'ns Sec. Litig.*, 798 F.2d 35, 38 (2d Cir. 1986) (questioning settlements that leave out individual defendant liability)). I will leave to the side the question of whether outside directors should bear greater personal liability for failures of oversight. To date, the risk of outside director liability—putting aside the context of a public offering of securities—is almost nil. See Black et al., *supra* note 110, at 1062.

132. See *supra* note 122 and accompanying text. On remediation in SEC settlements, see generally Cristie Ford, *Toward a New Model for Securities Enforcement*, 57 ADMIN. L. REV. 757, 785 (2005) (suggesting that negotiated compliance and monitoring efforts will produce more law-abiding behavior).

133. Booth's suggestion is to concentrate on the derivative action as the

of case law, however, the law is less clear than it might be about the liability of executives who are somehow complicit in financial misreporting. One can glean from *HealthSouth* a basis for rescission and restitution of incentive compensation contracts, albeit with interesting open questions remaining about contractual limitations on such remedies. It would be helpful to have guidance on the validity of clauses that seek to protect compensation notwithstanding breach of fiduciary duty. If the law was clearer, director accountability would be enhanced as well because directors making “business judgment” decisions on how to proceed would then be expected to address the restitutionary option in justifying their actions.

Indeed, Delaware law could benefit from more clarity on a number of issues relating to executive responsibility with respect to financial reporting. *Malone v. Brincat* stands for the proposition that officers and directors are responsible for candid disclosure to shareholders, whether or not shareholder action is sought.<sup>134</sup> However, purportedly so as not to conflict with the federal law that fills the field, this duty of candor is limited in cases that do not involve requests for shareholder action to intentional misrepresentation or nondisclosure where there is a duty to speak and requires a showing of individualized reliance (i.e., not a fraud-on-the-market-type presumption),<sup>135</sup> making these cases unsuited for class action treatment. In a case decided shortly after *HealthSouth*, Vice Chancellor Strine indicated that equitable doctrines, such as constructive fraud, should not be expanded in ways that would undercut the *Malone* limitations, and he resisted treating *HealthSouth* as an invitation for no-fault or negligence liability under the duty of candor.<sup>136</sup>

That point is well taken, though the concern is probably overstated. The duty of candor issue in the absence of shareholder action does overlap with a well-developed (and now more tightly controlled) class action regime under federal law, which is about the recovery of damages by open-market traders. The issue I have been stressing is the executive’s obligation of candor *to the corporation*, which is most clearly embodied in an affirmative duty of candor *vis-à-vis* the company’s board of directors and remediable via an action by or derivatively in the name of the corporation. This is clearly a state law issue, though again it is surprising that one finds so little Delaware law dealing with “candor inside the corporation.”<sup>137</sup> More

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mechanism for sanctioning corporate executives. See Booth, *supra* note 8, at 22–25.

134. 722 A.2d 5, 12–13 (Del. 1998).

135. *Id.* at 11.

136. See Metro Commc’n Corp. BVI v. Advanced Mobilecom Techs. Inc., 854 A.2d 121, 163 n.102 (Del. Ch. 2004). For further discussion of *Metro Communication*, see *supra* note 77 and accompanying text.

137. See Langevoort, *supra* note 20, at 1198–99.



importantly, claims of unjust enrichment brought by, or on behalf of, the corporation are of the sort where neither fault nor reliance have ever been required elements.<sup>138</sup> A flourishing body of law on recouping incentive compensation would not, therefore, contravene any significant *Malone*-type policies, regardless of whether one treats the issue as fraud on the board or fraud on the shareholders. Quite to the contrary, it would reinforce the body of law implicit in Delaware jurisprudence that contracts tainted in their making or performance by breach of fiduciary duty are voidable.

Indeed, there is probably room in Delaware law for greater recognition of the distinction between claims for equitable relief and claims for damages in terms of liability standards generally. Consider the recent *Disney* litigation.<sup>139</sup> Insofar as that case was an effort to impose damage liability on Disney's directors for their supposed bad faith in the process by which Michael Ovitz's contract was negotiated or terminated, plaintiffs properly faced a difficult burden, which they failed to satisfy.<sup>140</sup> But suppose the case was restyled so that it was simply an effort to rescind Ovitz's contract or cancel the termination and recoup the severance. Here, bad faith would become unimportant—the plaintiffs only used that label in an effort to avoid the exculpation provision in Disney's charter. Delaware's exculpation authority only goes to claims for damages against directors and specifically excludes cases of improper personal benefit. It seems likely that a third party could not enforce a contract with the corporation which he knew was made in breach of fiduciary duty by the company's directors.<sup>141</sup> Arguably, that would include awareness of gross negligence on the part of the directors or circumstances where the third party knew that material information had wrongfully been concealed from the board. As a matter of simple equity, rescission could be warranted—albeit with a countervailing quantum meruit claim for fair value of services—upon any factual showing that would defeat the apparent authority of those who negotiated the contract to act on the company's behalf.

My point here is not to say that *Disney* would or should have come out differently (in the end, there was no finding of gross negligence), but simply to show that if it were pursued as a rescission and restitution case, rather than one against the directors for damages, it would look somewhat different. This is a fruitful area for further Delaware litigation.

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138. See generally *In re HealthSouth S'holders Litig.*, 845 A.2d 1096, 1105 (Del. Ch. 2003) (indicating the elements of an unjust enrichment claim).

139. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (holding that the board of directors did not breach a duty of good faith by hiring and shortly thereafter terminating an employee with a generous termination package).

140. *Id.* at 772.

141. See *In re Paramount Commc'ns Inc. S'holders Litig.*, 637 A.2d 34, 50–51 (Del. 1994).

*D. The SEC*

The SEC has clear-cut authority to seek both restitution and civil penalties against wrongdoing executives, plus forward-looking relief in the form of injunctions, cease and desist orders, and officer/director bars.<sup>142</sup> The question here is simply one of probability of detection and institutional will, which in turn is driven by the Commission's limited resources coupled with some degree of litigation risk-aversion.

There would be some benefit from a clearer articulation of SEC policy on individual responsibility in cases of financial misconduct. Of particular interest here would be a statement of when and how Section 304 of Sarbanes-Oxley<sup>143</sup>—requiring repayment of incentive compensation and insider trading profits by CEOs and CFOs when there has been an accounting restatement based on “misconduct”—will be enforced. Courts have largely said that there is no implied private right of action.<sup>144</sup> If this is so, then external enforcement responsibility (coupled with exemptive authority) is given solely to the Commission. It would help to have a strong message about the facts and circumstances that make it appropriate or not to have such payments and the expectations as to the board's role in demanding disgorgement. As noted earlier, this can be done as part of an enforcement action wherein the Commission chooses not to penalize the company so long as it commits to seeking restitution from all complicit insiders. Because the natural form of resistance on the part of company managers will be to resist restatements (or at least restatements that might be characterized as involving misconduct), the Commission should also look to bring cases against both managers and auditors where companies apparently avoided restating in order not to trigger Section 304.

*V. CONCLUSION*

Corporate managers have much to fear if they are complicit in accounting fraud even under the system as currently structured, where enterprise liability crowds out adequate attention to individual liability. Many lose their jobs and their reputations, face the risk of criminal prosecution, and, perhaps, share with other investors the loss in the value of their company's stock and options that comes when the fraud is uncovered. That executives continue to partake in fraud notwithstanding this threat is either because of

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142. Thomas C. Newkirk, Assoc. Dir., & Ira L. Brandriss, Staff Attorney, Sec. and Exch. Comm'n, *The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws* (Sept. 19, 1998), <http://www.sec.gov/news/speech/speecharchive/1998/spch222.htm>.

143. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §304, 116 Stat. 745, 778 (2003) (codified as amended at 15 U.S.C. § 7243 (2005)).

144. *In re Bisys Group Inc. Derivative Action*, 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); *Neer v. Pelino*, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005).

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the extraordinary gains that come from pulling off a deception or the ability of the human mind—and organizational culture—to blind a person to palpable risks. It is probably a bit of both. Either way, we should be cautious about assuming that tweaking the individual liability system will necessarily produce better deterrence.

That said, it still strikes me as something of a baseline for the legitimacy of our corporate law system that remedies not leave executives who either instigated, helped execute, acquiesced in, or closed their eyes to fraud with most or all the wealth that was generated by the deception. It is all the worse if we have created a system of liability that garners support only because of the illusion that it deters wrongdoing, but in fact mainly just moves money from the pockets of some investors to those of others, at substantial cost.

The latter should be reformed in any event, but it would be a shame if the relatively small amount of deterrence and compensation offered by the current litigation regime were to be eliminated without careful attention to the problem of individual executive responsibility. We should admit, of course—as Vik Khanna has argued in the criminal context<sup>145</sup>—that as a matter of politics, the current emphasis on enterprise liability might exist precisely *because* it provides cover for the protection of executive wealth. If so, it is naïve to expect that the system will change easily. At least, however, we should remove the cover and see what happens.

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145. See generally Vikramaditya Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L.Q. 95, 140 (2004).