TIES THAT BIND: CODES OF CONDUCT THAT REQUIRE AUTOMATIC REDUCTIONS TO THE PAY OF DIRECTORS, OFFICERS, AND THEIR ADVISORS FOR FAILURES OF CORPORATE GOVERNANCE

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"Let's be idealistic, but let's also be practical."[2]

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[2] E.M. Swift, *SI Vault: Miracle on Ice*, SPORTS ILLUSTRATED (Aug. 15, 2014), http://perma.cc/KW5X-4GM4 (statement of Herb Brooks, 1980 United States Olympic Hockey Coach).

Abstract

Executives and directors at large corporations rarely face personal liability for failing to impose effective controls on subordinates or outside suppliers, even when this failure results in significant financial or reputational damage to the corporation. My proposal for binding codes of conduct seeks to change the dynamics of corporate governance. These executives and directors would agree to meet certain standards and further

agree to automatic reductions in compensation if these standards are not met, regardless of whether there is an actual violation of the law.

Certain consumers and investors already send business to perceived "ethical" companies or companies that are known for having strong and effective management. Some executives and directors will therefore seek further business by agreeing to my proposed binding codes of conduct. Others will not adopt the codes. Consumers and investors will decide whether they care. My proposal is completely market-based, and requires no government intervention or changes to the law.

I. INTRODUCTION

Executives and directors of large corporations often keep their jobs and their generous compensation packages even when their incompetence or lack of effective oversight of employees or suppliers leads to reputational damage, massive losses for a company, or even systemic harm to the national economy. This seems patently unfair, when a minimum wage employee would likely face immediate termination for lack of attentiveness or negligence.[3]

The *Caremark* case,[4] decided nearly 20 years ago, is illustrative. Caremark's problems arose when it allegedly violated a law generally prohibiting kickbacks for referrals of Medicare or Medicaid business.[5] In 1995, Caremark pleaded guilty to a single felony count of mail fraud and agreed to make various payments totaling approximately $250 million.[6]

While Caremark paid a price, Caremark's directors and officers emerged unscathed.[7] A derivative action against Caremark's directors for insufficient oversight was settled using corporate funds to pay the plaintiff shareholders' legal fees.[8] No directors had to pay out of their pockets. The Delaware Chancery Court reluctantly accepted the settlement, but not

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[3] This concern is exacerbated by the large pay gaps between executives and employees at large corporations. Elliot Blair Smith & Phil Kuntz, *Disclosed: The Pay Gap Between CEOs and Employees*, BLOOMBERG, May 2, 2013, http://perma.cc/MP4M-QVE6 (stating that CEOs of Standard & Poor's 500 companies averaged 204 times the income of nonsupervisory workers in their industries).

[4] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[5] *Id.* at 960.

[6] *Id.* at 960-61.

[7] Certain lower-level Caremark executives were tried for their role in the illegal activity but ultimately acquitted by arguing in part that they were simply following the orders of more senior management. *Genentech and Caremark Executives Acquitted*, N.Y. TIMES, Oct. 4, 1995, http://perma.cc/6C8N-VQFN. "We're pleased and excited at the outcome," said Les Jacobson, a Caremark spokesman. *Id.* As demonstrated by the spokesman's comments, there was apparently little fear in corporate headquarters that this defense might actually lead to the indictment of higher-level executives.

[8] Caremark additionally agreed to modest changes to its governance policies. *Caremark*, 698 A.2d at 971-72.

because the settlement paid too little, or did not target individual directors or officers. Instead, the court labeled the plaintiffs' case against Caremark's directors as "weak"[9] and opined that "[i]f the directors did not know the specifics of the activities that lead to the indictments, they cannot be faulted."[10]

As will be described below, the law provides strong protections to directors and officers of large corporations in instances of lax oversight. Directors and executives typically must know about specific misconduct; having mere supervisory control when even massive criminal conduct occurs on their watch is not sufficient to impose personal liability.[11] Because of this reality, potential civil adversaries are often unwilling to take chances in litigating cases against directors and officers to their conclusion. When a corporation offers a large settlement to resolve shareholder litigation, plaintiffs are unlikely to quibble that the source of the settlement funds is from the corporation itself, or from an insurance carrier and not from the pockets of officers or directors.[12]

Binding codes of conduct would change the current dynamics by holding chief executive officers and other senior corporate agents[13]

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[9] *Id.* at 972.
[10] *Id.* at 971-72. *Caremark* is often cited for the proposition that a board has affirmative duties to act in good faith. *Id.* at 970. Whatever the standards, the court expressed its belief that the directors did not breach their duties even given the egregious facts of this case.
[11] *See infra* Part II.
[12] Directors and officers rarely suffer financial penalties in class actions for mistakes in judgment or any other reason. Michael Klausner, Jason Hegland, & Matthew Goforth, *How Protective is D&O Insurance in Securities Class Actions? An Update*, 26 PLUS J. 5 (May 2013) ("Among [class actions] filed [between] 2006 [and] 2010, 2% of settlements have included an out-of-pocket payment by an officer and none has involved a payment by an outside director"; noting that 18% of the cases were still outstanding.). Professor Klausner's group breaks down resolutions of all class actions between 2000 and 2013 as follows:

- Among resolved cases, 1,001 (53.47%) were settled and 871 (46.53%) dismissed.
- Among settled cases, individuals paid out-of-pocket in 44 (4.40%) of cases, and 957 (95.60%) were protected by some combination of insurance and corporate assets.
- Among all resolved cases (settled and dismissed combined), individuals paid in 2.35% of cases.

E-mail from Jason Hegland to author (July 3, 2014). S*ee also* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1550 (2006) (citing statistics showing that in the overwhelming majority of securities class action cases, "the corporate defendant and its insurer [and not officers or directors] typically advance the entire settlement amount").
[13] "Corporate agent" as I use the term includes senior executive officers and the individual board members at large corporations. The term is shorthand to describe parties who perform supervisory functions at a corporation. My focus is not on lower level employees within the organizations. Their direct involvement with the wrongdoing (i.e. a trader who illegally disseminates inside information) already exposes them to significant liability under the law.

personally accountable for inadequate supervision and bad corporate governance, regardless of whether they would be found liable under the law.

Some consumers and investors would send business to corporations with executives and directors willing to risk a portion of their compensation to show that they can meet minimal standards such as ensuring, most basically, that their companies do not engage in criminal conduct.[14] My proposal for binding codes of conduct is therefore a market-based approach to the problem of a lack of personal accountability for these senior executives and directors.

Codes of conduct are already common. Corporations, law firms, and financial firms in the United States adopt codes on a routine basis to foster good will with their clients and the public. Codes may state that executives and employees must act ethically and, for example, report improper behavior. Importantly, codes rarely provide for specific remedies when they are breached. Moreover, corporations often disavow their own seemingly applicable codes of conduct to avoid lawsuits from what they perceive as an overly aggressive plaintiff's bar.

In contrast, binding codes would be enforceable under all circumstances with automatic consequences to the corporate agents in the event of a violation. As outlined below, these codes can cover almost any area where traditional law has proved inadequate in assuaging public resentment over unchecked bad corporate conduct. The ultimate goal, of course, is to change corporate behavior from the current focus on avoiding liability through legal maneuvering to a new emphasis on acting ethically and not testing legal boundaries. Ideally, the codes would never be violated and executives and directors would not lose compensation.

In this article, I start with a review of why the law often fails in imposing personal liability on officers and directors of corporations for failures of oversight.[15] Most notably, the elements of intent and materiality are found in almost every statute seeking to hold corporate agents personally liable. Corporate executives and directors can often legitimately claim they had no direct supervision over individual wrongdoers within their organizations. Without actual knowledge of misconduct, they can have no intent to violate laws.

Nor by including directors in my definition do I wish to spark a debate about whether directors can be agents under agency law. Arnold v. Soc'y for Sav. Bancorp, 678 A.2d 533, 539-40 (Del. 1996) ("Directors, in the ordinary course of their service as directors, do not act as agents of the corporation . . . A board of directors, in fulfilling its fiduciary duty, controls the corporation, not vice versa.").

[14] Even a shift of five percent would have a profound effect on a corporation's bottom line. As set forth below, *infra* Part IV.D, the proposal requires a mechanism for publicizing the codes of conduct, so that consumers can make informed choices and reward or punish companies with corporate agents willing (or not) to sign.

[15] *See infra* Part.II.A–C.

Second, I explore voluntary codes that are common today.[16] These codes of conduct include rules that apply to corporations, individuals in corporations, and various professionals who provide advice to corporations. They are aspirational, and therefore are different from laws that set minimal bars. These codes do have limited positive value in changing corporate or professional firm culture. I conclude that these voluntary codes are insufficient because they do not typically <u>require</u> the imposition of personal financial liability when corporate agents fall short of their own stated ideals.[17]

Third, I describe how legally enforceable binding codes of conduct can help foster effective and ethical corporate governance.[18] I provide specific examples of binding codes that might be salubrious in the financial and workplace safety areas. These codes work as non-delegable duties and apply whether the executives in question knew about the malfeasance within their organizations. If there is violation, the compensation reductions for senior corporate agents are automatic and in the nature of strict liability.

To be specific, one such code of conduct would require an automatic reduction if the corporation pleads guilty to a criminal violation, such as in connection with money laundering or polluting a stream with toxic chemicals. The executive's intent or knowledge would be irrelevant. The point is to apply the reductions quickly under clear rules, thereby vindicating public concerns.

As with any strict liability regime, the codes may result in seeming unfairness in certain situations. Why should an executive take a reduction in instances when he or she is obviously removed from the actual wrongdoing? But executives never ask this question when the opposite occurs. Say their company derives large profits from the invention of a drug or some other product. Assume further that the executive never visited the lab in question and did not even know the product was under development. That executive would surely take his bonus if it relies in part on the profits from this product. By the same standard, corporate failures need not be tracked back to the executive's direct involvement. The compensation package should reward those who create a lawful and innovative work environment, but also punish those who create conditions where improper conduct is rife.

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[16] *See infra* Part III.

[17] Some executives voluntarily forgo compensation during very bad years, even when they are contractually entitled to compensation. While laudable, there is no obligation for them to do so under the voluntary codes of conduct that I describe below. Their acts take on an appearance of *noblesse oblige* which does not satisfy public outrage when large losses occurred under their stewardship.

[18] *See infra* Part IV.

The market already rewards well run companies with higher stock prices and lower borrowing costs.[19] By this measure, the markets should respond favorably when corporate agents express confidence in their firms' corporate governance structure by signing binding codes of conduct. In addition, the companies will grow as customers and investors reward these companies with additional business. Therefore, binding codes of conduct can partially address public hostility against bad management, a major focus of this article, but also have the positive effect of encouraging good corporate governance with all the economic benefits that come with it.

II. EXAMPLES OF STRONG LEGAL PROTECTIONS AGAINST PERSONAL LIABILITY AFFORDED TO DIRECTORS, OFFICERS AND OTHER CORPORATE AGENTS

Legitimate public policy reasons exist to protect corporate agents. Limiting liability encourages the entrepreneurial spirit and allows individuals to take chances without risking their personal wealth. Under the business judgment rule, an officer, director, or shareholder of a corporation is generally not personally responsible for the debts or obligations of the corporation.[20]

The basic drive of the law is to protect corporate agents. The following is a brief, non-exhaustive review of fiduciary law, fraud, and punitive damage standards to demonstrate the basic difficulties in holding individual executives and directors personally responsible for oversight failings.

A. Fiduciary Duties and the Requirement of Intent in Demonstrating a Breach

The need for fiduciary law arose in the 18th century with the growth of more complex commercial transactions. A fiduciary duty in

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[19] Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94-95 (1985) ("Of course, rational shareholders understand the risk that the managers' acts will cause them loss. They do not meekly accept it. The price they are willing to pay for shares will reflect the risk. Managers therefore find ways to offer assurances to investors without the need for direct monitoring; those who do this best will attract the most capital from investors. Managers who do not implement effective controls increase the discount.").

[20] Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("It is a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the [corporation]."); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036, 1070 (1991) (empirical study of 1600 veil piercing cases found no case of piercing in a public corporation, indicating "the presence of factors in the public corporation setting that make the presumption of limited liability unassailable[]").

common law is "[a] duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person. It is the highest standard of duty implied by law (e.g., trustee, guardian)."[21]

Basic to common law torts (of which corporate law fiduciary duties is a sub-species) is the distinction between accidental and intentional conduct. Both can lead to damages, but typically only intentional conduct by corporate agents' leads to personal liability.[22] Negligence and non-intentional conduct are covered through director and officer liability insurance, which is required in many states.[23] Importantly, if senior corporate agents know they will not be directly liable for failures due to negligent oversight that have devastating financial consequences for their organizations, they may be less vigilant in preventing these failures.[24]

States compete to make themselves more friendly to corporations, also fueling laws that shield corporate agents. As part of this strategy, states may change laws in response to court decisions imposing liability on corporations or their senior agents for bad conduct. In *Smith v. Van Gorkom*,[25] the Delaware Supreme Court found a corporate board grossly negligent and therefore liable under a duty of care standard[26]. The decision created a fear that Delaware would lose its status as a preferred corporate headquarters. A statutory change, which allowed a corporation to amend its charter to eliminate directors' personal liability for violation of the duty of

[21] BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

[22] Although corporate directors and officers may not be held liable for a corporation's intentional torts merely by virtue of the office they hold, they may be held liable for such torts if they have involvement in the tortious acts. Sports Imaging of Ariz., L.L.C. v. 1993 CKC Trust, 2008 Ariz. App. LEXIS 212, at *35-36 (Ariz. Ct. App. Sept. 30, 2008) (citing Jabczenski v. S. Pac. Mem'l Hosps., Inc., 119 Ariz. 15, 20 (App. 1978); Charles Bloom & Co. v. Echo Jewelers, 652 A.2d 1238, 1243 (N.J. Super. Ct. App. Div. 1995) (stating that a director or officer of a corporation does not incur personal liability for the corporation's torts merely by reason of his or her official character, but a director or officer who commits a tort, directs the tortious act to be done, or participates or cooperates therein, is liable to third persons injured thereby, even though liability may also attach to the corporation for the tort)).

[23] Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, U. CHI. L. REV. 487, 488-89 (2007).

[24] *Id.* As at other times in this article, I acknowledge that the current state of the law does sometimes play a role in moderating bad corporate conduct. In this case, the D&O insurer has an incentive to deter bad corporate conduct, because it is the one ultimately footing the bill. *Id.* at 489. However, D&O insurers also pass increased monitoring costs to the companies they insure and, indirectly, the company shareholders. *Id.*

[25] 488 A.2d 858 (Del. 1985).

[26] *Id.* at 884.

care.[27] A version of this statute has been passed in all states, and most large corporations have such an "exculpatory clause" for such acts.[28]

Likewise, suits alleging that a board failed to properly monitor the business of the corporation are generally known as *Caremark* claims after the case already discussed in the introduction.[29] The *Caremark* court set a high bar for liability, requiring a showing that "directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[30]

Again, I am discussing the standards for imposing liability on individual corporate agents, as opposed to reversing the transaction or taking action against a corporation directly in response to bad conduct.[31] More recent Delaware cases affirm this protection for board members and executives against personal liability. In *The Walt Disney Company Derivative Litigation*,[32] the Court of Chancery concluded that the defendant officers and directors of The Walt Disney Company did not breach their

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[27] DEL. CODE ANN. tit. 8, § 102(b)(7)(i) (2014). Because of this change, *Van Gorkom* remained the only case at least through 2006 in which an outside director was forced to make personal payments after a trial. Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059-60 (2006).

[28] Lawrence A. Hamermesh, *Essay: Fiduciary Duty, Limited Liability, and the Law of Delaware: Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000) ("[O]f one hundred 'Fortune 500' companies, ninety-eight of the stock corporations that incorporated in jurisdictions allowing for exculpatory charter provisions have adopted such provisions" and in "a sample of one hundred small-and mid-capitalization companies, all but one (a Delaware corporation) of those incorporated in a jurisdiction authorizing exculpatory charter provisions have included such a provision in their articles or certificate of incorporation.").

[29] *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).; Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (adopting the Caremark standard in finding that directors were not personally liable in a shareholder derivative suit where a reasonable information and reporting system exists, even if that system did not detect the misconduct).

[30] *Caremark*, 698 A.2d at 967.

[31] The focus of this article is on large corporations, addressing the threat of a reversal of a transaction acts as more of a deterrent upon the leadership of smaller entities. One such reversal may be sufficient to put the company out of business. This aligns the interests of the directors and officers with the shareholders and cuts abuse. In contrast, a large corporation can absorb multi-billion dollar losses from fraud without altering its basic profitability. Even in years when large fines are imposed, a large corporate can be immensely profitable. *See* Peter Eavis, *Steep Penalties Taken in Stride by JPMorgan*, N.Y. TIMES, Jan. 8, 2014, at A1 (noting that, even with total penalties of $20 billion over the last several years, "JPMorgan's shares are up 28 percent over the last 12 months. Wall Street analysts estimate that it will earn as much as $23 billion in profit this year, more than any other lender."); Jill Treanor, *200 HSBC staff paid more than £1m in 2012*, THE GUARDIAN, Mar. 4, 2013, http://perma.cc/5MPU-C428 ("HSBC paid 204 of its staff more than £1m in 2012, a year when Britain's biggest bank made profits of $20.6bn (£13.7bn) despite being fined £1.2bn by the US authorities for helping Mexican drug barons launder money through the financial system.").

[32] *In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 52 (Del. 2006).

fiduciary duties in connection with the termination of Michael S. Ovitz, the short-lived president of Disney. Ovitz held the spot for approximately 14 months but received a $130 million severance package when he left,[33] raising the ire of Disney shareholders.

The Court rejected all arguments presented by the plaintiff shareholders against Ovitz or the board of directors for hiring him. As to Ovitz, the Court found his pay package and severance to be perfectly appropriate, stating, "it makes no difference why Ovitz was not as successful as his reputation would have led many to expect, so long as he was not grossly negligent or malfeasant."[34]

The Court likewise found no legal fault with the board of the directors in approving the pay structure. Describing the duty of a director as one to avoid any conduct "disloyal to the corporation," Chancellor Chandler ultimately wrote that the threshold for liability for failing to act in good faith requires an "intentional dereliction of duty, a conscious disregard for one's responsibilities…. [This] may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act."[35]

This survey of one small area of fiduciary obligations shows the importance of intent in establishing personal liability against an executive or board. Incompetence and bad calls are not enough to impose personal liability. As the *Disney* and *Caremark* cases demonstrate, accepting a settlement using corporate funds may be a good alternative to a near certain defeat by a plaintiff in court. Because Delaware is such an important state for corporate law, the decisions suggest some real limits to the vulnerability of corporate boards and executives for bad management decisions.

B. Fraud in the Corporate Law Context and the Requirements of Intent and Materiality

On top of breaches of fiduciary duties, fraud is an obvious area to obtain penalties against corporate agents. Fraud is likewise difficult to prove due to the scienter and the heightened pleading requirements of the securities laws. Fraud cases are largely governed by the Securities Exchange Act of 1934, along with other rules and regulations propagated by the Securities and Exchange Commission.[36] As a general rule, section 10(b)

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[33] *Id.* at 35.
[34] *Id.* at 42.
[35] *Id.* at 67 (citing *In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 755 (Del. Ch. 2005)).
[36] Securities Exchange Act of 1934, Pub. L. No. 73-291, § 10, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982 & Supp. V 1987)), provides in relevant part:

reaches only knowing and intentional misconduct. "Since a person violates section 10(b) only if he knows (or perhaps if he should know) what he is doing is wrong, careless conduct cannot constitute a violation of the section even if it injures others."[37] Further, bad conduct involving deception comes within the scope of the section; fully disclosed misconduct cannot generally violate section 10(b).[38]

To establish an actionable claim, a private plaintiff must typically demonstrate that the defendant: "[(1)] made a misstatement or an omission of a material fact (2) with scienter (3) in connection with the purchase or the sale of a security (4) upon which the plaintiff reasonably relied and (5) that the plaintiff's reliance was the proximate cause of his or her injury."[39] Each element presents factual hurdles for the plaintiff (material, scienter, in connection with, etc.); and therefore, provides incentives to settle.

In addition, changes to the law have increased hurdles for plaintiffs in seeking to hold corporate agents accountable. Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA"),[40] over President Clinton's veto, and implemented several substantive changes related to pleading, discovery, liability, class representation, and awards of fees and expenses[41].

Prior to the PSLRA, corporations argued that plaintiffs could proceed with minimal evidence of fraud and then use pretrial discovery to round out their cases. The PSLRA addressed this perceived problem. Under the PSLRA, plaintiffs need more proof of fraud before they can initiate a suit. This makes it very difficult to file a frivolous suit, but it is much harder to file legitimate ones, as plaintiffs are forced to present evidence of fraud before any pretrial discovery has taken place.[42] A rational plaintiff might

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It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1982).

[37] Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act,* 42 STAN. L. REV. 385, 387 (1990) ("It would be very hard to define exactly what section 10(b) and rule 10b-5 forbid.").

[38] *Id.*

[39] AES Corp. v. Dow Chem. Co., 325 F.3d 174, 178 (3d Cir. 2003) (internal quotation marks omitted), *cert. denied*, 540 U.S. 1068 (2003).

[40] Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[41] 15 U.S.C. §§ 78u-4(a)(6), (b)(2), (b)(3)(B), (b)(4), (e), (f), 78u-5 (2000).

[42] *See, e.g.*, Sedona Corp. v. Ladenburg Thalmann & Co., No. 03 Civ. 3120, 2005 U.S. Dist. LEXIS 23905, at *11 (S.D.N.Y. Oct. 14, 2005) ("Thus, the stay [on discovery] would apply where there is a pending motion to dismiss brought by either one or all of the defendants, and

accept a settlement offer using corporate funds, and not the assets of the corporate agents, rather than litigate the inevitable motion to dismiss by a top firm defending the corporation and its corporate agents.[43]

Sometimes the laws, even those passed with good intentions, lack sufficient force. In the early part of the twenty-first century, corporate fraud began to seem endemic. Sarbanes-Oxley[44] required expanded and more frequent disclosure by public companies of their finances to prevent fraud.[45]

However, in *Garfield v. NDC Health Corp.*,[46] the Eleventh Circuit recited precedent that held that the mere certification of financial statements does not satisfy the heightened pleading standard for scienter required by the PSLRA[47]. The court concluded that the "Sarbanes-Oxley certification is only probative of scienter if the person signing the certification was severely reckless in certifying the accuracy of the financial statements."[48] Per *Garfield*, executives can argue that there is no Sarbanes-Oxley violation even when they sign grossly inaccurate statements, because they simply relied upon others, often highly credentialed accounting professionals.[49]

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regardless of whether the motion is brought initially to dismiss a complaint, or subsequently, in response to an amended complaint.").

[43] Additionally, Congress passed the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") to make federal court the exclusive forum for securities-fraud class actions so that litigants could not avoid the intended effects of the PSLRA. SLUSA was enacted because of a perception that plaintiffs were migrating to state courts to avoid the effects of the PSLRA. Cecilia A. Glass, *Sword or Shield? Setting Limits on SLUSA's Ever-Growing Reach*, 63 DUKE L.J. 1337, 1343-44 (2014).

[44] Sarbanes–Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).

[45] Section 304 of Sarbanes-Oxley requires a CEO or CFO to return incentive-based compensation to an issuer when a financial restatement occurs "as a result of misconduct." 15 U.S.C. § 7243(a) (2006). Agreeing with the SEC, one court has found that the misconduct refers to the misconduct of the issuer (i.e. the entity actually issuing the stock) and not the executive. SEC v. Jenkins, 718 F. Supp. 2d 1070, 1078 (D. Ariz. 2010).

It is far from clear that the case will have a large impact. The *Jenkins* court did not address the defendant's apparent intention to seek indemnification under the Delaware law that allows the corporate defendant to be indemnified if the defendant acted in good faith. *Id.* at 1078-1079. Obviously, if indemnification under state law is allowed, Section 304's purpose would be thwarted.

Further, other courts might find that the *Jenkins* decision presents due process problems of a constitutional dimension, which could be avoided by simply interpreting the statute to require the personal misconduct of the CEO as a precondition of seeking reimbursement. *Id.* at 1075-1076 (Defendant's request to read scienter back into this statute was unsuccessful in this case, but could be raised again.).

[46] 466 F.3d 1255 (11th Cir. 2006).

[47] *Id.* at 1266-67.

[48] *Id.* at 1266.

[49] In addition, the PLSRA creates a safe harbor which provides special protection for alleged misstatements that are "forward-looking" in nature. 15 U.S.C. § 77z-2(c)(1)(B)(ii).The safe harbor shields written forward-looking statements from liability if any one of the following criteria is met: (1) the statement was identified as a forward-looking statement, "and is accompanied by meaningful cautionary statements identifying important factors that could

Thus, even laws such as Sarbanes-Oxley that sought to tamp down corporate excess typically require a showing of intent or direct involvement of the officer, greatly limiting the reach of the law to punish wrongdoing. In fact, companies and their directors are frequently sued under the securities laws and state corporate law, and settlements are common. But, the actual payments are nearly always made by the companies involved--either directly or pursuant to directors' rights to indemnification--or by a D&O insurer, a major shareholder, or another third party. Corporate agents typically do not pay.[50]

C. Punitive or Exemplary Damages and the Requirement of Intent

Another example of how the law protects corporate agents is in the punitive damages area. Plaintiffs may seek punitive damages in only very limited situations.[51] For example, New York allows punitive damages "in [ ] fraud and deceit case[s] where the defendant's conduct evinced a high degree of moral turpitude and demonstrated such wanton dishonesty as to imply a criminal indifference to civil obligations."[52]

Moreover, when punitive damages are appropriate, the Supreme Court has limited the penalties. In *State Farm Mutual Automobile Insurance Co. v. Campbell*, the Supreme Court reviewed the approval by the Utah Supreme Court of a $145 million punitive verdict against State Farm, noting that State Farm had refused to settle based in part on corporate policies that the Utah court found to be "reprehensible."[53]

In reversing, the Supreme Court looked at guideposts first set forth in *BMW of North America, Inc. v. Gore*, requiring courts to consider: "(1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and

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cause actual results to differ materially from those in the forward-looking statement"; (2) the statement was immaterial; or (3) the statement, if made by a business entity, was not made or approved by an executive who had actual knowledge that the statement was false or misleading. 15 U.S.C. § 78u-5(c)(1). As is already clear, the law need not completely protect corporate agents, but merely inject uncertainty into the plaintiffs' case, inducing plaintiffs to settle by accepting corporate funds. The safe harbor acts imposes such uncertainty, with the avoidance of personal liability for "cautionary statements."

[50] Klausner, Hegland, & Goforth, *supra* note 12.

[51] *E.g.*, Cooper Industries, Inc. v. Leatherman Tool Grp., Inc., 532 U.S. 424, 433 (2001) (stating that compensatory damages seek to redress a plaintiff's concrete loss, while punitive damages are aimed at the different purposes of deterrence and retribution).

[52] Walker v. Sheldon, 10 N.Y.2d 401, 405 (1961) (citation omitted). *See also* Den v. Den, 222 A.2d 647, 648 (D.C. 1966) (the standard for awarding punitive damages is sometimes expressed in terms of the requirement that the breach must have "the character of[] a willful tort[]").

[53] 538 U.S. 408 (2003).

the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases."[54] In *State Farm*, the Supreme Court concluded that the punitive award should not have been a multiple of the compensatory award, but rather "at or near the amount of compensatory damages."[55] The Supreme Court therefore remanded the case.[56]

The summary above shows that plaintiffs face significant obstructions before securing punitive damages. First, they must show that the conduct was reprehensible, and secondly, even if they succeed, they may be limited in the amounts they may seek. Again, the elements as articulated in *Gore* (degree of reprehensibility, comparison with "comparable" cases, etc.) are fact driven. The uncertainty that a punitive award will stand even after a hard fought battle in court also may guide plaintiffs toward settlements prior to obtaining judgments

D. Counter-arguments

Of course, corporate agents might not view the law as particularly forgiving. In the same way a plaintiff seeking to hold corporate agents personally liable faces obstacles and uncertainty under the law, corporate agents can legitimately fear that bad conduct may expose them to personal liability in limited circumstances.[57] Corporate agents are, also, mindful of their reputations and dislike the inevitably bad public portrayals of their roles in cases in which their companies are wrapped up in scandal. These factors can moderate their behavior.

Further, even if a corporate agent suffers no personal consequences for malfeasance, a corporation that must settle using corporate funds has incentives to moderate agent activities.[58] A corporation can obtain a downward modification under the United States Sentencing Guidelines with effective controls on employees.[59] A corporation therefore has reasons to impose effective controls on corporate agents. D&O insurers, which backstop corporations, also, scrutinize corporate governance practices.[60]

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[54] *Id.* at 418 (citing BMW of North America, Inc. v. Gore, 517 U.S. 559, 575 (1996)).
[55] *Id*. at 429 (citing Gore, 517 U.S. at 575).
[56] *Id.*
[57] As demonstrated by the class action figures cited above, only a small group of individuals do ultimately pay from their own pockets. Klausner, Hegland, & Goforth, *supra* note 12.
[58] A corporation may even be held criminally responsible for the illegal conduct of its employees if: (1) the illegal act was committed while the employee was acting within the scope of employment, and (2) the employee's conduct was undertaken, at least in part, for the benefit of the corporation. United States v. Basic Constr. Co., 711 F.2d 570, 573 (4th Cir. 1983).
[59] *See infra* Part IV(A)(6).
[60] *See* cases cited *supra,* note 22.

Whatever the efficacy of these checks on corporate behavior, the burden is on the plaintiffs and not defendants to prove actual intent and materiality in connection with alleged breaches of fiduciary duty and fraud.[61] The advantage clearly lies with deep-pocketed corporate defendants, who can pay unlimited legal expenses and can argue that plaintiffs are overreaching under the state of the law.

III. SUCCESSES AND FAILURES OF VOLUNTARY CODES OF CONDUCT

Until now, the discussion has focused on the current laws, and how they insulate corporate agents for poor decisions. Statutes proscribe behavior, and courts of necessity focus on whether a specific law applies to a specific act. Rather than accepting responsibility, corporations and their agents may look for legal loopholes and press their legal advantages to encourage settlement from corporate assets.

It is better to create an ethical environment in which employees do not skate close to the boundaries of the law. Voluntary codes of conduct guide the behavior of corporate actors by laying down general principles. As such, they deserve serious consideration when trying to construct a regime of ethical conduct. At the same time, their distinct limitations must be recognized.

I define voluntary codes of conduct as policies that: (a) are "commitments voluntarily made by companies, associations or other entities, which put forth standards and principles for the conduct of business activities in the marketplace;"[62] (b) have no specific sanctions for violations; and (c) are available to the public for review, whether on the internet or otherwise. I include SEC filings under this category to the extent they contain general statements about preferred corporate conduct. I also include consent orders and Corporate Integrity Agreements, common in health care cases, to the extent these contain best practices for corporations. Even if court orders carry with them the implied threat of further action if violated, penalties are not a foregone conclusion with most of these orders.

Voluntary codes of conduct fulfill at least three functions. The first is to place company employees on notice that violations may result (but significantly for my argument need not result) in some sanction. The second

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[61] *See supra* Part.II.A–C.

[62] Org. for Econ. Cooperation and Dev. [OECD], *Codes of Corporate Conduct: An Inventory*, at A ¶ 4, TD/TC/WP(98)74/FINAL (May 3, 1999), *available at* https://perma.cc/5J3G-KR6Q?type=pdf. *See also* OECD Directorate for Financial, Fiscal and Enterprise Affairs, *Codes of Corporate Conduct: Expanded Review of their Contents* at 3 (OECD, Working Paper No. 2001/6), *available at* http://perma.cc/PYS7-8X3H; Fiona McLeay, *Corporate Codes of Conduct and the Human Rights Accountability of Transnational Corporations: a Small Piece of a Larger Puzzle* (N.Y. Univ. Sch. of Law Global Law Working Paper 2005/1).

is to signal to the government and regulators that the corporation is serious about applying its internal controls on its employees.[63] The third is to cast the corporation in a positive light with its consumers, investors, and shareholders.

A. Sources of Voluntary Codes of Conduct

1. Industry Trade Groups

Both corporations and their executives join groups that require minimal standards of behavior. Executives win awards from organizations that promote social welfare and ethical behavior and those awards often appear prominently in their biographies and in corporate literature. As such, joining these organizations help bolster the reputation of companies and, also, force them to adhere to standards that exceed bare legal requirements.

2. Internal Corporate Policies

Voluntary codes of conduct are, also, generated by large corporations themselves, and are available for review by the employees and the public on a company's website.[64] These codes sometimes start with a dictate to follow the law, but typically impose additional requirements on employees.

The HSBC website, for example, recognizes the need to follow relevant anti-money laundering laws, but imposes additional requirements as well, stating that "[t]he banking industry has concerns that money laundering schemes will increase and if successful, will lead to the erosion of public confidence in the banking system. Bank personnel therefore must therefore report any unusual transactions. Compliance will not only help the Corporation avoid stringent penalties, but also will assist us in fulfilling our obligations to our fellow workers, our parent company and our

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[63] Section 404 of Sarbanes-Oxley requires management at public companies to select an internal control framework and then assess and report on the design and operating effectiveness of their internal controls annually. As discussed below, good corporate governance can provide for downward modifications of penalties under the United States Sentencing Guidelines. *See infra,* Part IV.A.6.

[64] A small portion of the public actually reads these codes of conduct. Regardless, the Supreme Court assumes that public and material information is incorporated into the stock price. *See* Basic v. Levinson, 485 U.S. 224, 247 (1988) ("Because most publicly available information is reflected in market price, an investor's reliance on any public . . . misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."). This principle was recently affirmed. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2411 (2014) ("Congress may overturn or modify any aspect of our interpretations of the reliance requirement, including the *Basic* presumption itself. Given that possibility, we see no reason to exempt the *Basic* presumption from ordinary principles of *stare decisis*.").

communities."[65] This is a characteristic of the code of conduct. It goes beyond legal principles with its introduction of moral or ethical obligations of the corporation to the greater community.

B. Codes of Conduct: The Voluntary Aspect Becomes Clear When There is Actually a Violation of a Code or Tragedy Strikes

1. Financial Realm

HSBC recently consented to a violation of the money laundering laws between 2004 and 2010 in what the government called "stunning failures of oversight."[66] The settlement, announced December 11, 2012, reflected the seriousness of the violation, including a $1.256 billion forfeiture and $665 million in civil fines.[67] As part of the resolution, HSBC acknowledged compliance lapses, including a failure to maintain an effective anti-money laundering program, and conducting transactions on behalf of customers in Burma, Cuba, Iran, Libya and Sudan, which were all subject to U.S. sanctions.[68]

Yet many who had overall responsibilities have remained with HSBC and have prospered.[69] Others have moved on to prestigious posts. In 2010, Steven Green, in charge at HSBC during the period of the inappropriate conduct, became a minister in David Cameron's coalition cabinet.[70] The lesson is that voluntary codes of conduct can be broken, without consequence.

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[65] *Statement of Business Principles and Code of Ethics*, HSBC GLOBAL PUB. SERVICES (December 2013), https://perma.cc/5H3Y-AN4J?type=pdf [hereinafter Code of Ethics].

[66] United States v. HSBC Bank USA, No. 12-CR-00763 ILG (E.D.N.Y. July 1, 2013), (the "HSBC Case"); Peter Finn and Sari Horwitz, *Justice Department Outlines HSBC Transactions with Drug Traffic*, WASH. POST, Dec. 12, 2012, http://perma.cc/AVV4-SSHJ.

[67] *Id.* The deferred prosecution agreement can be found in the HSBC Case docket, Document 3-3 (12/11/12).

[68] *Id.*

[69] HSBC's new chief executive is Stuart Gulliver. He was on the HSBC board since 2008. *Stuart Gulliver*, FORBES, http://perma.cc/PHW9-5VYR (last visited Dec. 23, 2014). In his own words, "[b]etween 2004 and 2010, our anti-money-laundering controls should have been stronger and more effective, and we failed to spot and deal with unacceptable behavior." Dominic Rushe, *HSBC Failed to Act on Money Laundering Says U.S. Senate*, GUARDIAN, (Jul. 17, 2012), http://perma.cc/AGA2-NHD7. Mr. Gulliver was awarded a bonus of nearly £2 million annual bonus in 2012 for his "strong leadership" and "personal behavior" in tackling the revelations that led to the fine. Jill Treanor, *200 HSBC Staff Paid More than £1 Million in 2012*, GUARDIAN (March 5, 2013, 15.51 EST), http://perma.cc/3MVP-JTXZ.

[70] *Lord Green of Hurstpierpoint*, UK.GOV, https://perma.cc/BZZ3-5B86 (last visited Dec. 23, 2014). He took this position before the settlement.

HSBC stipulated that money-laundering took place. Here, as detailed above, HSBC's codes of conduct addressed money-laundering.[71] In addition, it must be noted that the 10-Ks filed by HSBC during the time period of the illegal activity also emphasized the prevention of money laundering. The 10-K filed in 2007 specifically laid the onus of risk management oversight on HSBC's board of directors and its various committees,[72] as well as its Chief Operating Officer, the Co-Chief Credit Officers and the Executive Vice President for Compliance and Anti-Money Laundering[73]. It further provided that the HSBC staff was to be trained in "mandated programs for such areas as anti-money laundering."[74]

Therefore, HSBC would have been within its rights to enforce its codes of conduct against its directors and officers, who were ultimately responsible for anti-laundering policies and training and clearly on notice that HSBC assigned a top priority to preventing violations.[75] However, these codes lacked automatic enforcement mechanisms. Executives and directors in corporations often avoid serious consequences for even seemingly clear-cut violations of their own codes of conduct.

2. Workplace/Safety Related

One more example of a failure of voluntary codes of conduct is appropriate. On April 24, 2013, an eight-story building collapsed in Bangladesh, killing over 1,000 workers.[76] United States and European clothing companies purchased apparel from factories in the building. Customs records showed that over the period of eight months, the New

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[71] Code of Ethics, *supra*, note 65, at 8.
[72] HSBC USA Inc., Annual Report (Form 10-K) at 75 (Mar. 3, 2008), *available at* http://www.sec.gov/Archives/edgar/data/83246/000116923208001174/d73744_10-k.htm.
[73] *Id.*
[74] *Id.* at 88.
[75] Again, there was no question about the widespread nature of the violations. *See* Press Release, U.S. Dep't of the Treasury, Treasury Department Reaches Landmark Settlement with HSBC (Dec. 11, 2012), *available at* http://perma.cc/J2YJ-PZ6H ("Since at least mid-2006, the bank lacked an effective risk-based [Anti-Money Laundering] program reasonably designed to manage risks of money laundering or other illicit activity, given the bank's products, services, transaction volume, scope of business activities, geographic reach, and customers. The bank's prolonged systemic failures to comply with [Bank Secrecy Act] suspicious activity reporting requirements resulted in the failure to detect and adequately report evidence of money laundering and other illicit activity."). One telling red flag that was apparently ignored: In some bank branches the boxes of cash being deposited were so big the tellers' windows had to be enlarged. Jill Treanor, *HSBC money-laundering fine: key players*, THE GUARDIAN (Dec. 14, 2012), http://perma.cc/M5J8-87A2.
[76] Julfikar Ali Manik & Jim Yardley, *Building Collapse in Bangladesh Kills Scores of Garment Workers*, N.Y. TIMES, Apr. 24, 2013, http://perma.cc/EKS9-2RFJ.

Wave factory inside Rana Plaza had made more than 120,000 of clothing that had been sent in 21 shipments to The Children's Place.[77]

It is instructive to look at The Children's Place 10-K for the year 2011, before the Bangladeshi tragedy. In this filing, the company stated as follows: "[b]y requiring our manufacturers and suppliers to participate in our social compliance program, we are able to monitor factories to ensure that they operate using safe and humane working conditions, and that we are working with factory managers that appreciate and comply with socially responsible practices."[78]

Even with a seemingly clear cut a violation of this principle, the immediate reaction of The Children's Place after the collapse was to issue a neutral statement that it was evaluating its options.[79] As of November 2013, The Children's Place had refused to contribute to a fund for factory workers affected by the building collapse.[80]

Eventually, The Children's Place "joined forces with other leading North American apparel retailers, and former U.S. Senators George Mitchell and Olympia Snowe, to create the Alliance for Bangladesh Worker Safety. This Alliance will empower and protect workers by significantly elevating fire and building safety in Bangladeshi garment factories."[81]

The Children's Place website trumpeted that:

> As a member of this Alliance, we have signed on to a binding, five-year agreement that will be transparent, results-oriented, measurable and verifiable. The agreement includes specific and measurable actions across areas essential to dramatically improving safety including common standards, inspections and remediation, training and increased cooperation with the Bangladeshi and U.S. governments as well as with the factory owners to ensure that there is accountability among all parties.[82]

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[77] Steven Greenhouse, *Retailers Split on Contrition After Collapse of Factories*, **N.Y. TIMES**, May 1, 2013, at A8.

[78] The Children's Place Retail Stores, Annual Report (Form 10-K) at 8 (Mar. 28, 2011), *available at* http://perma.cc/XS5E-6TPQ.

[79] Steven Greenhouse, *Retailers Are Pressed on Safety at Factories*, **N.Y. TIMES,** May 10, 2013, at B1 (the Childrens' Place spokeswoman stated "[w]e have not reached any decisions at this point, but are committed to supporting changes to improve safety and working conditions[]").

[80] Steven Greenhouse, *U.S. Retailers Decline to Aid Factory Victims in Bangladesh,* **N.Y. TIMES,** Nov. 22, 2013, at B1 ("The Children's Place, which had used one of the factories inside Rana Plaza, but said that factory was not supplying it when the building collapsed, declined to comment about contributing.").

[81] The Children's Place, *Social Responsibility: Policy & Standards for Factories and Suppliers* ("Children's Place Announcement") (Mar. 26, 2014), http://perma.cc/B6B5-YYGQ.

[82] *Id.*

Alliance members further agreed to share their knowledge, experiences, and best practices to collectively contribute to a safety fund that is currently $42 million and growing, and to, also, provide access to substantial low-cost capital for factory improvements.[83]

The new Alliance is a substantial improvement over the codes of conduct in place at the time of the collapse. At the same time, it has shortcomings. Most obviously, the Alliance protocol does not provide any specific penalties against executives or directors of the participating companies for future violations.[84] Certainly, no executive is required to forfeit his or her job or salary if there are violations. The protocol, also, says nothing about responsibilities of the member companies if the protocol is strictly followed, but another collapse occurs. In fact, when the next tragedy occurs, the apparel companies may point to this Alliance protocol to state they have no further obligations.[85]

But what about The Children's Place code of conduct that was in effect at the time of the collapse, as reflected in the 10-K for the year 2011? There was no indication, at least in any press releases of the kind touting the company's participation in the Alliance, that executives, with general oversight responsibility, were being held responsible for failing to put in place effective systems to recognize dangerous conditions.

These examples point to the basic weakness of codes of conduct: They do not need to be followed. Codes of conduct should impose specific and automatic penalties on corporate agents for breaches, and the next section describes steps for doing so.

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[83] The Alliance for Bangladesh Worker Safety, *Action Plan Overview* ("Alliance Announcement"), http://perma.cc/B6B5-YYGQ (last visited Dec. 28, 2014).

[84] *Id.*

[85] There is a reason to be skeptical that corporations will treat these new standards as anything more than as the absolute boundaries of their obligations if tragedy strikes again, given this initial reluctance of certain corporations to send aid to Bangladesh immediately following the collapse. Wal-Mart's actions in a recent case are instructive. In *Doe I v. Wal-Mart Stores, Inc.*, 572 F.3d 677, 680, 684 (9th Cir. 2009), Wal-Mart successfully argued that it was not responsible to a supplier's foreign workers even though all of Wal-Mart's contracts with these employers incorporated Wal-Mart's code of conduct obliging these suppliers to provide basic labor standard protections to their employees and allowing Wal-Mart to monitor compliance, including canceling contracts if the supplier "fail[ed] or refuse[d] to comply" with the code. The court agreed with Wal-Mart that the company "had no legal duty under the [codes of conduct] or common law negligence principles to monitor its suppliers or to protect Plaintiffs from the suppliers' alleged substandard labor practices. Wal-Mart is not Plaintiffs' employer, and the relationship between Wal-Mart and Plaintiffs is too attenuated to support restitution under an unjust enrichment theory." *Id.* at 685. The fact that Wal-Mart's suppliers had substandard working conditions was irrelevant to Wal-Mart's analysis of its legal obligations.

IV. A NEW WAY FORWARD: BINDING CODES OF CONDUCT

In previous sections, I have discussed the hurdles to holding corporate agents personally liable in instances of ineffective oversight. In this section, I propose binding codes of conduct as a solution. The binding codes of conduct that I propose share a common trait. They all rely on a specific, easily identifiable event to trigger their application, such as a criminal conviction of an employee. They all require automatic action against the corporate agent, such as disgorgement of compensation, in the event of breach. As such, binding codes of conduct are akin to strict liability statutes. There is a second part to the proposal, and that is the need to publicize the binding codes so that consumers and investors can actually choose to shop at complying corporations. Publicity is the key and the biggest challenge to this proposal.

I address an immediate question of corporate attorneys, whispering in the ears of the corporate agents. Would a reduction in compensation for a violation of a binding code of conduct be an admission of liability under the law and therefore draw the attention of plaintiffs' attorneys, always ready to seize on the slightest pretext to commence a legal action? The answer is no, as the binding codes of conduct do not discuss intent, materiality, and notice. Binding codes of conduct may contain some elements of fraud or breach of fiduciary duties, but they do not contain all the elements.[86] The binding codes of conduct are not designed to replace the law, but to supplement it. I already stated that this is an important concession to incentivize corporate agents to adopt the codes. Likewise, the use of the term "Automatic Reductions" rather than "Automatic Penalties" is designed to remove the stigma corporate agents may feel in signing the codes.

A. Examples of Binding Codes of Conduct

The following are proposed binding codes of conduct that are likely to attract customers, investors, and shareholders who desire tight corporate compliance procedures. If a violation is found, automatic compensation reductions will ensue (the "Automatic Reductions") that are further described below. These codes address the problem outlined in the opening paragraphs of this article, which is the fact that the current legal regime typically does not impose personal liability on corporate agents for major corporate failures, to the consternation of shareholders, investors, and the public.[87]

[86] *See supra* Part II.
[87] *See supra* Part II.

1. Code of Conduct Would Apply if Criminal Conduct is Found or a Subordinate is Found Liable for Company Losses

A code of conduct should require an automatic reduction in compensation of top executives and directors if a corporation is convicted of a crime or a ring of employees in company acts irresponsibly, leading to significant losses. The intentions of the corporate agents or even their knowledge of the bad acts would be irrelevant. A code of conduct of this kind provides a strong incentive for executives and directors to maintain strict controls on traders and other employees who may otherwise engage in reckless behavior.

Consider how the *Caremark* case would have proceeded differently if such a code of conduct was in place. The company pleaded guilty, and so any corporate agents who signed a code of this kind would have incurred immediate compensation reductions. Even if subsequent proceedings resulted in a lack of liability for individual executives or directors, the public and shareholders would have been accorded some basic vindication for the corporate misconduct. But this raises an additional question: Would the board members have agreed to a plea deal holding the corporation criminally liable if they knew they would face automatic reductions in their own compensation for doing so? Here, the answer is more difficult. I believe they would have still accepted the plea. An indictment of the corporation and subsequent trial would have been devastating to the corporation, and any director or executive would have recognized this fact.

This code would apply in other contexts. A pharmaceutical company may be found criminally liable for having systematically overbilled Medicare for a particular drug. A coal company may be found liable for polluting a stream that feeds a city's water supply. A car company may be fined for failing to fix an obvious design defect in a vehicle model. Or, as cited above, a clothing company may cut corners by hiring suppliers with unsafe work conditions.

In each of these situations, the top executives and directors would typically claim that they had no knowledge of the improper conduct. Such a claim, while relevant in establishing a breach of fiduciary duty or fraud, would be irrelevant under the code of conduct. All that would be required is a conviction or a fine of more than $10,000,000.[88] Here, the criminal count

[88] A threshold of $10,000,000 in losses before the imposition of Automatic Reductions provides some measure of protection to an executive or director from liability in the event of petty theft committed by employees, an inevitable occurrence in any large organization.

could be in connection with a federal, state, or local law. The SEC, OSHA, or any other federal, state, or local agency can impose a fine.[89]

Knowing that their own compensation is directly at stake and that they might suffer the acute embarrassment of violating a code, corporate agents will be far quicker to take action to stop these abuses. Ultimately, such self-corrections will pay for themselves as inappropriate conduct decreases.

The code can have a positive ripple effect. Corporate agents may put in place controls on their sales force to stop overly aggressive marketing that targets government programs, such as the sale of medical devices funded by Medicaid. They would do so out of fear that a salesperson might break the law in meeting sales goals. As such, the code may have the effect of cutting down on fraud on the government.

2. Code of Conduct Would Address Inaccurate Financial Statements

Sarbanes-Oxley sought to increase corporate responsibility by requiring executives to personally certify the financial statements of their corporations. However, courts have been loath to impose liability, creating standards that shield CEOs and CFOs. As discussed, the *Garfield* court found that the CEO was not liable for false certifications unless the CEO was "severely reckless" in signing the certifications.[90]

The binding rule can provide that a corporate agent who signs a financial document filed with the SEC will be liable if that financial document requires a restatement in an amount greater than $5 million. A CEO or CFO who signs this protocol will likely review the financial results line by line to make sure the financial statements are accurate. Note that an admission that the code applies does not equate to an admission to liability under Sarbanes-Oxley. If an executive concedes a code violation, he or she will still be able to argue that he or she lacked intent and therefore is not liable under applicable law.

3. Code of Conduct Would Make Say on Pay Law Effective

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[89] This code applies a "one size fits all" approach to a threshold for a violation. For a large corporation, $10,000,000 is a rounding error. Nevertheless, the code would apply to a large corporation as well as to smaller corporations. As in other places, the codes strive for simplicity to avoid legal maneuvers or squabbling over whether a company meets certain income or capital prerequisites. If an executive or director decides that the codes are unfair, he or she can choose not to sign and let consumers and investors decide if they care.

[90] Garfield v. NDC Health Corp., 466 F.3d 1255, 1266 (11th Cir. 2006).

Following financial crises, Congress typically acts to buttress laws. These changes sometimes prove less effective than originally anticipated. Upon being signed into law on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") has provided a means for shareholders to voice their concerns regarding important corporate decisions. Among other things, Dodd-Frank requires companies to bring a non-binding shareholder vote on senior executive compensation ("Say on Pay") at least once every three years.[91] Insiders can continue to vote their shares in favor of their own pay packages. These are obvious limitations under the current law.[92]

Further, courts have held that corporate boards can safely vote against the recommendations of the shareholders and not lose their "business judgment" protection if they approve executive compensation. For example, the Georgia Superior Court in *Teamsters Local 237 Additional Security Benefit Fund v. McCarthy*[93] applied Delaware law to dismiss a case involving an alleged breach by the company board of its duties of loyalty, candor, and good faith by approving "excessive" executive pay. The court specifically held that the shareholder "say on pay" vote did not rebut the presumption of the business judgment rule.[94] However, the court also concluded that such a vote could be used, but only along with other facts to rebut the business judgment protection.[95]

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[91] Section 951 expressly states that the shareholder vote is not binding and it "may not be construed . . . to create or imply any change to the fiduciary duties" nor "to create or imply any additional fiduciary duties." 15 U.S.C. § 78n-1(c).

[92] Following an adverse shareholder vote on executive pay, Oracle issued a DEF 14A (a type of disclosure required by the SEC) on September 20, 2013, in which the company explained its reasons for ignoring the shareholder vote, stating that,

> [t]he Compensation Committee and the rest of our Board of Directors were disappointed with the results of the fiscal 2012 Say-on-Pay vote. . . . The Compensation Committee believes Oracle's executive compensation philosophy and program achieve this goal [linking executive compensation to Oracle's financial performance and long-term stock price] in a manner that is appropriate for Oracle (and not necessarily other companies) and that significant changes to our executive compensation program were not warranted.

Oracle Corp., DEF 14A at 33 (September 20, 2013), *available at* http://perma.cc/C6KC-RC45.

[93] No. 2011-cv-197841, 2011 WL 4836230, at *4 (Ga. Super. Sept. 16, 2011).

[94] *Id.* at *10.

[95] *Id.* Courts may also decide that the say on pay litigation was irrelevant to board action in reducing executive compensation. *Citigroup S'holder Derivative Litig.*, Case No. 12 Civ. 3114 JPO, 2013 U.S. Dist. LEXIS 117741, at *4 (S.D.N.Y. Aug. 19, 2013) (In denying legal fees for plaintiff's lawyers who filed a "say on pay" litigation that was subsequently dismissed after the board promised to take action, the court held that "shareholder pressure, not the lawsuits at issue in this action, was the cause of Citigroup's policy changes."). Plaintiffs will hesitate to file complaints if they must worry that subsequent information reveals the board was already considering changes to compensation.

A binding code of conduct can apply where current corporate law has proved inadequate in moderating the conduct of corporate agents. In this case, a binding code of conduct may state that a corporate agent will agree to withdraw the compensation request if 55% of shareholders vote against the pay package, even if the vote is only advisory under applicable law or corporate bylaws.[96]

The supermajority requirement strikes a balance. Corporate decision makers have a legitimate need to make tough or unpopular calls for the good of the company. At the same time, directors and executives know that they must at least approximately align their decisions with shareholder sentiment.

4. *Code of Conduct Would Require the Resignation of Directors if a Supermajority of Shareholders Votes Them Out*

Mandatory codes of conduct can take the form of individual pledges by directors to act in a certain way. At most United States public companies, shareholders elect directors by a plurality of votes cast rather than a majority of votes cast.[97] Under plurality voting, the nominee who receives the most "for" votes for a particular board seat wins. This means that in an uncontested election, a nominee will be elected even if she receives just one "for" vote. Plurality voting in uncontested elections could result in "rubber stamp" elections, entrenched boards, and, at times, directors who lack the confidence of most of the shareholders.[98] Even some companies that have embraced majority voting for directors give their boards discretion to overrule shareowners and reappoint incumbent directors who fall short of majority support in uncontested elections.

This can change with a binding code of conduct. A director will agree to resign if he/she receives less than 45% of the shareholder support in a vote, even if the vote is only advisory under applicable law or corporate

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[96] A corporate agent who fails to withdraw his or her compensation package breaches this code of conduct. The remedy is not injunctive relief to stop the corporate agent from accepting the compensation package, which may require extended litigation, but strict and immediate application of the automatic reductions.

[97] DEL. CODE ANN. tit. 8 § 216(3) (2014) provides that absent a specification to the contrary in the certificate of incorporation or by-laws of a corporation, "[d]irectors shall be elected by a plurality of the votes of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors."

[98] Modified plurality voting policies have been adopted by a number of corporations. These so-called "plurality plus" policies require a director to tender a resignation to the board if he or she receives more "withheld" votes than "for" votes. However, the board may reject this resignation. City of Westland Police & Fire Ret. Sys. v. Axcelis Techs., Inc., 1 A.3d 284 n.4 (Del. 2010). In contrast, the binding code would require a resignation in the instance of an adverse vote, with no opportunity for the board to reverse the decision.

bylaws. Again, this supermajority requirement will allow directors to vote their consciences in the interests of a corporation without worrying that a mere majority will vote them out. At the same time, directors will know that there is at least a chance they may be voted out by shareholders if a lack of oversight by the board leads to large corporate losses.

Consider how the Disney/Ovitz case may have proceeded differently if Disney board members signed this code of conduct, and Ovitz signed the previous code. The board and Ovitz would have had to consider the embarrassment of a possible shareholder vote against an overly generous pay package. The prospect, by itself, may have stopped the entire gambit. What if Ovitz did not agree to sign a binding code of conduct? This may have been a "red flag" for the board to consider some other candidate. Of course, the point is not to punish executives and directors through shareholder action. Rather, the point is to alter their behavior – and corporate culture – by creating real consequences for bad decisions.[99]

This code can have other positive outcomes. Recently, certain shareholder resolutions have sought to increase diversity in the boardroom.[100] These resolutions are typically non-binding and as such can be ignored by the board. With this code in place, board members may be more inclined to act on non-binding resolutions suggesting changes to corporate governance, with the theoretical threat of their removal by a vote of a supermajority of shareholders.

5. Code of Conduct Would Prohibit Trading on Client or Customer Securities or Providing Tips Based on Insider Information

Insider trading is pernicious because of the breach of trust between the corporate officers and general shareholders. This behavior undermines public confidence in the markets and is a reason why people mistrust Wall Street and consider investing an unfair and rigged game. Corporate agents may be aware of information not generally available to the public, such as products in development, cash flow issues, or possible lawsuits. If their companies are financial entities, they may have information on companies that are potential takeover targets. Corporate agents can trade on this

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[99] Executives and directors may cynically request higher salaries or larger compensation packages to offset the financial risk in signing these binding codes of conduct. The codes of conduct themselves have features to moderate these requests, as shareholders will have the power to vote down compensation (Code Number 3), and will be able to oust directors who approve or receive outsize compensation (Code Number 4).

[100] One coalition has filed shareholders' resolutions with 20 companies that have no women on their boards for a vote at their annual meetings. The investors filing these resolutions are urging these companies to adopt charter language supporting board diversity and institute a practice of including women and minority candidates on their boards.

information to directly profit, or they can also provide information to favorites (perhaps as a quid pro quo for receiving information from their favorites when the time comes).

As with other areas of law discussed above, executives and other corporate agents have significant defenses against charges of insider trading. They can argue that the information they provided was not material, or that they did not receive any benefits from the tip.[101]

A code of conduct cannot address all the permutations of insider trading. However, a code can attack the problem at its source, by preventing tippers who are corporate agents from personally profiting from insider knowledge. Moreover, it can impose mandatory sanctions on the tipper if a third party is convicted for trading on insider information obtained by the corporate agent (as on the golf course), regardless of whether the tipper personally gained.

Such a code would vindicate public concern that corporate agents should suffer some personal liability when engaging in insider trading. By agreeing to the Automatic Reductions regardless of whether material non-public information was used, executives will be less likely to engage in careless talk.

Further, corporate agents would be more inclined to maintain company secrets in the presence of third parties, knowing these third parties may use the information in inappropriate ways. If the third party (or a remote tippee) is convicted for using this information, Automatic Reductions would apply to the corporate agent. This code is easily enforceable, as the source of the third party's information would be disclosed in any criminal trial or plea of that third party.

6. Code of Conduct Would Require a Company to Expressly Abide by the Sentencing Guidelines' Highest Standards for Compliance Programs

The United States Sentencing Guidelines ("Guidelines"), which became effective on November 1, 1991, are the federal law for sentencing corporations.[102] The Guidelines allow for upward or downward

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[101] *See* Basic Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988) (articulating standard of materiality for purposes of insider trading as information a reasonable investor would consider important and noting "trading (and profit making) by insiders can serve as an indication of materiality") (emphasis omitted); United States v. Newman, Index Nos. 13-1837-cr (L), 13-1917-cr (con) (2d Cir. Dec. 10, 2014) (a corporate insider has committed no breach of fiduciary duty "unless he receives a personal benefit in exchange for the disclosure. . . .").

[102] *2011 Federal Sentencing Guidelines Manual*, UNITED STATES SENTENCING COMMISSION, http://perma.cc/GD6W-636R (last visited Jan. 5, 2015).

modifications in part based on the adequacy of internal mechanisms at corporations "for preventing, detecting, and reporting criminal conduct."[103] Thus, the Guidelines can be critical in positioning companies to avoid or minimize the consequences of an indictment for the illegal acts of an employee or other inappropriate acts.[104]

It seems self-evident that corporations, whether accused of wrongdoing or not, to follow the Guidelines. Interestingly, though, some believe that corporations can and should ignore the Guidelines after conducting a cost/benefit analysis.[105] A code of conduct can change this cavalier attitude.

To assess a corporation's due diligence, the Guidelines list seven factors that courts, and corporations, should consider when determining whether a compliance program is sufficiently effective, which includes: 1) The compliance program must be reasonably capable of reducing the prospect of criminal conduct; 2) High-level personnel must be assigned overall responsibility to oversee the compliance program; 3) The corporation must use due care not to delegate substantial discretionary authority to individuals whom the organization knew, or should have known, had a propensity to engage in illegal activities; 4) The corporation must effectively communicate its compliance program to all employees and other agents; 5) The corporation must take reasonable steps to achieve compliance with its program, by utilizing monitoring, auditing and reporting systems; 6) The compliance program must be consistently enforced through appropriate disciplinary mechanisms; 7) After an offense has been detected, the organization must take all reasonable steps to respond appropriately to the offense and to prevent further similar offenses.[106]

A mandatory code of conduct may therefore provide that if a corporation is found liable for an upward modification under the Sentencing Guidelines, the code of conduct shall apply. The mere threat of liability will cause an executive to create internal controls that will ensure the tightest corporate compliance possible.

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[103] *Id.*

[104] Martin B. Klotz, Mei Lin Kwan-Gett, & Michael S. Schanchter, *New Corporate Sentencing Guidelines Provide Guidance Regarding What Constitutes an Effective Corporate Compliance Program*, METROPOLITAN CORP. COUNS., n.1 (Nov. 10, 2010), http://perma.cc/RTH6-43KA.

[105] Robert W. Tarun & Peter P. Tomczak, *Introductory Essay: A Proposal for a United States Department of Justice Foreign Corrupt Practices Act Leniency Policy*, 47 AM. CRIM. L. REV. 153 (Spring, 2010). Similar to a car company "rationally" deciding to forgo safety features because the inevitable lawsuits will cost less than the safety features, this view holds that corporations may "rationally account for the incentives and penalties established by the Sentencing Guidelines in implementing a corporate compliance program." *Id.* at 189. According to these authors, "situations exist in which corporations rationally and responsibly choose to remedy bribery conduct internally and not self-report misconduct." *Id.* at 155.

[106] *Id.*

7. *Code of Conduct Would Prohibit Gifts Above De Minimis Value*

Kickbacks and bribery exist in spite of laws and related voluntary codes of conduct forbidding this conduct. A code of conduct can address this problem. An executive or board member would agree not to give or accept any gift worth more than $150 a year, whether in cash or otherwise, in connection with a person or entity with which the company does business. The ban on gifts would apply to anyone seeking business with and/or anyone substantially affected by the performance of the employee's duties. For example, a company bidding for a company contract would be a prohibited source of gifts.

The $150 limitation allows for a situation where two parties find they are sharing a cab ride on a rainy night and one forgets to pay. Or, one buys a gift of flowers for the other on a significant anniversary. In that case, the Automatic Reductions would not apply, assuming the amount is under $150.

The rule would require these corporate agents to modify their behavior in real ways. They would now have to "go Dutch" to any restaurant or on any golf outing. However, the rule would eliminate any argument that a corporate contract is awarded based on a gift rather than on the merits of the transaction.

8. *Code of Conduct with Respect to Third Party Advisors: Holding Attorneys Liable for Unjustified Conclusions in Opinion Letters*

Because of the key role of attorneys in advising corporations, attorneys should consider binding codes of conduct. This is especially true because lawyers have significant legal protections even when they make suboptimal decisions upon which corporate agents rely. Indeed, counsel can argue that the failure to conduct appropriate professional due diligence, even if negligent, unacceptable, a violation of applicable rules of conduct, *etc.*, does not amount to fraud. One example of this type of protection is described in *Sable v. Southmark/Envicon Capital Corp.*[107] In that case, disgruntled investors brought a class action against a law firm that had prepared tax opinion letters for a set of limited real estate partnerships, alleging RICO violations premised on mail and wire fraud.[108]

In relevant part, the plaintiffs in that case contended that the law firm committed fraud by preparing tax opinion letters that recited values, revenues, and rents of properties held by the partnerships, which the law

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[107] 819 F. Supp. 324 (S.D.N.Y. 1993).
[108] *Id.* at 337.

firm stated had "been represented . . . to our satisfaction as being true and correct."[109]

In rejecting the claim against the law firm, the court held that the plaintiffs' allegation that the law firm failed to perform its due diligence when it accepted the sponsor's representations was insufficient as a matter of law to establish liability because, "[t]his claim, even if supported by facts, would not rise above the level of negligence absent other facts neither pleaded nor suggested; negligence is insufficient to state a claim for securities fraud. Courts in this district have repeatedly rejected the existence of an attorney-client relationship as sufficient in itself to provide the factual basis for fraudulent knowledge…." Further, "[e]ven if [the law firm] and others should have made further inquiries to attempt to uncover the alleged fraud, 'failure [to make further inquiries] does not rise above the level of negligence, which is legally insufficient,' unless facts are alleged which tend to establish knowledge of the fraud."[110] The court dismissed the allegations of mail fraud for the identical reason.[111]

The *Sable* case shows that a failure to investigate even obvious red flags would result in a failure of proof in demonstrating fraud. Merely failing to adequately investigate the veracity of a client's representations is insufficient to establish attorney liability.

As a practical matter, a law firm can blame the corporation for not providing accurate information even as corporate agents rely on the "advice of counsel" defense in stating that they do not intend to violate laws, and therefore, should not be subject to personal liability. This type of circular finger pointing by highly paid corporate agents infuriates the public.

A binding code of conduct could state as follows: "*The law firm will disgorge any fees paid in connection with the preparation of an opinion letter that is subsequently cited in connection with any criminal penalty imposed on a company or its employees or agents.*"[112]

Law firms who are willing to sign such a code of conduct would be more careful in investigating the *bona fides* of the information presented by the corporation in support of the opinion letter. These law firms may find that investment banks and other financial institutions, all potential clients, appreciate that a firm is serious enough about its reputation to sign a binding code of conduct. Like all other binding codes of conduct, a law firm can

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[109] *Id.*
[110] *Id.*
[111] *Id.* at 341.
[112] It would be difficult, from the corporation's viewpoint, to seek a refund check from individual lawyers who worked on opinion letters, when these lawyers work for large firms. Therefore, these corporations can seek a refund from the firms in question. The law firms, which track individual revenue, will then presumably impose the appropriate reductions on individual attorneys.

ignore the code of conduct, and businesses can then decide if they wish to transact business or otherwise retain such a law firm.

9. *Code of Conduct with Respect to Third Party Advisors: Requiring Auditors to Provide Accurate Valuations in Connection with Thinly Traded Assets*

Some investors feel that auditors have become too close to the companies they audit. The auditors may not sufficiently question assumptions by corporations in assigning value to rarely traded assets. The auditors' blessings may give cover for corporate agents to certify faulty financials. This in turn blunts any argument that an executive intended to deceive investors.

A binding code of conduct, this time imposed upon the auditor,[113] would cause auditors to be much more careful in accepting assumptions. "*An auditor will disgorge fees in connection with any corporate financials certified by the auditing firm that were later cited as a basis in the imposition of criminal penalties against the corporation.*" This rule is most relevant for thinly traded assets, but applies to all assets and liabilities of an audited company. Certain investors would become highly suspicious of financials if auditors do not sign this code of conduct, creating an incentive for auditors to sign.

The criminal prerequisite to this code ensures that only the most serious breach would result in liability under this code, providing a measure of comfort for auditors. In addition, the worst that happens to auditors under this provision is that they lose their fee. The mere possibility of a reduction in compensation will make auditors more cautious and provide them with a greater incentive to review information provided by a corporation.

B. Adoption of Automatic Reductions for Violations of Binding Code of Conduct

Specific and swift negative consequences must follow any violation of binding codes of conduct. The codes of conduct as described above provide bright lines, purposefully eliminating the factual issues that come with demonstrating intent or materiality. Again, the purpose is to minimize the chances that corporate agents will employ legal teams to fight the implementation of reductions in compensation, and to provide the public with swift results.

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[113] *See PCAOB*, https://perma.cc/RWM4-QRVE?type=source (last visited Jan. 5, 2015) (auditors are governed by rules by the Public Company Accounting Oversight board.).

The Automatic Reductions should likewise present clear guideposts, imposing a reduction of 25 percent of the gross compensation package of the corporate agent for the three years prior to the act, with a look-back period of five years to account for actions that are not immediately obvious.[114] Tying the reduction to net and not gross income would open the door to creative financial arrangements to minimize take-home compensation. This introduces unnecessary complexity. The intention is to reduce net compensation by 50 percent after taxes.

The funds should be returned to the corporation, minus a 10 percent contribution to the organization that creates the codes of conduct (described below). The director or officer should not be permitted to seek indemnification from his or her corporation of any amounts paid as Automatic Reductions.

The procedures for enforcing the codes of conduct should, likewise, be standard. The corporate board, if not implicated in the violation, should take swift action by requesting voluntary disgorgement, or failing that, should institute legal action to recover the funds. In this regard, the return of funds to the corporation can be accompanied with a statement of legal disclaimers by the corporate agent if he or she desires. The disclaimers protect a corporate agent from arguments that the mere act of disgorging compensation is an admission of civil or criminal misconduct. Again, the purpose of binding codes of conduct is to create an enforcement regime outside of legal remedies, because the legal system remains easily exploitable by corporate agents to avoid liability.

If a board refuses to act within a set period of time (and the time to act should be a specific period without extensions to promote certainty), a binding code of conduct should be enforced privately through a derivative suit. If the directors or officers are located in another country, these codes could be enforced by someone with standing in that country. Because of the strict liability nature of the codes of conduct, legal fees in such a suit will be limited, and in any event all fees would result from the failure by directors and officers to honor the terms of the binding codes of conduct. Strict liability addresses a key concern of corporations, which is to avoid time consuming and expensive litigation.

C. Example of How the Binding Codes of Conduct Would Work

Consider Big Financial, a company with 20,000 employees scattered across the globe, with a large presence in the United States. In a

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[114] A corporate agent may be in violation of more than one code of conduct. If so, the compensation should be reduced by twenty-five percent of the remaining compensation for each violation (i.e. 25% of the remaining 75%).

surprise announcement, the company announces that the firm incurred billions of dollars of losses under the weight of risky real estate investments and a short-term inability to refinance its operations. Big Financial's share price swoons and there is immediate talk of the need for bankruptcy relief.

In the months preceding the startling disclosure, the executives made statements expressing confidence in the health of the firm. A post-disclosure investigation by the corporation's attorneys is undertaken. This investigation clears the executives from any wrongdoing, and points the blame towards rogue traders within the company, who doubled down on bad investments, which in turn ultimately devastated Big Financial. Within six months after the incident, two lower level employees plead guilty to fraud, vindicating the corporation's conclusions.

In the inevitable shareholder lawsuit, the executives of Big Financial would typically argue that they had no basis to believe a collapse was imminent, that their representations about the corporation's health were speculative, and that any blame should be assigned to the rogue employees. The chances of securing recoveries directly from executives would be questionable at best.[115]

This is the type of result that outrages the public. Why should an executive not face personal liability for shoddy management of the employees, when the corporate culture encouraged this bad conduct? Now assume that Binding Code Number 1 is in place. The lower level employees have pleaded guilty, and therefore the Automatic Reductions apply to the corporate agents who signed the binding codes. Regardless of whether these executives face civil or criminal liability several years down the road, they would have to disgorge significant compensation immediately in the form of Automatic Reductions, providing immediate relief to shareholders who invested in the company exactly because they expected better results from these individuals. As importantly, the Automatic Reductions meet the expectation of the general public that top executives and directors at large corporations should be penalized for poor management that results in significant losses.

D. The Role of an Organization in Formulating and Publicizing Binding Codes of Conduct

If corporations and their agents are going to subject themselves to these codes, they should have the reward of good publicity if they are in

[115] Klausner, Hegland, & Goforth, *supra* note 12. In certain instances, the high hurdles prevent enforcement action. According to newspaper reports, the SEC decided not to file charges against individual executives over the September 2008 collapse of Lehman Brothers because some SEC officials decided it would be legally unjustified to do so based on an inability to show that the misrepresentations were material. Peter Eavis & Ben Protess, *S.E.C. Tension as It Examined Mortgage Cases*, N.Y. TIMES, Dec. 20, 2013, at A1.

compliance with the strict standards. Consumers, investors, and shareholders, including those in other countries, should have a neutral, easily accessible and reputable source that lists recommended binding codes of conduct and corporations that comply with these standards. As a practical matter, the site should have no more than 10 codes of conduct that are easily readable and understandable to the public.

A private organization, which I call the Code of Conduct Board ("CCB"), should be created. It will have two purposes. First, it will formulate the actual codes of conduct and, second, it will manage the website and publicize the codes of conduct. The site would rank corporations by the number of executives and directors who sign codes of conduct. This way corporations with the largest number of signing executives and directors would obtain the highest ranking. Corporations that do not sign the chief executive officer and at least one outside director would be included on the list of non-signing corporations. A copy of a proposed contract is found in the appendix. The site would also be a place for the public to review overall compensation for executives and directors.

To avoid confusion, the codes should not change in form more than once every two years. Further, corporate agents should have a short window every two years to decide to join or withdraw from the program, but otherwise are bound by their decision.

A section of the website should provide a form email to allow consumers to express their opinions about corporate agents' adoption or failure to adopt the binding codes of conduct. The website would record this consumer sentiment and, also, be a conduit to inform companies of consumer interest in the website and the codes.

Although I propose binding codes of conduct, these codes are not static. The CCB could employ business experts to formulate policies and propose new binding codes after two years. Or it could rely on the public to create codes of conduct, for example by allowing an occasional vote online of thirty or forty proposed codes of conduct, with the top ten being adopted. The CCB must have some institutional expertise in the area of corporate governance in order to propose codes that are legal and practical, but must, also, have a good sense of the zeitgeist of the public and recognize areas of the law that the public finds problematic.

The entity could be funded by accepting payments from companies with corporate agents who sign binding codes of conduct. As suggested above, it could be funded in part from the proceeds of the Automatic Reductions.

Regardless of the source, the CCB would probably require sufficient funds for one or two CCB employees, a budget for IT support for its website, and a budget for meetings of academics, representative corporate agents, and consumers, all of whom would have input on the final shape of the binding of codes of conduct. It would have to pay stipends sufficient to attract to the committee those who might not otherwise have the resources to devote several days in meetings. The CCB would also need limited space to store signed binding codes of conduct, which would be executed by corporate agents as legally binding documents.

E. Possible Issues with Binding Codes of Conduct and Responses

1. Public Policy Considerations

As already discussed, directors and officers are protected under the business judgment rule.[116] Liability insurance protects against personal liability for mere negligence.[117] However, with binding codes of conduct, negligence becomes irrelevant because intent is irrelevant. Do codes that impose liability upon corporate agents' conflict with the law, in Delaware and elsewhere? And if the codes apply, can a director or executive seek indemnification from the corporation for any clawed back compensation?

The answer to both questions should be "no." As to the first point, the law already affords corporate agents with great flexibility to negotiate rights and responsibilities that impact on fiduciary duties.[118] The intent of this law is to encourage corporations to provide their officers and directors with <u>better</u> protection against personal liability, thereby making a state like Delaware a more attractive place to incorporate.[119] In this regard, business lawyers routinely argue that well-crafted contracts limiting agent liability cannot be attacked collaterally.[120] For example, if an executive's contract has a liquidated damages clause, and all parties are represented by counsel, an executive facing a lawsuit will be able to argue that the parties should be bound by the terms of their contract even if the damages from the executive's actions far exceed the liquidated damages amount.[121]

However, there is no reason why the law cannot be used to place more liability on executives and directors, rather than less. It would be an odd result for executives and directors to argue that binding codes of

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[116] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (*overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Thompson, *supra* note 20, at 1070.
[117] *See supra* note 22.
[118] *See supra* note 22.
[119] *See supra* note 22.
[120] Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 BUS. LAW. 999, 1032 (2009) (discussing how, to minimize the chance of liability for executives, one should "[b]e certain to include express language specifying that no officers or agents of either contracting party shall have any personal liability (whether in contract or in tort) with respect to the negotiation, execution, delivery, or performance of the agreement or any misrepresentations made in connection therewith….").
[121] *Id.*

contract are void as against public policy when they are willing to argue that the freedom to contract allows them to narrow their fiduciary duties.

As to the second point, officers and directors can be indemnified if they act in "good faith" and in a manner "reasonably believed to be in or not opposed to the best interests of the corporation."[122] This is a restatement of the business judgment rule already discussed above. However, even Delaware law does not require a company to indemnify a corporate agent. Regardless of the indemnification law, the binding codes of conduct should make clear that any executive or director shall not accept that indemnification in the specific instance of a violation of the codes.

2. *United States Based Companies' Fear of Class Action Liability*

American corporate culture is concerned with the threat of lawsuits for failed compliance.[123] It bears repeating that the existence of a violation of a binding code would be insufficient to establish actual legal liability. As outlined above, legal liability typically requires intent or materiality.[124] Binding codes do not have these requirements. Binding codes of conduct requirements may be necessary elements to legal liability, but they are insufficient by themselves to establish liability.

A common complaint by corporations of class actions is the inability to quantify liability when faced with a lawsuit. The potential judgment could be one dollar or billions of dollars. The litigation can drag on for years. As described by the Delaware Chancery Court, corporate directors of public companies need the significant protection of the business judgment rule because they "enjoy (as residual owners) only a very small proportion of any 'upside' gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky! -- you

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[122] DEL. CODE ANN. tit. 8, § 145(a) (2014).

[123] In response to the Bangladesh building collapse, American corporations faced immediate pressure to sign binding protocols. They largely refused, citing a fear that their consent would be deemed an admission of guilt. The Gap's chief executive, Glenn Murphy, stated after the Bangladesh fire "If we were to sign onto something that had unlimited legal liability and risk, I think our shareholders should care about that." Johan Lubbe, a legal adviser to the National Retail Federation, asserted that the Americans' worries about litigation are legitimate. "The liability issue is of great concern, at least on this side of the Atlantic," Mr. Lubbe said. "For U.S. corporations, there is a fear that someone will try to impose liability and responsibility if something goes awry in the global supply chain." Steven Greenhouse, *U.S. Retailers See Big Risk in Safety Plan for Factories in Bangladesh*, **N.Y. TIMES,** May 22, 2013, at B1. Many of these companies have since taken steps to improve overseas factory conditions, but it is their initial reflexive response that I note here.

[124] *See supra* Part II.

supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution)."[125]

My proposal addresses these complaints by imposing liability that is no more than a portion of the compensation of corporate agents. The compensation reduction is easy to calculate and would not require significant litigation, addressing key concerns of corporations and the Delaware Chancery Court. At the same time, the compensation reduction would vindicate public concerns as set forth at the beginning of this article.

F. Limits of Binding Codes of Conduct

Binding codes of conduct work best in industries that are highly competitive, highly fragmented, and with low barriers to entry, exactly where corporate agents can distinguish themselves with customers by signing the codes. In other words, the codes of conduct work best in a free market. One example is with shirts. Consumers can buy shirts from many different companies. The cost of a shirt may be marginally higher to ensure that factory conditions are safe, [126] but at least some consumers would be willing to pay more.

In certain situations, the system I propose would work less well. First, there are times when: (a) the interest of the investor or shareholder is completely aligned with that of the company in taking morally or ethically questionable (but legal) actions, or (b) the difference between taking a questionable action and not is a material difference in a firm's profits.

An example is appropriate. Unlike government economic reports, which have strict embargo rules relating to their release dates,[127] economic reports produced by universities or private organizations are often released a

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[125] Gagliardi v. TriFoods Intern., Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).

[126] Rubana Huq, *The Economics of a $6.75 Shirt*, WALL ST. J., May 17, 2013, at A15 (estimating that the wage cost of a shirt "works out to about 38 U.S. cents per shirt[]"). This statement suggests that a slight price rise could substantially cover improved conditions for workers. This also assumes that the corporation must in fact pass on the cost to customers, rather than keeping prices at current levels, and reducing executive compensation or shareholder dividends.

[127] Commodity Futures Trading Commission Chairman Gary Gensler cited the 1983 film Trading Places to justify including the "Eddie Murphy Rule" in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In that film, the fictional Duke brothers attempted to short the orange juice futures market by using a confidential Department of Agriculture report. The false report was planted by the protagonists Louis Winthorpe III (since brought low in a Duke brothers' "nature versus nurture" experiment), and a poor street hustler named Billy Ray Valentine, played by Eddie Murphy. Section 746 of Dodd-Frank addresses the use of confidential reports by making it unlawful for a federal employee to knowingly disseminate information which has not been made public by the government that may affect the price of a commodity and for any person to misappropriate such information where that person knows, or recklessly disregards, that such information has not been disseminated.

few seconds early to paying customers. These reports, like government reports, have the ability to move markets. Even a seemingly small time advantage allows financial institutions with sophisticated algorithms to place bets before the general public has access. Therefore, the early release for paying customers, while legal, would also strike many as unfair or unethical. For example, on March 15, 2013, stocks tumbled on news that a key indicator of consumer sentiment dropped.[128] The consumer sentiment report was issued by the University of Michigan, and as a result of an early release of just two seconds to paying customers, a wave of bets was placed one second before its public release that the market would decline, which was exactly what happened.[129]

But it is hard for a financial firm to ignore such easy profits. Clients of these financial firms would typically not want their financial firm to provide lower returns because the firm refuses to utilize information as soon as it is legally available. Therefore, a change in laws or regulations is necessary if society decides that such practices are inappropriate. A remedy might be to embargo all market moving information, whether produced by a public or private entity, so that the information is not released early to a select few.

Second, binding codes of conduct aimed at executives will not work when corporate board approval is necessary to take a particular action.[130] One example is a binding code of conduct that requires an executive to increase minimum wages paid to company employees. Such a policy might be a smart business decision, as a percentage of customers may prefer to shop with a company paying its employees more than the market rate. However, it would also be an unfair code. An executive does not have the power under corporate law to act unilaterally to change the corporate policy on minimum wages, but rather would require board approval.

Third, binding codes of conduct are less effective where the marketplace lacks competition. If a large box store is the only store selling hardware supplies within 50 miles of a customer, a customer has little choice but to shop at the box store. The box store's executives may sign binding codes of conduct, but if they choose not to, a customer may find it less easy to shift business to another corporation. The procedures work best where customers actually have choices on where to shop and where the

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[128] Brody Mullins, Michael Rothfeld, Tom McGinty & Jenny Strasburg, *Traders Pay for an Early Peek at Key Data*, WALL ST. J., Jun. 12, 2013, http://online.wsj.com/articles/SB10001424127887324682204578515963191421602.

[129] *Id.*

[130] Directors exercise control over the company's business and property. DEL. CODE ANN. tit 8, § 141(a) (2014). Officers are delegated day-to-day control over corporate affairs, subject to the confines of the bylaws or resolutions of the board. DEL. CODE ANN. tit. 8, § 142(a) (2014).

market is elastic. In other words, the binding codes of conduct require a robust market as a precondition.

V. CONCLUSION

This article is about instilling good habits, rather than seeking to change laws or arguing that laws as written are inadequate. Corporate agents receive significant financial benefits when corporate stock rises. These agents should face financial consequences when company stock declines precipitously, there is widespread operational or financial mismanagement, or there are misleading statements and misrepresentations about the company's financials, which leads to artificially high stock prices that improperly trigger bonus clauses. Corporate agents should, likewise, suffer financial consequences if the company routinely violates its own internal codes of conduct regarding conflicts of interest, work-place safety, or environmental concerns.

Yet, the law does not provide easy remedies for those seeking to hold corporate agents personally liable. An executive or high level employee has great discretion in conducting business. The business judgment rule and the statutory hurdles in showing a breach of fiduciary duty or fraud protect these corporate agents from personal liability when transactions by lower level employees go terribly wrong.[131]

Likewise, when a voluntary code of conduct or statement of corporate principle is violated, corporations are quick to state that the corporation is not bound or the codes are irrelevant.[132] The law and voluntary codes, therefore, have only limited effect in encouraging good corporate habits.

Similarly, when the focus shifts to the outside lawyers or financial advisors for providing bad advice to corporations, these professionals may assert that under relevant law, they cannot be responsible for mere opinions provided to their clients. They have no intent to breach duties or to commit fraud and, therefore, have no liability.[133]

My proposal would be unnecessary if the law imposed strict liability on executives or directors for the acts of their corporations or subordinates.[134] If anything, the law is moving in the opposite direction.

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[131] *See supra* Part II.
[132] *See supra* Part III.
[133] *See supra* Part IV.A.8.
[134] During the financial crisis caused by Enron, there was some discussion of the possibility of imposing strict liability. Franklin R. Edwards, U.S. Corporate Governance: What Went Wrong and Can It Be Fixed? (unpublished paper prepared for B.I.S. and Federal Reserve Bank of Chicago conference) at 17 (Oct. 31-Nov.1, 2003) ("[W]e need to revisit the liability system that should be applied to gatekeepers. The current 'fault-based' (or negligence) regime has proven to be costly and ineffective. It may be time to consider replacing it with a

State law in particular has grown more protective of corporate agents, presumably to entice businesses to incorporate in a particular state. For example, a Delaware court has recently approved of corporate by-laws that require shareholders to pay company legal fees in an unsuccessful lawsuit, upending the traditional rule that each side pays its legal fees.[135]

With binding codes of conduct, there will be examples of seeming unfairness. One corporate agent will face large reductions in pay, while another will face no compensation reduction for a similar course of conduct that results in losses below a certain threshold. While true enough, corporate agents will not lose their liberty, and their compensation packages will remain significantly higher than that of the average American.

Of course, there is an argument that with further checks on corporate agents, American corporations will be at a disadvantage. Talented executives and directors are "in demand" and will simply move to corporations without restrictions. Alternatively, these corporate agents will lose all incentives to work hard if they know their compensation is at risk. Anyone who has ever spoken to a director or executive at a large corporation knows that he or she would take great umbrage at the thought that he or she is less than fully engaged at his or her job regardless of the compensation. And the notion that there are only a few people talented enough to run large corporations borders on the silly. But even if I am wrong, the codes align corporate practices with the expectations of the public, the central theme of this article.

I am proposing an experiment. I believe that at least some customers and investors will send business to corporations with directors

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'strict liability' regime with limits or caps. A strict liability regime would impose strict liability on gatekeepers for material misstatements and omissions in offering documents and financial statements and remove due diligence-based defenses. It would force gatekeepers to take measures to prevent issuer misconduct without requiring a costly inquiry into whether the gatekeepers satisfied inexact standards of conduct (i.e, reasonable care or due diligence defenses)."), *available at* https://perma.cc/GQ3M-N22F.

[135] On May 8, 2014, in *TP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), the Delaware Supreme Court found that a bylaw shifting attorneys' fees and costs to the losing party in intra-corporate litigation can be valid and enforceable under Delaware law. *Id.* at 555. The Delaware Supreme Court also held that fee-shifting bylaws are consistent with Delaware law, noting that contracting parties may agree to modify the so-called American Rule (which generally requires parties to pay their own costs and fees, regardless of the outcome of a litigation) and instead require the losing party to pay the winner's attorneys' fees. *Id.* at 557. The court further stated that the intent by a corporation to deter litigation is not, standing alone, an improper purpose for creating these bylaws. *Id.* at 560.

This ruling could discourage class action or securities lawsuits. Over one-third of all class actions filed between 2000 and 2003 and settled between 2001 and 2009 were dismissed with prejudice or voluntarily dropped by the plaintiffs. Klausner, Hegland, & Goforth, *supra* note 12. Prospective class action plaintiffs must consider the distinct prospect of paying the corporate defendant's legal fees in light of this large dismissal rate and therefore will be deterred from commencing lawsuits in the first place.

and executives who sign binding codes of conduct. These are the customers who want assurances that corporations are confident in their ethics and governance procedures. As more customers move their business, more corporate agents will face increased pressure to climb on board and adopt the binding codes. As explained, some directors and executives may also adopt the codes to signal to the market that they are serious about tightening corporate controls, with the expectation of higher stock prices and lower borrowing costs. Congress may take note, or it may not, but change in corporate governance will come regardless.

APPENDIX

CONTRACT SETTING FORTH BINDING CODES OF CONDUCT

WHEREAS, I, _[Name]______, as ___[president, director, etc.]__ of ____[company]___ (the "Company") enter into this contract to help further the Company's goals of complying with law and being a good corporate citizen; and

WHEREAS, I am willing to make a personal financial commitment as a pledge of my efforts to further these goals; and

WHEREAS, the Code of Conduct Board ("CCB") is a private organization that formulated this contract; and

WHEREAS, I agree with the CCB that many of the customers, investors and shareholders of my Company will look favorably on my willingness to sign this contract; and

WHEREAS, I authorize the CCB to publicize this contract and I will do the same.

Binding Codes

I agree to be subject to the Automatic Reductions (defined below) under the following conditions:

1. The Company is convicted of a crime for an act that occurs while I am at my present position.
2. The Company or an employee of the Company (acting in his/her corporate capacity) incurs a final and non-appealable penalty, fine, or judgment of more than $10,000,000 for an act that occurs while I am at my present position.

3. A financial document I certify and file with the SEC requires a restatement in an amount greater than $5 million.
4. I fail to withdraw my compensation package if 55% of the Company's shareholders vote against my compensation package.
5. I fail to resign when I receive less than 45% of shareholder support in a duly authorized vote on my retention.
6. I provide insider information as determined by a state or federal court that leads to a conviction, whether or not I am a party to that action.
7. The Company is found liable for an upward modification under the United States Sentencing Guidelines, the federal guidelines for sentencing corporations.
8. I give or accept any gift worth more than $150 a year, whether in cash or otherwise, in connection with a person or entity with which the Company does business. For an avoidance of doubt, the restriction applies whether the gift is intended to be business related or personal.

Automatic Reductions

"Automatic Reductions" shall mean a reduction of twenty five percent of my gross compensation package for the three years prior to the action triggering these reductions. If I am with the company for fewer than three years, the reductions will apply for every year I was with the Company.

Enforceability

In the event of a disagreement on whether this contract applies, and more than one year passes from the date of the event in question without action by the board of the Company to enforce the terms of this contract, I consent to the standing of the Company's shareholders to enforce the terms of this contract. I further agree to personally pay all reasonable legal expenses of any prevailing party if a court finds that the Automatic Reductions apply.

In addition, I agree that the CCB may disclose the existence of a lawsuit against me, or whether I have been subject to Automatic Reductions.

I waive any right of indemnification from my Company if the Automatic reductions apply to me. I will return any payments in the nature of indemnification that is provided to me by the Company.

The Automatic Reductions shall apply to any actions triggering Automatic Reductions that occur within two years after I sign this contract, assuming that I am in my position when the actions occur. This contract shall be enforceable up to six years after the actions in question.

Dated:

____
[Signature]