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Are All Risks Created Equal? Rethinking the Distinction Between Legal and Business Risk in Corporate Law

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ARE ALL RISKS CREATED EQUAL? RETHINKING THE DISTINCTION BETWEEN LEGAL AND BUSINESS RISK IN CORPORATE LAW

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Abstract

Should corporate legal risk be treated similarly to corporate business risks? Currently, the law draws a clear-cut distinction between the two sources of risk, permitting the latter type of risk and banning the former. As a result, fiduciaries are shielded from personal liability in the case of business risk and are entirely exposed to civil and criminal liability that arises from legal risk taking. As corporate law theorists have underscored, the differential treatment of business and legal risk is highly problematic from the perspective of firms and shareholders. To begin with, legal risk cannot be completely averted or eliminated. More importantly, decisions involving negligible levels of legal risk might yield significant profits for firms. Thus, the outright ban on legal risk-taking harms shareholders, who would have favored a more nuanced regime to legal risk.

In this Article we make two novel contributions to corporate law scholarship, one descriptive and one normative. Descriptively, we offer a novel justification for the differential treatment of business and legal risk. We argue that because of the exposure of board members to personal liability for losses resulting from legal risk, they will veto all policies and decisions implicating legal risk, minimal though they may be. Aware of this disposition, managers, whose compensation is often tied to performance and are therefore more risk-seeking, will prefer not to raise policies and decisions that implicate legal risk to board discussion. This, however, works to the detriment of shareholders who are deprived of the protective mechanism of board overview with respect to legal risk. Legal risks, therefore, largely escape board scrutiny. While the justification we advance has stronger explanatory power than prior justifications, it leaves open the possibility that the law may be redesigned in a more nuanced and desirable way. This leads to the normative contribution of the Article. Consistent with the modern philosophy toward risk which maintains that all risks can be managed, we propose that legal risks be divided

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into two categories of severity: risks involving criminal prohibitions and risks pertaining to non-criminal norms. They should then be further classified based on its probability of occurrence, into three classes of risk: remote, reasonable and probable risk. Combining our two criteria generates six classes of legal risks, for each of which we develop a unique liability regime. The framework that we advance would allow corporate executives and directors to address low and reasonable levels of legal risk in a responsible way that would benefit shareholders, without eroding respect for law and morality.

INTRODUCTION

This Article addresses an intriguing puzzle in corporate law: its differential treatment of business risk and legal risk. Business decisions, risky though they may be, fall under the duty of care and as long as they do not involve a conflict of interest, are judged under the deferential business judgment rule. Furthermore, companies can grant directors and officers exemptions from liability for negligent violations of the duty of care, as well as insure them against personal liability in such cases. Decisions that violate the law, by contrast, constitute a violation of the duty of loyalty,[1] and hence, they are not entitled to the deferential standard of the business judgment rule. As a consequence of this distinction, corporate managements can take on high business risks, but must steer clear of decisions and policies that involve minimal legal risks, even when the potential rewards are very high.

To illustrate, consider the following two examples. Assume that Jane Smith, the CEO of Acorn Inc., decides to construct to build a new production plant at a cost of $10,000,000. In discussion with the board, she notes that based on the company's analysis of future business trends there is an 80 percent probability that the construction of the new plant will generate a profit of $40,000,000 for the company. However, there is a 20 percent chance of a global economic crisis, in which case the plant will not be built and the $10,000,000 investment in the land will be lost. On these facts, the expected value of the transaction to the company is $32,000,000, so Jane recommends that the company moves forward with the transaction. The board approves the plan. Unfortunately for the company, the risk of a global economic crisis materializes, and the company loses $10,000,000.

Assume the same facts as before, with one difference: the company's parcel is in an area that is zoned for light industry and it is not clear whether Acorn's production plant is considered light or heavy. There is an 80 percent chance that the plant will be classified as "light" and a 20 percent chance that it will be classified as heavy. The expected gain and loss are exactly the same as in the previous example: the expected profit to Acorn is $32,000,000 and the potential loss is $10,000,000. The plant is built, but to the company's great chagrin, the municipality classifies it as heavy industry. The investment in the plant goes to waste, inflicting a $10,000,000 loss on the company.

From an economic perspective, the two scenarios are identical, both in terms of the risks and the outcomes. From a legal perspective, however, there is a world of difference between them. The

[1] Or duty of good faith, *see infra* note 16.

second scenario involves a legal risk. Violations of the law are considered breaches of the duty of loyalty and as such they cannot be insured against and are not subject to exclusions and exculpatory clauses.[2] Consequently, the second decision exposes the management and board to personal liability if derivative actions are brought against them. The first decision, by contrast, would be analyzed as a potential violation of the duty of care under the deferential business judgment rule. Moreover, if a court finds the company's directors and officers negligent and orders them to pay damages to the company, the payments will be covered by their directors' and officers' liability insurance. Finally, it is possible that the directors and officers will not have to pay anything if their employment contracts contain exculpatory clauses.

It should be emphasized that while our examples concern liability for active decisions, the distinction between business risks and legal risks is applicable to both commissions and omissions. In fact, the exposure of the board to oversight liability is far greater when the oversight refers to a legal risk. As Chancellor William Chandler stated in *Citigroup* "imposing Caremark-type duties on directors to monitor businesses is fundamentally different [than legal risks]."[3]

The stark differentiation between business risk and legal risk under extant law gives rise to a puzzling question: what is the rationale behind this distinction? As persons trained in law, we may feel that the answer is straightforward: no one should break the law, or even consider breaking it. But this dogmatic approach begs the question. Firms face multiple business and legal uncertainties. Dealing with risk, business or legal, is an unavoidable aspect of the commercial world. Not all risks can be cost-effectively preempted or eliminated, irrespective of the source of the risk or the best efforts of the firm's directors and managers. Furthermore, from the vantage point of shareholders, all corporate decisions should be geared toward maximizing returns for shareholders. This does not mean, of course, that shareholders expect boards and managements to knowingly break the law. At the same time, there is no basis for assuming that shareholders expect managements and boards to avoid legal risk, trivial though it may be, at all cost. Nor is it practical to harbor such expectation given the complex web of laws and regulations that engulfs the business world. Accordingly, the distinction between business risk and legal risk is far from trivial.

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[2] DEL. CODE ANN. tit. 8, § 102(b)(7) (2020).
[3] *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 131 (Del. Ch. 2009).

The challenge presented by the distinction between business risk and legal risk has not evaded legal scholars. Stephen Bainbridge has differentiated between the two forms of risk, claiming that while legal risk is dichotomous in nature in the sense that "you are either breaking the law or not,"—business risk "is inevitably intertwined with risk taking."[4] Unfortunately, Bainbridge's justification cannot carry the day. In some cases of legal risk, the uncertainty is not merely epistemic, but is inherent in the operation of firms. Nor is Bainbridge's theory capable of explaining, even if it were correct, why firms should forego lucrative opportunities that stand to generate hefty profits for them only because they implicate a negligible level of legal risk.

In an important recent contribution, Elizabeth Pollman has suggested a different rationale for the distinction. According to Pollman the harsher approach to legal risk is intended to convey a clear and unequivocal message about the importance of respecting the law.[5] While there is much to commend about Pollman's expressive theory, it leaves the central puzzle intact. First, as is true of all expressive theories, it points us in a general policy direction, but cannot prescribe the precise calibration of the message. Nor can expressive theories explain the exact contours of the doctrine. Second, it is unclear why the expressive message emanating from our criminal law regarding the duty to obey the law is insufficient and needs to be reechoed by our corporate law.[6] Third, one must wonder whether the marginal expressive gain from adopting the distinction between legal and business risks outweighs the losses to firms and shareholders. In this context, it should be kept in mind that the shareholders in public corporations are the public at large.

In this Article, we seek to make two important contributions to corporate law scholarship. First, we advance a novel justification for the differential treatment of business and legal risks. Although from a general economic standpoint, there is no difference between the two risks, there is a critical difference between them from the vantage point of the shareholders. Due the board's exposure to personal liability for decisions involving legal risk, the board will refuse to discuss opportunities

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[4] Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 988 (2008-2009).
[5] Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2029 (2019) ("*Caremark* itself can be viewed as a seminal message opinion, catalyzing lawyers to advise corporate clients to put in place compliance systems and be mindful of oversight obligations").
[6] Elizabeth Pollman provides an historical explanation: in the past, corporation had much more detailed purpose clauses, limiting considerably the scope of activity of the corporation. These limitations have been relaxed overtime, the limitation to lawful conduct in the purpose clauses and a form of a relic to clauses with more extensive limitations. *Id.* at 2019-20.

that implicate legal risks, let alone carefully analyze them. Analysis of legal risk may constitute evidence of scienter and thus heighten the exposure of directors to legal sanctions.[7] Realizing that boards will categorically oppose and veto any course of action that implicates a legal risk, management and employees who stand to benefit from legal risk taking, will elect not to bring such matters before the board. Hence, policies and decisions that run the risk of violating the law will eschew board discussion and oversight. No similar problem arises with respect to business risk. Consideration of business risk does not expose directors and officers to personal liability. On the contrary, it decreases the potential liability of directors for violating the duty of oversight.

Our second intended contribution is more significant. Notwithstanding our novel justification for the distinction between business risk and legal risk, we argue that the line between the two should be redrawn. Not all *legal* risks were created equal. Following the traditional distinction in criminal law, we incorporate into our proposed framework the distinction between criminal prohibitions that fall into the category of mala in se and administrative proscriptions that fall into the category of mala prohibita.[8] Prohibitions in the first category comport with our moral intuitions and are perceived as inherently wrong; restrictions that belong in the second group do not address behavior that is considered morally wrong *per se*, but rather it is the legal ban that renders the activity impermissible. To illustrate this distinction, compare theft and tax planning. Theft is considered a moral wrong independent of the legal prohibition. Reporting violations, by contrast, are not deemed immoral per se and often fall into the grey area in which right and wrong turns on intricate legal definitions. Furthermore, legal risk arises from legal uncertainty. There are varying degrees of uncertainty, however. Certain decisions are very risky from a legal perspective. Others are only minimally risky. This distinction is no stranger to corporate law. The Generally Accepted Accounting Principles (GAAP) that have been endorsed by SEC regulations clearly distinguish between "remote" risks of loss that need not be included in financial reports, and reasonable and

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[7] Even though on a formal level they may be liable for corporate illegal conduct due to their failure of oversight even without knowledge of the illegal action, there are barely any cases in which such liability was imposed. *See* Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L. J. 709, 756 (2019); Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DEPAUL L. REV. 729, 732 (1996); KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 75 (2006).

[8] For a similar suggestion, of distinguishing between mala in prohibita and mala in se in respect to legal risks, *see* Stephen Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 592-93 (2008). As we will elaborate in part IV, our distinction will operate differently than their suggestion, interacting with the level of risk and the leading to a distinctive liability regime.

likely risks of loss that ought to be reported.[9] Based on these distinctions, we propose to overhaul corporate law doctrine as it applies to legal risks. Instead of treating all legal violations as breaches of the duty of loyalty, we call for the adoption of a more nuanced approach that would differentiate between categories of legal violations based on their severity. In this vein, we suggest a distinction between potential violations of criminal prohibitions and possible violations of administrative norms. In the former case of risks that may lead to a criminal violation, boards and officers would only be allowed to consider remote legal risks, i.e., courses of action that are highly unlikely to violate the law. In the latter case that involves potential violations of administrative rules and regulations, directors and officers would be allowed to consider both remote and reasonable risks, i.e., courses of action that do not represent a probable likelihood of breaking the law. Importantly, our proposal submits that different levels of risk-taking will be subject to differential liability regimes matching the level of the risk involved in the decision. Furthermore, it would require corporate fiduciaries to provide external validation of their risk assessment.

The risk level and the supporting evidence will determine the applicable judicial review standard. If the management and board are in possession of an administrative pre-ruling that affirms the legality of the decision, the decision would be immune to judicial review. If the management and board relied on an expert opinion stating that there is only a remote risk of illegality, courts will review the substance of the opinion to ensure that it is well-grounded. Finally, if the expert opinion on which the directors and officers relied states that their legal risk was reasonable (but not probable), it will be subject to enhanced scrutiny, under which the directors and officers will bear the burden of showing that the risk they chose to take was reasonable and that the expected benefits exceeded the potential harm.

The adoption of our proposed framework would transform the way courts and corporations approach legal risk from outright disapproval to qualified sanctioning. And although implementation of our proposal would not place business risk and legal risk on equal footing, it would allow managers and officers to openly weigh and consider business strategies that involve an acceptable level of legal risk

[9] *See infra* 110.

Structurally, the Article unfolds in four parts. In Part I, we will discuss the differential treatment of business risk and legal risk under extant law. We will then show that the prevailing legal approach to legal risk may often result in destruction of value for shareholders. Against this backdrop, in Part II we explore existing justifications for the distinction between business and legal risk. We conclude that although they have surface appeal, they do not survive scrutiny and therefore cannot provide a basis for said distinction. In Part III, we advance a novel, process-oriented, justification for the differential treatment of business and legal risk. We argue that because under current law directors will categorically refuse to consider decisions and policies involving legal risk, they will not be subject to the same exacting approval procedure as other policies and decisions. Consequently, the quality of policies and decisions implicating legal risks would be compromised. In Part IV, we propose an alternative regime to govern legal risk. Under our proposal, board decisions involving legal risk would be subject to a differential standard of review, depending on the probability of the risk (remote, reasonable or probable) and the nature of the criminal norm implicated (mala in se or mala prohibita). A short conclusion will ensue.

I. THE DISTINCTION BETWEEN COMMERCIAL AND LEGAL RISKS.

The distinction between business and legal risk is part and parcel of corporate law. Decisions and policies involving business risk are adjudicated under the business judgement rule (BJR), which largely shelters managers and board members from personally liability for decisions that resulted in losses to their firms.[10] Decisions and policies that implicate legal risk receive very different treatment. If a legal risk materializes, it exposes the managers and board members to liability for breach of the duty of loyalty.[11] Breaches of the duty of loyalty do not come within the ambit of the BJR.[12] Nor are they typically subject to exculpatory clauses or directors and officers liability insurance.[13] Worse yet, they also expose managers and directors to criminal liability.[14] Therefore,

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[10] *See e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Citigroup*, 964 A.2d at 125 ("The presumption of the business judgment rule . . . function[s] to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of company's business risk."). Regarding the effective protection of the BJR, *see* Lori McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 WM. & MARY BUS. L. REV. 521 (2013).
[11] *See, e.g.*, *Abrams v. Allen*, 297 N.Y. 52, 55-56, 74 N.E.2d 305, 306 (1947) (holding that directors may incur liability if they use corporate property for an illegal purpose).
[12] *See Miller v. AT&T*, 507 F.2d 759, 762 (3d. Cir. 1974).
[13] *See infra*, note 69.
[14] *See Miller*, 507 F.2d at 763 (holding that defendant directors can be found criminal liability if they breached their fiduciary duty to the corporation).

from the vantage point of directors and officers, managing business risks is part of their job description, while legal risks must be averted at all cost.

The distinction between business risk does not originate in a specific statutory provision. Section 102(b) of the Delaware Corporate Governance Law provides that the charter of corporations may include the particular goal for which they have been incorporated or simply state that the "purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized…and by such statement all lawful acts and activities shall be within the purposes of the corporation."[15] Based on the statutory language that limits the corporate purpose to lawful aims and conduct, courts have determined that directors and officers duty of good faith requires them to be loyal to the corporation's legally authorized purposes, even if disobeying the law would maximize shareholder value.[16] Chancellor Allen has defined the duty of loyalty as requiring directors to "manage the corporation within the law, with due care and in a way intended to maximize the long run interests of shareholders."[17] An important ramification of the duty to obey the law is the imposition of personal liability if fiduciaries knowingly violate the law.[18] As vice Chancellor Strine stated in Desimone v. Barrows, "[i]n short, by consciously causing the corporation to violate the law, a director would be disloyal to the corporation and could be forced

[15] DEL. CODE ANN. tit. 8, § 101(b)(2020).

[16] In *Cede & Co. v. Technicolor, Inc*. 634 A.2d 345, 361 (Del. 1993), the Delaware Supreme court held that the duty of good faith is an independent and separate duty from the duty of loyalty. There is some dispute, whether it actually matters whether it is an independent duty, or a duty that is nested under the duty of loyalty. The general consensus is that the question is mostly a semantic question. *See* Bainbridge, Lopez & Oklan, *supra* note 8; Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006); Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457 (2009); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, (2004); Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010); Robert B. Thompson, *The Short, But Interesting Life of Good Faith as an Independent Liability Rule*, 55 N.Y.L. SCH. L. REV. 543 (2010); Julian Velasco, *How Many Fiduciary Duties Are There in Corporate Law?* 83 S. CAL. L. REV. 1231 (2010).

[17] *TW Servs., Inc. v. SWT Acquisition Corp*., CIV. A. Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989).

[18] *See Metro Comnc'n Corp. BVI v. Advanced Mobilecomn Techs. Inc.*, 854 A.2d 121, 131, 163-64 (Del. Ch. 2004) (holding directors as violating the duty of loyalty and imposing on them personal liability whey they engaged in unlawful bribery for the benefit of the firm); *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) "([O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey"); *In re Walt Disney Co. Derivative Litig*., 907 A. 2d 697, 755 (Del. 2005) ("A failure to act in good faith may be shown, for instance . . . where the fiduciary acts with the intent to violate applicable positive law").

to answer the harm he has caused . . . . [T]he knowing use of illegal means to pursue profit for the corporation is director misconduct."[19]

The terms "consciously causing" violations[20] or "intent to violate"[21] are open to two possible interpretative approaches. The first is that the consciousness or the knowledge required for such liability, must pass a certain level of certainty. The second is that mere knowledge or awareness of the *possibility* that a certain action may cause a violation is sufficient for constituting such liability. Theoretically, it is possible to accept the first option and exclude liability for violating the duty of care from cases in which there exists a certain level of uncertainty regarding the illegality of the action. The acceptance of such an approach would create at least partial symmetry, or at least prevent polar asymmetry between the assumption of legal risk and business risk. Just as the exposure to business risk is permitted and fiduciaries are shielded from personal liability for the realization of such risks by the BJR,[22] exposure to legal risk is permitted in some instances and fiduciaries are protected to a certain extent from personal liability. As we have noted in the introduction, from a theoretical standpoint, one would expect a similar treatment of similar patterns of risk independent of their source. Even if a full symmetry between the two levels of risk is not adopted, one could expect at least a partial symmetry—that *some* level of legal protection is provided to fiduciaries assumption of legal risk that benefits the corporation. Yet in practice, courts in Delaware and elsewhere, adopt the second approach of complete asymmetry to business risk and do not provide protection to fiduciaries that expose the corporation to *any* level of legal risk. Fiduciaries are personally liable for any corporate legal risk that has materialized.

The asymmetry between business risk and legal risk is emphasized in Miller v. AT&T.[23] Miller, a shareholder in AT&T, sued the company and its directors and managers over the decision not to collect funds it has transferred as loans to the Democratic party. Miller claimed that it was an illegal donation.[24] The court ruled that the BJR does not cover a calculated decision to expose the

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[19] *Desimone v. Barrows,* 924 A. 2d 908. 934-35 (Del. Ch. 2007).
[20] *Id*. at 934.
[21] *Walt Disney Co*., *supra* note 18 at 755.
[22] The business judgment rule is actually designed to "increase stockholder wealth by engaging in those [business] risks that, in [directors'] judgment, are in the best interest of the corporation 'without the debilitating fear that they will be personally liable if the company experiences losses.'" *In re Goldman Sachs Grp., Inc. S'holder Litig.*, No. 5215-VCG, 2011 WL 4826104, at *21-22 (Del. Ch. Oct. 12, 2011) (quoting *Citigroup*, 964 A.2d at 139).
[23] *Miller,* 507 F.2d at 762 (3d Cir. 1974).
[24] *Id.* at 761.

company to a legal risk.[25] Accordingly, even though a decision not to collect a business loan is ordinarily covered by the BJR, a decision not to collect a loan that exposes the firm to a legal risk is not is excluded from its protective sphere. The distinction between business risk and legal risk has also been seemed to be adopted by the American Law Institute.[26]

Nowhere is the differential approach to legal risk and business risk more accentuated than in the context of oversight liability. In *Caremark*, the Delaware Chancery Court recognized the possibility of imposing liability on directors for oversight failure if the board did not adopt an effective reporting system or ignored red flags.[27] In *Citigroup*, Chancellor William Chandler elucidated the challenge involved in oversight liability suits, explaining that "imposing Caremark-type duties on directors to monitor business risk is fundamentally different [than legal risk]."[28] This view has been reiterated in subsequent cases.[29]

Even though Delaware courts have not yet imposed liability on directors for violating their oversight duties, a few cases survived motions to dismiss.[30] All these cases involved a common

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[25] *Id.* at 762

[26] PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(b)(1), 4.01(a) (Am. Law Inst. 2008) (emphasizing that the business judgement rule does not apply to legal violations and "extraordinary situations" that enable a corporation to depart from a legal rule, do not include situations of legal risk).

[27] *Caremark*, 698 A.2d at 970 ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.").

[28] *Citigroup*, 964 A.2d at 131. A similar understanding of *Caremark* has also been adopted in *Corp. Risk Holding LLC v. Rowlands*, No. 17-cv-5225(RJS), 2018 WL 9517195 (S.D.N.Y. Sept. 28, 2018) (dismissing derivative suite against directors who didn't monitor cybersecurity risks, because it did not result from a violation of the law or employee misconduct).

[29] *Asbestos Workers Local 42 Pension Fund v. Bammann*, No. 9772-VCG, 2015 WL 2455469, at *14 (Del. Ch. May 22, 2015); *Goldman Sachs*., 2011 WL 4826104, at *21-22; *Okla. Firefighters Pension & Ret. Sys. v. Corbat*, No. 12151- VCG, 2017 WL 6452240, at 18* (Del. Ch. Dec. 18, 2017); *Capital One Fin. Corp. v. Fairbank*, No. 11693-CB, 2016 WL 6081823, at *8 (Del. Ch. Oct. 18, 2016). Regarding the cases that interpret *Caremark* as drawing the line between business risk and legal risk, *see* Pollman, *supra* note 5, at 2043.

[30] Most recently, in *Marchand*, the Delaware Supreme Court reversed the Chancery Court's dismissal of a breach of duty of loyalty against an ice cream company that had violated manufacturing regulations causing the death of three people. *See Marchand v. Barnhill*, 212 A.3d 805, 809 (Del. 2019). The other cases of suits against directors for oversight failure that survived a motion to dismiss all involved legal violations. *See*, *In re Clovis Oncology, Inc. Derivative Litig.*, C.A. No. 2017-0222-JRS, 2019 WL 4850188, at *6 (Del. Ch. Oct. 1, 2019) (failure to spot a violation of FDA regulations for clinical trial protocols); *In re Am. Int'l Grp., Inc.*, 965 A.2d 763, 779 (Del. Ch. 2009) (failure to arrest and facilitation of sale of illegal financial products); *In re China Agritech, Inc. S'holder Derivative Litig*., C.A. No. 7163-VCL, 2013 WL 2181514 at *18 (Del. Ch. May 21, 2013) (failure to oversee use of proceeds of a securities offering for stated purposes); *In re Massey Energy Co.* C.A. No. 5430-VCS, 2011 WL 2176479, at *1 (Del. Ch. May 31, 2011) (oversight of violation of mining safety laws and regulations); *La. Mun. Police Emps. Ret. Sys. v. Pyott*, 46 A.3d 313, 316 (Del. Ch. 2012) (failure to notice violation of FDA regulations of off-label marketing). It

feature: they dealt with claims concerning legal risks.[31] In contrast, all motions to dismiss in cases involving commercial risks have been granted.[32] In *Salsitz v. Nasser*, the court explicitly noted that it would not impose liability on directors for losses to the firm arising from the materialization of a business risk.[33] No such statement can be found with respect to legal risks. The clear distinction between business risk and legal risk in respect to oversight duty also underlies active decisions of fiduciaries, as we discussed above. If courts distinguish between business risk and legal risk in the case of omissions of directors, providing lower protection for the latter, a fortiori they afford even lower protection for the generation of legal risks through commissions.

As noted in the beginning of the Article, the distinction between business and legal risk is far from self-explanatory. From the point of view of the shareholders, the source or nature of the risk is irrelevant. The only variables that matter are the expected loss associated with the risk and the expected value of the policy or decision that gives rise to the risk.

II. JUSTIFYING THE DISTINCTION

The problematic nature of the distinction between legal and commercial risks has not escaped the searching gaze of corporate law scholars. A review of the academic literature reveals several

should be noted that some of these cases, specifically *AIG* and *Pyott* are not classical *Caremark* suites for lack of oversight—there were some indications for the directors' active role in the violations. For an overview of the *Caremark* claims that passed a motion to dismiss and their common denominator of legal violations, *see* Pollman, *supra* note 5 at 2036-41.

[31] Pollman, *supra* note 5 at 2036. *City of Birmingham Ret. & Relief Sys. v. Good* 177 A.3d 47, (Del. 2017) reinforces the distinction between business risks and legal risks. A ruptured pipe of Duke Energy caused a spill of toxic wastewater into the Dan River. The company paid a fine of 100 million dollars for the violations that contributed to the spill. The judges of the Delaware Supreme Court were divided on whether to impose liability on the directors of Duke Energy for disregarding its oversight responsibility of such violation. The majority of four judges ruled for dismissal of the claim against the directors, and a minority of one Judge—Chief Justice Leo Strine—dissented, arguing that directors should be found liable. Chief Justice Strine has explained the difference between his opinion and the opinion of the majority as a disagreement of whether the directors have deliberately exposed the company to legal risks. Chief Justice Strine held the opinion that even though the board has taken some measures to address regulatory concerns, it has "accepted and supported" a business strategy that "skirted" environmental laws and mitigated the legal risk by political influence-seeking. *Id*. at 68. In contrast, the majority did not find the board's behavior to consist of deliberate exposure to legal risks, but that the plaintiffs were relying on a conflation between the "bad outcome of the criminal proceeding with the actions of the board." *Id.* at 59. Thus, according to Chief Justice Strine, all judges agree that a board's knowledge of exposure to legal risk justifies imposing on directors' personal liability. The question in *Birmingham*, was whether the board was aware that the firm was exposed to a legal risk.

[32] Pollman, *supra* note 7, at 756.

[33] *Salsitz v. Nasser*, 208 F.R.D. 589, 597 (E.D. Mich. 2002) (holding that the board's decision not to track the safety record of Firestone tires, and the manifestation of that associated risk, "is not a sufficient ground on which to hold the Defendants liable").

justifications that have been offered in support of the distinction. Some of these justifications address the distinction between legal risk and business risk head on. Others do not address it directly, yet we believe that they are relevant to the discussion. In the proceeding paragraphs, we survey all existing justifications of the differential treatment of business and legal risk and critically evaluate them.

A. The different Nature of Business Risk and Legal Risk

Chancellor Chandler's opinion in *Citigroup* has prompted Professor Stephen Bainbridge to advance a theory that supports the differential approach to business and legal risks.[34] Although the decision dealt with oversight liability, Professor Bainbridge's justification of the distinction extends beyond the particular context of the case, covering both omissions and commissions. Professor Bainbridge's point of departure is that" [i]n fact, risk management and law compliance are fundamentally different."[35] To support this proposition, he demonstrates that the professional literature does not treat the two forms of risks differently. The Corporate Directors Guidebook addresses both risk and compliance in the same section.[36] Furthermore, the actions that reduce business risk often have the effect of lowering exposure to legal risk, and thus, put directors in good standing from a compliance perspective. Therefore, the ultimate goal of directors is to make sure that all the appropriate policies, methodologies and infrastructure are in place.[37]

Yet, Professor Bainbridge believes that there is a difference in the nature of business and legal risks, which justifies a differential treatment of the two: "[w]hereas law compliance has something of an 'either/or' aspect—you are either breaking the law or not—business risk management is inevitably intertwined with risk taking."[38] The precise meaning of Professor Bainbridge's words is not entirely clear, and thus, it is open to interpretation. There are two possible ways to understand him. The first interpretation suggests that legal risk is binary, whereas business risk is not. The

[34] Bainbridge, *supra* note 4, at 979.
[35] *Id*. at 980.
[36] AM. AAR ASS'N COMM. ON CORP. LAWS, CORPORATE DIRECTOR'S GUIDEBOOK 27-28 (5th ed., 2007). For additional examples in the professional literature in which there is not distinction between the two form of risks, *see* Bainbridge, *supra* note 4, at 980.
[37] MICHEL CROUHY ET AL., THE ESSENTIALS OF RISK MANAGEMENT 30 (2006).
[38] Bainbridge, *supra* note 4, at 988.

second is that legal risk can be fully averted, whereas business risk cannot; firms need not break the law but must make risky business decisions.

There are two problems with Professor Bainbridge's theory. First, both readings of his justification do not hold water. As we will show, it is neither true that legal risks are binary, whereas business risks are not, nor is it true that legal risks can be avoided altogether. Second, his theory cannot provide a basis for the extant legal regime. We discuss these problems in turn.

The claim that legal risk is binary in nature whereas business risk is not, mischaracterizes the problem. All risks are binary in the sense that they either materialize or they do not. Of course, risks may partially martialize. But this is true for both business and legal risks. For example, a merger or an acquisition may partially fail and result in a loss that represents 50% of the maximum loss contemplated before the transaction. Similarly, an enforcement agency or a court, may find that a company violated the law, but impose a fine that amounts to 50% of the maximum fine stipulated under the law. In the case of legal risks, the level of exposure and the magnitude of the loss depend on a host of factors, some of which are factual and some concern the blameworthiness of the perpetrators.

Professor Bainbridge's second argument, that legal risk can be fully averted whereas business risk cannot, fares no better. As Professor Norman Beveridge—who served as the Chief Legal Office of a Fortune 600 company (Amerace)[39] before joining the academic world—has put it: "there is no such thing as a corporation . . . in compliance with law, rather there are only corporations (and businesses) out of compliance with the law to varying degrees."[40] Professor Beveridge is correct. Companies operate in an intricate web of laws regulations. In addition to corporate law and securities regulation, their activities interface with labor and employment discrimination laws, environmental and safety regulations, contract and tort law, and of course criminal law. Companies that operate overseas must be mindful of the foreign legal regimes of the sovereign countries in which they have business activities. Compliance is a mammoth challenge that involves an endless process of information gathering and analysis. It is unrealistic to assume, therefore, that legal risk

[39] Alvin C. Harell, *A Tribute to Norwood Beveridge*, 35 OKLA. CITY U. L. REV. 247, 247 (2010)
[40] Norwood P. Beveridge, *Does the Corporate Director Have a Duty to Always Obey the Law?*, 45 DEPAUL L. REV. 729, 732 (1996)

can be brought down to zero. A faithful portrayal of the real world reveals that neither business risk nor legal risk can be fully eradicated.

As a concrete example of our general point, consider the case of kickbacks to physicians. Pharmaceutical companies cannot offer kickbacks to doctors to induce the latter to recommend certain drugs or treatments.[41] It is possible for directors to oversee that the company does not have a systemized kickback policy. But this will not necessarily eliminate all local initiatives of individual employees to offer kickbacks to doctors in violation of the firm's policy. Even if a firm attempts to monitor all the interactions of its employees with doctors by mandating that all such interactions be recorded, it may not suffice. Agents, who are eager to improve their performance may disregard the recording requirement or send a friend or a third party to provide the kickback. Of course, additional precautions may be put in place. For example, it is possible to require that every salesperson be accompanied by another to ensure compliance. Yet even this measure can be circumvented, and the two employees can operate in cahoots to bypass the company's policy. It should also be remembered that at some point, the marginal cost of each additional precaution will exceed the incremental benefit.

A similar dynamic can be seen in the case of bribery of government officials, a practice banned by the Foreign Corrupt Practices Act (FCPA).[42] Despite the ban and the attendant harsh consequences in the case of a violation, corporate agents may nonetheless have a strong individual incentive to bribe foreign government officers to increase their sales-based compensation. Here, too, a wide range of techniques may be employed to combat this risk, but none can eliminate it entirely.

A second problem with Professor Bainbridge's argument is that even if one were to agree with his premise that legal risk can be eliminated, it does not necessarily imply that it should be. Professor Bainbridge's explication makes the analytical error of conflating the "can" and the "should," but there is an analytical difference between the two. More importantly, from a policy perspective, clearly not everything that can be done should be legally prescribed. To illustrate our point, let's revisit the kickbacks problem. Assume that the only way to eliminate kickbacks from pharmaceutical companies to doctors requires the abolition of all conferences and academic events,

[41] 46 CFR § 164.508(a)(3)(ii).
[42] FOREIGN CORRUPT PRACTICES ACT OF 1977, 15 U.S.C. §§78dd-1 to -3.

as the interaction between pharmaceutical companies' employees and doctors provide ample opportunity for kickbacks. Should pharmaceutical companies be forced not to hold conferences? The answer is far from clear. Shareholders will bear a significant loss from this overly careful policy. Hence, it is reasonable to assume that they would want the company to refrain from going to such extremes and accept a certain exposure to legal risk. If a business strategy involves exposure to a remote legal risk associated with a small expected loss and a large potential gain, the shareholders may want the company to adopt it.

Our general point is simple: companies should be expected to approach all types of risk based on a comprehensive and careful analysis of the relevant losses and gains; they should not be expected to avoid certain risk completely irrespectively of the probability of their occurrence and the losses associated with them. Should a policy that is associated with 0.002 probability of breaking the law and a small fine be dismissed out of hand even if it can yield a large expected gain to the shareholders? We believe that the answer should be no. Such a policy should be discussed and analyzed. We understand that a concern may arise that such an approach may result in violations of the law. Yet, this concern may, and should, be effectively addressed by increasing the sanctions associated with certain conducts and adjustments in the level of enforcement.

B. Epistemic justification for the distinction

An alternative way to understand Bainbridge's distinction between the two risks, is as an epistemic distinction. The uncertainty that accompanies commercial risk is an objective uncertainty that is inherent in any business activity. In contrast, the uncertainty that is associated with legal risk is subjective uncertainty, in the sense that there is actually an answer to whether the practice is legal or not. And while it is possible that individuals and firms may not readily know the answer, they can reach it by seeking assistance from lawyers or judges. The same analysis does not apply to business risks as there is not objective way, let alone an institutional framework, for dispelling business uncertainty.

Similarly, to the previous justification, this justification, too, faces a pair of obstacles: First, it is far from clear that the proposed epistemic distinction between the two types of risk is actually correct. Second, even assuming that the distinction is correct, it does not necessarily support the difference between the two forms of risks.

The proposition that every legal question has one right answer has been suggested and popularized by the late legal philosopher, Ronald Dworkin. Dworkin believed that legal dilemmas could always be resolved and that even the most challenging questions had a correct answer.[43] It should be noted, though, that Dworkin adopted an ideal conceptualization of the law. Importantly, he never argued that actual courts always reach the right answer.[44] Rather, he employed the construct of a "Herculean" judge and postulated that she would be able to reach the right answer.[45] It should also be noted that Dworkin's theory, even with its provisos, has not been universally accepted.[46] Some scholars argue that Dworkin's himself has retracted from his "one right answer" in his subsequent work which developed the concept of legal interpretivism.[47]

Indeed, it is highly debatable that there is a correct answer to every legal question, even in the abstract. We are not aware of any jurist who argues that, in practice, all legal questions can be answered correctly. Justice Robert Jackson essentially admitted as much when he said of himself and his fellow Justices "we are not final because we are infallible, but we are infallible only because we are final."[48] Similarly, according to the Holmesian conception, uncertainty is inherent in law. Oliver Holmes defines law as "[t]he prophecies of what the courts will do in fact, and nothing more pretentious."[49] Professor Frank Partnoy deduces from the Holmesian conception of law that the duty of directors and managements to comply with the law is to *estimate* what will be the regulators position in the future.[50] According to such understanding of compliance with the

[43] *See* Ronald Dworkin, *No Right Answer?, in* LAW, MORALITY, AND SOCIETY 58 (Peter Hacker & Joseph Raz eds., 1977); RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 279-90 (1978); RONALD DWORKIN, A MATTER OF PRINCIPLE 119-45 (1985); Ronald Dworkin, *On Gaps in the Law*, *in* CONTROVERSIES ABOUT LAW'S ONTOLOGY (Paul Amselek & Neil MacCormick eds.,1991).
[44] DWORKIN, TAKING RIGHTS SERIOUSLY, *id.* at 365.
[45] RONALD DWORKIN, LAW'S EMPIRE 264-65 (1986).
[46] *See e.g*., Jeremy Waldron, *Did Dworkin Ever Answer the Crits?, in* EXPLORING LAW'S EMPIRE (Scott Hershovitz ed., 2006) 155, 162-164 (arguing that Dworkin has not refuted the position of the CLS, that Judges have strong discretion which enables them to choose between various possible judgments); Joseph Raz, *Dworkin: A New Link in the Chain*, 74 CAL. L. REV. 1103 (1986).
[47] Scott Shapiro, *The Hart-Dworkin Debate: A Short Guide for the Perplexed*, *in* RONALD DWORKIN 22, 35-36 (Arthur Ripstein ed., 2007).
[48] *Brown v. Allen*, 344 U.S. 443, 533 (1853).
[49] Oliver Wendell Holmes Jr., *The Path of the Law,* 10 HARV. L. REV. 457, 461 (1897). Even the Dworkinian jurisprudence also supports this view. The fact that the court reached a certain decision regarding the legality of a certain practice, does not necessarily mean that their answer was the right answer all along, and the court has merely "discovered" the pre-existing law. According to the Dworkinian view, even though there may be certain interpretations which are clearly wrong, there is a range of possible interpretations, that the court decisions 'constitutes' the proper interpretation and does not merely discover it. *See* DWORKIN, *supra* n. 45.
[50] Frank Partnoy, *The Law of Two Prices: Regulatory Arbitrage, Revisited*, 107 GEO. L. J. 1017, 1040.

law, there is no difference between business uncertainty and legal uncertainty. In both cases, one must foreshadow or estimate the outcome of future events.

But even if one accepts the epistemological distinction between commercial and legal uncertainty, it does not follow that the disparate doctrinal treatment of the two risks is justified. From a practical standpoint, ascertaining the correct answer to intricate legal questions is too expensive and thus impractical for most individuals and many firms. It is unclear why the theoretical possibility of obtaining a correct answer generates the conclusion that one *should* obtain the answer, irrespective of the cost involved. At the very least, the law, if it were based on this justification, should have reflected this factor by calibrating liability based on the means of litigants and the cost of obtaining authoritative legal answers. Therefore, the epistemic distinction between legal and business risks does not provide a justification for the differential treatment of business and legal risks under current doctrine.

C. The Expressive Justification

In a recent article, Professor Elizabeth Pollman has offered a different justification for the differential treatment of business and legal risks.[51] According to Pollman, the law's strict and uncompromising approach to legal risk is intended to convey an expressive message about the special importance of obeying the law.[52] Professor Pollman points out and acknowledges that there is no reason to assume that one source of risk is more pro-shareholder that the other.[53] Both forms of risk—business and legal—can benefit shareholders to the same extent.[54] Even though from the perspective of shareholders there is no difference between the two types of risk, the law differentiates between them in order to solidify the duty to adhere and comply with the law.[55] The

[51] Pollman, *supra* note 31, at 2043-44.
[52] *Id*.
[53] *Id*.
[54] *Id*. at note 163.
[55] As Pollman notes, the distinction leaves some wiggle room, enabling to exclude from the prohibition decisions that produce significant social value. *See* Pollman, *supra* note 32, at 749-750. The problem with this kind of mechanism, that even when contemplating a decision to assume a legal risk with significant social value, the fiduciaries cannot rely that their decision would be protected and that courts will utilize the wriggle room for protecting the decision. They are under considerable personal risk, and thus will still refrain from exposing the firm to legal risk, even when it has considerable social value.

purpose of distinction, therefore, is to strengthen the authority of the law and the rule of law, especially in the corporate context:

> The fiduciary duty of good faith…embeds a safety valve for public policy in the obligations of fiduciaries that cannot be eliminated. Expressing legal compliance and oversight obligation within corporate law acknowledges societal interests in the rule of law and preserves the ability of courts to flexibly respond to particularly salient and egregious violations of public trust, should they arise, without upending case law developed over decades.[56]

This view seems to suggest that allowing corporate fiduciaries to consider legal risk, even remote ones, would substantially harm the reverence of individuals toward the law. This is especially true in the corporate realm, which is more susceptible to illegality than other spheres, due to a wide range of behavioral effects that induce illegality such as group decision-making, harm to unspecified individuals, and benefits conferred on third parties.[57] Hence, considerations of legal risk should not be allowed, regardless of the gains they may yield for shareholders.[58]

While there is much to commend about Professor Pollman's analysis, we find the expressive justification unsatisfactory. First, as many scholars have pointed out, it is not clear that expressive theories of the law have any independent weight. Expressive theories focus on the communicative function of the law, while remaining agnostic as to the substance of the underlying message. That is, expressive theories are not committed to a single value that ought to be promote. Rather, they accept the possibility of value pluralism. The desirability of expressive justifications ultimately depends on the substantive value the legal norm embodies. If the value underling a legal norm is unjust or inefficient, there is no reason to amplify to it. In contrast, if the value a legal norm seeks to promote is just and noble, why not finetune and improve the substance of the norm itself? Professors Rick Pildes, Elizabeth Anderson and Cass Sunstein have argued that expressive theories may be important, nonetheless, in cases where legal norms embody pluralistic values.[59] In these

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[56] Pollman, *supra* note 29, at 2016.
[57] *See* Yuval Feldman, Gideon Parchomovsky and Adi Libson, *Corporate Law for Good People*, 115 NW. L. REV. (forthcoming, 2021), 5-6, available on SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3226767.
[58] Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013 (2019)
[59] *See* Richard H. Pildes & Elizabeth S. Anderson, *Slinging Arrows at Democracy: Social Choice Theory, Value Pluralism, and Democratic Politics*, 90 COLUM. L. REV. 2121, 2176-77 (1990). For an elaborated account of the

instances, expressive theories may be employed to mitigate conflicts between different values or to emphasize one message, while deemphasizing another.[60] Respect for the law, as Pollman utilizes it, however, does not seem to fall in this category of cases. Second, even if one accepts the premise that respect for the law should be increased, it does not entail that the taking of legal risk should be banned altogether. Concretely, the expressive justification can explain why the law should take a stricter approach to legal risk-taking than to business risk-taking, but it cannot tell us what the precise calibration of the difference ought to be. Hence, one cannot infer from the expressive justification that considerations of legal risk should be taken off the table completely – only that business risk should be treated more leniently. Third, and finally, the importance of compliance with the law can be emphasized by alternative, and more direct, ways – for example, by increasing the sanction on legal violations by corporations.[61] This course of action would increase deterrence and render potential violations unprofitable.

D. The greater risk legal risks impose on long-term shareholders

Another theory that may be preferred to justify the distinction between business and legal risk is that shareholders might be especially averse to legal risk taking because it may expose them to mismanagement and other abuses of discretion on the part of the management. This theory assumes a correlation between fiduciaries' willingness to adopt an aggressive approach toward legal risk and their disregard for internal corporate norms and expectations. On this theory, managers who are open to taking legal risks will also be prone to nominate close friends as directors, demand excessive compensation, tunnel resources, or engage in self-dealing. In light of this dynamic, it is in the best long-term interest of shareholders that fiduciaries never contemplate breaking the law or consider exploiting legal gray areas. Hence, the prohibition on legal risk taking ultimately benefits shareholders.

Partial support for this theory can be found in studies by Professor Mehir A. Desai and Dhammika Dharmapala. Desai and Dharmapala have examined the impact of aggressive tax planning on share

expressive view, *see generally:* Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000); Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

[60] PILDES & ANDERSON, *id*. at 2145-47.

[61] Garry S. Becker, *Crime and Punishment: An Economic Approach* 76 J. POL. ECON. 169 (1969).

value.[62] One would have expected higher share prices in corporations that engage in aggressive tax planning for the simple reason that it increases the corporations' after-tax revenues. Surprisingly, Desai and Dharmapala found the opposite correlation: as companies adopted more aggressive tax planning and paid less tax, their share prices were lower, everything else being equal.[63] The most plausible explanation of this effect is that even though aggressive tax practices increase after tax profits and thereby benefit shareholders, they signal to shareholders that the management might utilize equally aggressive tactics to channel more funds into their own pockets, at the expense of the shareholders.[64] Desai and Dharmapala's findings, at the very least, sound a cautionary note about the consequences of adopting a less than forthright approach to the law. Aggressive tax planning, after all, is but one example of a calculating approach toward legal restrictions. Hence, an argument can be made that the same vicious circle identified by Desai and Dharmapala may arise with respect to legal risk, more generally.

Notwithstanding Desai and Dharmapalas research, the hypothesis that assumption of legal risk exacerbates the managerial agency problem has not been endorsed by other scholars. We, too, believe that given the current state of knowledge, it is impossible to draw broad implications from directors and officers approach to legal risk and their ethicality vis-a-vis shareholders. First, as we emphasized earlier, legal risk cannot be avoided altogether. It is inherent in the activities and operations of corporations. Consequently, managements must adopt a strategy toward legal risk whether they like it or not.[65] Second, it is impossible to extrapolate from Desai and Dharmapala's work that shareholders perceive all legal risks in the same way, and more importantly, that they view all managerial responses to risk in identical fashion. Desai and Dharmapala's work focuses on *aggressive* tax planning and its signaling effects.[66] It is highly doubtful that balanced and reasonable responses to legal challenges would be perceived in a like manner by the shareholders.

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[62] Mehir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and Firm Value,* 91 REV ECON. & STAT. 537 (2009).
[63] *Id*.
[64] *Id*. at 545-46.
[65] See, *supra* note 40 and accompanying text.
[66] Desai & Dharmapala, *supra* note 62, at 545-46.

In fact, there are reasons to believe that a responsible approach to legal risk may actually send a positive signal to shareholders.[67]

Moreover, if the shareholders of a certain company worry that the management's willingness to take on legal risk would develop into an "aggressive managerial culture," they can prohibit the assumption of legal risk in the company's charter or bylaws, such as a prohibition on establishing an offshore company for evading taxes and so forth.[68] The central implication of Desai and Dharmapala's analysis is that shareholders do not like aggressive managerial behavior by the management. But existing legal doctrine does not distinguish between aggressive and non-aggressive legal risk taking, but prohibits any legal risk taking.

III. A NOVEL JUSTIFICATION FOR THE DISTINCTION: LACK OF EFFECTIVE OVERSIGHT ON LEGAL RISKS

In this Part, we offer a novel justification for the distinction between business and legal risk. What distinguishes our justification from those discussed in Part II is that it centers on corporate law and corporate governance and does not rely on external principles or general theories. It can therefore be called an internal justification. As we will explain, we do not necessarily argue that our justification fully disposes of all the challenges that the distinction between business and legal risk poses, but it provides a stronger reason for treating business and legal risks differently.

We argue that there is a critical difference between business and legal risk from the perspective of shareholders. As we will explain, assumption of legal risk exposes not only directors and officers

[67] For instance, take the case of Airbnb, Tesla, Uber and DraftKings discussed by Pollman and Barry. Pollman and Barry demonstrate how challenging existing regulation leading even to regulatory transgression is central to the business model and success of these "regulatory entrepreneurs." *See* Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 384-85 (2017). The market does not seem deflate the value of these firms, even given their aggressive position to regulation. *See id*. at 401 and 426 note 226.

[68] An example of a Corporate Charter Amendment in which shareholders deviate from practices prescribed by law, is the adoption of a majority voting requirement in uncontested director elections. Most states impose a minimal requirement for a director to be nominated; that she receives the most votes that other contestants. In quite a few companies, shareholders have pushed for a majority voting rule, that requires a director to receive a majority of all votes, including "withhold" votes. Such rule enhances the director's accountability to its shareholders because it requires him to reach a much higher level of active support of shareholders in order to be nominated. Professor Min notes that between 2006-2013 shareholders have amended charters in 39 companies, requiring directors to reach a majority of votes, and not only a plurality of the votes. *See* Geeyoung Min, *Shareholders Voice in Corporate Charter Amendments*, 43 J. CORP. L. 289, 307-08 (2018).

to personal losses, but also shareholders. Under current doctrine, decisions that involve business risk are subject to effective oversight by the board while those implicating legal risk are not. As we emphasized throughout the Article, consideration of legal risk exposes board members to personal liability for breach of their fiduciary duty of loyalty if the risk materializes Directors and officers liability insurance and exemptions do not apply to violations of the duty of loyalty.[69] Nor can directors and officers seek the protection of the BJR in this case.[70] Breaches of the duty of loyalty also expose the directors to criminal liability and social stigmatization.[71] Thus, directors would prefer to avoid legal risk at all cost by steering clear of any decision or action involving legal risk and categorically refusing to discuss or analyze it. Board discussions of legal risk undermine the directors' ability to benefit from one of the strongest criminal defense claims: that they were unaware of the illegality of the action.[72] Furthermore, generally speaking, board members have a limited upside from taking on legal risk.[73] Unlike managers whose compensation is tightly pegged to performance, board members' variable component of their compensation, which is contingent on the company's success, is more limited.[74] This stands in stark contrast to

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[69] *See, e.g.* 8 Del. C. §102 (barring Delaware corporations from eliminating directors' personal liability to the corporation through their certificates of incorporation for "any breach of the director's duty of loyalty.").

[70] *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (For directors, "[t]he 'business judgment rule,' however, yields to the rule of undivided loyalty.").

[71] For example, under the Securities Exchange Act of 1934, breaches of the duty of loyalty through insider-trading violations are punishable by up to 20 years in prison. (15 U.S.C. 78ff).

[72] It is true that under the *Caremark* rule, boards are exposed to liability for legal violations even if they had no awareness to the legal risk the firm was facing—if it had utterly failed to "attempt to assure a reasonable information and reporting system exists." Thus, the board is "digging its head in the sand" in order to avoid awareness to legal risk, which will not protect it from liability. Yet such responsibility is imposed only in extreme circumstances in which the firm including the board has purposefully structured a pattern in which the board is not notified even of the most basic and significant legal risk the firm is facing. *Marchand v. Barnhill*, *supra* note 30, is an example for such extreme circumstances of a *Caremark* claim regarding legal risk that has passed a motion to dismiss. In *Merchand*, the management has not brought to the boards attention letter from regulators noting that the firm may be transgressing laws and regulations regarding food safety, which are "intrinsically critical" to the firm's business which produces only one product—ice cream (*id*. at 822). This case exemplifies a situation in which the board not merely failed to establish a reporting system for the firm's legal compliance but demonstrated complete disregard to the issue.

[73] Quite a few dynamic and fast-growing companies that function as "regulatory entrepreneurs," which some of them are even public companies, are structured similarly to start-ups, in which the directors are founder entrepreneurs and venture capitalists. For the description of such firms and their structure, *see* Pollman & Barry, *supra* note 67, at 398-99.

[74] This is especially true in relation to independent directors, who consist a majority of directors in U.S. public firm, given the requirement of U.S. stock exchanges that a majority of board of publicly traded companies should be independent. Inside directors are more sensitive because they may be holding a large stake of the firm's shares. A study comparing CEO compensation and director compensation examine panel data of over 1000 firm between 1992-2001 found that the cash element in CEO compensation is almost double than that of directors: over 40% for the former and 26% for the latter. *See* Ivan Brick et al., *CEO compensation, director compensation and financial performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403, 408 (2006). But the actual gap in the sensitivity of their

their personal loss in case the risk materializes. In addition, directors' absolute compensation derived from a specific firm is significantly lower than that of executives—directors tend to have a more diversified portfolio of income streams and are thus less dependent on the income they receive from a specific firm.[75] The upshot is that when it comes to legal risk, directors are mainly exposed to the downside. As a consequence, any issue of legal risk raised to the board will not be considered and board members will automatically vote against it. The personal payoff balance of directors is common knowledge, and of course, is also known to executives.

The perspective of executives on legal risk is quite different from those of directors. They, too, may incur personal liability if a legal risk materializes. However, since their compensation is tied to the performance of the firm, they may have an incentive to assume legal risk if the potential rewards are high enough. Aware of the board's negative disposition toward legal risk, management members may consciously elect not to raise opportunities involving legal risk with the board knowing that the board would vote them down. Rather, they will prefer to keep such opportunities alive by refraining from raising them to the board. This strategy of suppression yields another benefit to the executives: it allows them to claim that they were unaware of the illegality surrounding their actions.[76]

The fact that decisions involving business risk receive close scrutiny from the board while decisions implicating legal risks do not, justifies the differential legal treatment of business and legal risk. Board oversight is one of the chief protective mechanisms afforded to shareholders. Dispersed shareholders cannot be relied on to effectively monitor management. A vast literature

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compensation to performance is actually much larger. In general, independent directors' compensation, unlike executive compensation, rarely includes an option component. Even when it includes a stock component, in many cases it is a fixed-value stock component which is insensitive to the performance of the stock. This is more prevalent than the fixed-number stock component which is sensitive to performance. The prevalence of the fixed value component at the expense of the fix number component is only growing in the last years. *See*, e.g., Kathleen A. Farrel et al., *How do Firms Adjust Director Compensation*, 14 J. CORP. FIN. 153 (2008). The literature on director compensation is relatively modest in comparison to that of CEO compensation, and thus does not provide a detailed picture of directors' compensation packages. *See Sanjai Bhargat,* FINANCIAL CRISIS, CORPORATE GOVERNANCE AND BANK CAPITAL 101 (2017).

[75] For instance, a study of panel data of over 1000 firms between 1992-2001 has found that the average total compensation of CEO was $4,054,793 in comparison to $67,225 of directors. *See* Brick et al., *id*.

[76] Even though on a formal level they may be liable for corporate illegal conduct due to their failure of oversight even without knowledge of the illegal action, there are barely any cases in which such liability was imposed. *See* Elizabeth Pollman, *supra* note 7, at 756; Norwood P. Beveridge, *Does the Corporate Director Have a Duty Always to Obey the Law?*, 45 DEPAUL L. REV. 729, 732 (1996); KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 75 (2006).

suggests that dispersed shareholders have neither the ability nor the incentive to perform this task.[77] Monitoring is a task that requires substantial financial and cognitive resources. An individual shareholder who wishes to take on this task stands to incur significant expenditures, while reaping only a tiny portion of the benefits, commensurate with her percentage of the company's share. The lion's share of the benefit will be distributed among all other shareholders. It is similarly unrealistic to expect masses of anonymous shareholders to pool their energy and resources together and monitor the board collectively.[78] For this reason, the task of overseeing the management was assigned to the board and was defined as an immutable duty.[79]

The board of directors is intended to overcome the collective action problem that plagues dispersed shareholders. It is the board that is supposed to perform this function for them.[80] As the importance of the policy or decision facing a company increases, so does the significance of board oversight. In the case of decisions and polices that involve business risk, shareholders can rest assured that they pass two levels of review – at the management and at the board. Decisions and policies that implicate legal risk will not be subject to the same dual scrutiny.

Naturally, our justification is not above criticism. One criticism of our theory is that it overstates the importance of board oversight for shareholders. Several eminent scholars have noted that in practice boards do not effectively monitor the management of firms.[81] Although formally it is the shareholders who nominate directors, practically it is mostly the management that controls the nomination process by deciding which candidates are up for election.[82] Consequently, directors

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[77] John C. Coffee Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001); *see also* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006); A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). John C. Coffee Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 15 (1986) (noting that "[a] little over fifty years ago, Berle and Means reported that the separation of ownership and control in the modern corporation had left shareholders effectively powerless, as managers could neither be ousted from office by shareholders who were widely dispersed, and therefore incapable of coordinated action, nor disciplined effectively by the capital market - at least so long as managers could rely on internal cash flow to finance corporate expansion.").

[78] Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Paul L. Lee, *Risk Management and the Role of the Board of Directors: Regulatory Expectations and Shareholder Actions*, 125 BANKING L.J. 679 (2008)

[79] *See infra*, notes 93-95. *See also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

[80] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1262 (2008).

[81] *See, e.g.*, S. Boivie, et al., *Are boards designed to fail? The implausibility of effective board monitoring*, 10 ACAD. MGMT. ANNALS 319 (2016).

[82] William K. Sjostrom Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 466 (2007) (arguing that management controls all aspects of the proxy materials and, of course, uses this control to

will try to appease the management, either to express their gratitude or to increase the probability of being reelected.[83]

We believe that this criticism proves too much. While there is a heated debate in the academic literature regarding the efficacy of the board in monitoring management or shareholders, no-one argues, to the best of our knowledge, that board monitoring is completely ineffective and that it provides no benefit whatsoever to shareholders. Even if it is true that the board is more attuned to the preferences of management than to those of shareholders, this does not mean that the board flouts its monitoring responsibility or is completely insensitive to the interests of shareholders. All the criticism proves is that the level of monitoring is not optimal.[84]

In this vein, it ought to be remembered that only a relatively small percentage of the decisions taken by the management implicate the narrow self-interests of management members.[85] The vast majority of the decisions that are brought to the board do not involve conflicts between management and shareholders' interests, hence, in the ordinary course of events, therefore, board monitoring constitutes an important mechanism of protecting the interests of shareholders.

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ensure its nominees are elected. Thus, it is generally not possible for a shareholder to use the corporation's proxy card to instruct the proxy to vote for someone other than a nominee listed on the card.).

[83] Yaron Nili, *The New Insiders: Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97 (2016); *See* Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 72-73 (1990) (noting that "managers dominate their boards by using their de facto power to select and compensate directors and by exploiting personal ties with them").

[84] *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5, at 37 (2002); 3 Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 685 (2007); William K. Sjostrom, Jr., *The Case Against Mandatory Annual Director Elections and Shareholders' Meetings*, 74 TENN. L. REV. 199, 216 (2007).

[85] According to some scholars, the main function of the board is not merely to supervise management, but to serve as an additional tier for analyzing managerial strategic decisions. This model of boards is dubbed the "managerial model of boards." *See* Fenghua Song & Anjan V. Thakor *Information control, career concerns, and corporate governance*, 61 J. FIN. 1845 (2006); Renee B. Adams & Daniel Ferreira, *A theory of friendly boards*, 62 J. FIN. 217 (2007); Milton Harris & Artur Raviv, *A theory of board control and size*, 21 REV. FIN. STUD. 1797 (2008). According to such model of boards, its central function is not limited to instances in which management may be conflicted. Yet is should be noted that some scholars view the supervision of the managerial decision-making process the main function of the board. This approach is dubbed the "supervisory role of boards." *See* Benjamin E. Hermalin & Michael S. Weisbach, *Endogenously chosen boards of directors and their monitoring of the CEO*, 96 AM. ECON. REV. (1998); Andres Almazan & Javier Suarez, *Entrenchment and severance pay in optimal governance structures*, 58 J. FIN. 519 (2003). It should be noted that this dispute is not merely normative, but also descriptive as well—what function do boards actually fulfill, analyzing the impact of various features of the board on managerial decision-making.

Furthermore, even in those cases where managerial interests conflict with those of the shareholders, the board should not be thought of as a mere rubber stamp in the hands of the managers. First, not all directors are effectively nominated by the management. There are quite a few directors nominated against the will of management, after being supported by hedge funds or institutional investors, against the position of management.[86] Second, not everyone views directors as calculating self-interest maximizers. Directors may be driven by other motivations, such as maintaining their self-image as ethical actors.[87] Third, market forces, too, exert a disciplining effect on directors, mitigating their tendency to side with management. The performance of firms affects the reputation of directors and their future earnings. Hence, directors cannot afford blatantly to disregard the interests of shareholders.[88] Finally, what market forces leave unaddressed is picked up by the law. The law imposes a duty of care and a duty of loyalty on directors to ensure that they act in the best interests of shareholders, not management. The point and purpose of these duties is to crate as perfect an alignment as possible between the interests of directors and shareholders.[89] We do not claim, of course, that the law accomplishes this result. We suffice ourselves with the much more modest, and in our opinion realistic, argument that the law has *some* effect on the behavior of directors.[90] That legal prescriptions and the sanctions associated with them affect subjects' behavior is the foundation of all legal systems. Unsurprisingly, this effect is also present in the corporate world. A review of the literature reveals that directors are sensitive and responsive to the duties corporate law imposes on them.[91]

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[86] In 2020, 131 directors suggested by activists have won seats: 24 in proxy fights and 107 through settlement. In 2018 the number was even higher—161 seats won by activists against the will of management. *See* LAZARD 2020 REVIEW OF SHAREHOLDER ACTIVISM, January 2021, p. 14, available at https://www.lazard.com/media/451536/lazards-2020-review-of-shareholder-activism-vf.pdf. In many of these contests, activists are backed by institutional investors. *See* Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U.L. REV. 971, 993-94 (2019).

[87] Feldman, Libson & Parchomovsky, *supra* note 57, at 11-12.

[88] Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783, 794 (1972) (Arguing that "the policing of managerial shirking [in the corporate context] relies on across-market competition from new groups of would-be managers as well as competition from members within the firm who seek to displace existing management.").

[89] Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PENN. J. BUSS. L. 675 (2009).

[90] [90] Lisa M. Fairfax, *Spare the Rod, Spoil the Director - Revitalizing Directors' Fiduciary Duty through Legal Liability*, 42 HOUS. L. REV. 393 (2005).

[91] *See* Robert Flannigan, *The Economics of Fiduciary Liability*, 32 DEL. J. CORP. L. 393, 427-28 (2007) (concluding that fiduciary duties have are effective in the prevention of se-dealing, even though market forces can also play a role in deterring fiduciaries from self-dealing transactions). *See also* S. Deakin & A. Hughes, *Directors' Duties: Empirical Findings, Report to the Law Commissions*, ESRC CENTRE FOR BUSINESS RESEARCH, August 1999, pp. 32-36 available

Another possible criticism that may be raised against our proposed justification of the difference between business and legal risk is an objection we addressed in our discussion of preexisting justifications, namely instead of adopting a prophylactic ban on legal risk-taking, lawmakers should allow firms and shareholders to set the level of legal risk-taking that is right for them contractually. Doing so would permit risk averse shareholders to ban managers and directors to take on any legal risk, while allowing shareholders who are less averse to legal risk to empower corporate fiduciaries to assume certain legal risks. In short, private ordering would enable shareholders to decide for themselves whether such risks serve or harm their interests.

While reliance on private ordering clearly has surface appeal, its shortcomings become apparent upon closer examination. In a world without transaction costs and perfect information, shareholders could rely on private ordering to protect their interests and tailor the level of the protection to their risk preferences.[92] In the real world, positive transaction costs and asymmetric information prevent shareholders from protecting their interests against managerial abuse. For this reason, corporate law does not exclusively rely on default arrangements that can be modified contractually and complements them with mandatory protections for shareholders that cannot be contractually waived.[93] One example of such mandatory protection is the duty of companies to a board: shareholders in public companies cannot relinquish their right to nominate a board.[94] Nor

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at https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc261_Company_Directors_ESRC_Research.pdf.

[92] The most famous example in which shareholders have rejected a clause intended for their protection was in the example of *Smith v. van Gorkom*, 488 A.2d 858 (Del. 1985), in which shareholders in many firms have exculpated fiduciaries from the duty of care, that was supposed to protect them. The prevailing explanation for this change was that the Vangorkom case increased the liability of fiduciaries which increased the price for shareholders by the higher price firms had to pay for insurance of executives. Shareholders determined that the protection the duty of care offers them in not worth the price they pay. *See* Yaron Brook and Ramesh K. S. Rao, *Shareholder Wealth Effects of Directors Liability Limitation Provisions*, 29 J. FIN. QUANTITATIVE ANALYSIS 481, 483 (1994).

[93] Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 551–53 (1990) (citing self-dealing rules as one example of mandatory law); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1486 (1989) (arguing self-dealing rules are "largely mandatory, at least for publicly held corporations"); Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 607 n.164 (1995) (claiming the rules on self-dealing by managers are mandatory); Randall S. Thomas, *What Is Corporate Law's Place in Promoting Societal Welfare?: An Essay in Honor of Professor William Klein*, BERKELEY BUS. L.J. 135, 139 (2005) (stating self-dealing rules are mandatory for public corporations).

[94] *See*, e.g., DEL. CODE ANN. tit. 8, § 242(b)(1) (2002); REVISED MODEL BUSINESS CORP. ACT § 10.03(a), (b)(l) (2016) (requiring changes in the corporate charter to be approved by the board). *See also* Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 846, 857-858 (2008) ("we identify three significant remaining mandatory provisions that stockholders may not contract around: the stockholders' right to elect directors . . ."). The Columbia Law Review published in 1989 a symposium on mandatory provisions in corporate law. The following scholars have supported and justified mandatory corporate provisions:

can the board abdicate its duty to monitor management, even if the majority of shareholders consent to this eventuality.[95] Corporate law perceives the board as an indispensable organ that is essential for the protection of shareholders against managerial abuse. Similarly, the duty of loyalty of corporate fiduciaries is an immutable duty that cannot be waived or modified contractually.[96] These mandatory obligations provide shareholders with a legal safety net, which purpose is to reduce monitoring costs for the shareholders. Finally, one could raise the question: Why not extend the BJR to legal risk? Applying the BJR to decisions involving legal risk, so the argument goes, would put business and legal risk on a par from the vantage point of directors, allowing them to review decisions involving legal risk. If the BJR applied to legal risk, directors would not shy away from decisions involving legal risk and executives would bring such decisions to the board. This argument is in error. While extending the BJR to legal risks would shelter directors against derivative actions, it would not immunize them to criminal liability. The BJR has no effect on criminal law and criminal sanctions have a much stronger deterrent effect than civil remedies.[97] In order to equalize both risks, it would be necessary not only to change the scope of the BJR, but also to reform criminal law and relieve directors from criminal liability for decisions they make.

John C. Coffee Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1690-91 (1989); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1524-25 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1598-99 (1989). The Symposium included "contractarian" scholars that represented the more critical view toward mandatory provisions. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV.1416, 1446-48 (1989); Fred S. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530, 1544 (1989); Roberto Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Law*, 89 COLUM. L. REV. 1599, 1615-16 (1989).

[95] DEL CODE ANN. Tit. 8, § 141(a) (2001). *See also Schroeder v. Buhannic*, C.A. No. 2017-0746-JTL (Del. Ch., January 10, 2018) at 8, https://delawarecounselgroup.com/wp-content/uploads/2018/02/pierre-schroeder-et-al.-v.-Philippe-Buhannic.pdf (holding that a shareholders' agreement cannot deprive the board of its statutory authority to manage corporate affairs and appoint officers).

[96] Welch at el., *supra* note 94, at 846, 859-860. ("we identify three significant remaining mandatory provisions that stockholders may not contract around . . . and the directors' duty of loyalty"). *See also* Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 496 n.16 (2002) (providing "the duty of loyalty of corporate directors" as an example of mandatory corporate governance regulation). It should be noted that since 2000, Delaware enables a waiver of a partial element of the duty of loyalty—the restriction on corporate fiduciaries to appropriate new corporate business prospects for themselves. *See* DEL. CODE ANN. tit. 8, § 122(17) (2017). Regarding this change in law and its effect, *see*: Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075, 1077-78 (2017).

[97] Regarding the significant role of criminal and administrative law alongside civil liability in deterring corporate officers, *see* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgement Rule*, 60 BUS. L. 439, 469 (2005).

We strongly caution against making this change. There are weighty policy and practical reasons not to adopt it. From a policy standpoint, relieving directors of criminal liability for harms arising from the materialization of legal risk would legitimize massive legal violations behind the corporate veil. This, in turn, would create an opportunity for an undesirable legal arbitrage: it would likely lead individual offenders to set up corporations to take advantage of the legal protection they provide. As likely, it would be sophisticated offenders who will use this option, whereas small time offenders would not. Practically, exempting directors from criminal liability requires a large-scale legal reform that involves many settled doctrines. The costs associated with such a reform is likely to be very high—not to say, prohibitive—and, in our opinion at least, they will far outweigh the benefits.

Accordingly, we believe that the distinction between business risk and legal risk should not be eradicated. The approach to legal risk should be stricter than that of business risk. This, however, does not imply that consideration of legal risk should be banned altogether. Rather, our discussion points us in a different direction. Instead of maintaining a sharp dichotomy between business and legal risk, sanctioning the former and shunning the other, we argue that the law should take a more nuance and variegated approach to legal risk. Consistent with this insight, in the next Part, we develop a new legal framework that strikes a better balance between business and legal risk, without unduly undermining respect for the law.

IV. A NEW FRAMEWORK FOR EVALUATING LEGAL RISK

In the two previous Parts, we discussed and critically evaluated existing justifications for the differential doctrinal treatment of business and legal risk. Furthermore, we introduced a new justification—the lack of board oversight of legal risk—and assessed its merits and limitations. Although the justifications we discussed, including our own, clearly have explanatory power, we are of the opinion that none of them can fully justify the sharp distinction between the two forms or risk that informs legal policy in the corporate domain. Therefore, in this Part we embark on the task of designing a new, and to our minds superior, legal framework for addressing legal risk.

The sharp distinction between business and legal risk arises from the current doctrine, which classifies every legal violation as a breach of the fiduciary's duty of loyalty.[98] As a result, directors and officers are fully exposed to civil and criminal liability with respect to harm that arises from the materialization of legal risks. At the same time, the law provides directors and officers with a panoply of protections against liability for harms resulting from the materialization of business risks.[99] As we explained, this doctrinal wedge causes a gap between commercial and legal risk, which works to the detriment of shareholders. The principal lesson of our analysis is not that the distinction between business and legal risk should be abolished altogether, but rather that the doctrine that applies to legal risk ought to be reassessed and refined. In light of this conclusion, we construct a wholly new regime with respect to legal risk that distinguishes among various legal risks based on two parameters: whether the relevant risk involves a potential violation of a criminal prohibition or an administrative norm, and the intensity of the risk, represented by its probability of materializing.

A. Criminal Violations v. Regulatory Infractions

The first parameter we employ in designing our new framework to legal risk concerns the character of the legal risk. In this respect, we suggest a distinction between risks that may lead to a criminal violations and risks that may result in a regulatory infraction.[100] While both are obviously prohibited by the law, they vary in the degree of severity. Criminal violations are considered more severe and morally objectionable than regulatory infractions. As criminal law scholars have noted the distinction between criminal violations and regulatory infractions largely tracks the

[98] It is questionable whether the duty to obey the law is derived from an independent fiduciary duty of good faith, or whether it is nested under the fiduciary duty of loyalty. This is mostly a semantic question, that does not have much substantive impact. *See* Melvin Eisenberg, *The Duty of Good Faith and Oversight,* 55 Del. J. Corp. L. 1 (2006); Sean J. Griffith, *Good Faith Business Judgement: A Theory of Rhetoric in Corporate Law,* 55 DUKE L. J. (2005); Hillary Sale, *Delaware's Good Faith,* 89 CORNELL L. REV. 456 (2004); Leo Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. 629 (2010); Julian Velasco, *How Many Duties Are There in Corporate Law?* 83 S. CAL. L. REV. 1231 (2010)
[99] *See Miller v. AT&T*, *supra* note 12. See *also Roth v. Robertson*, 118 N.Y.S. 351 (Sup. Ct. 1909) (imposing liability on corporate managers for a bribe paid in order that the amusement park company would be able to operate on Sundays, despite Sunday Closing Laws and thus maximizing its profits). Regarding the irrelevance of the Business Judgement Rule to legal violations, *see* Patrick J. Ryan, *Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(A) of the American Law Institute's Principles of Corporate Governance*, 66 WASH. L. REV. 413, 448 (1991); Stephen Bainbridge, *The Business Judgement Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 97-98 (2004).
[100] For a similar distinction, *see* Bainbridge et al., *supra* note 8.

philosophical mapping of legal violations in two the categories of *mala in se* and *mala prohibita.*[101] A mala in se prohibition is a prohibition on an activity that is morally wrong, independent of the fact that it is legally prohibited, for example, robbery and murder.[102] Mala prohibita are prohibitions on activities that are not morally repugnant independent of the law.[103] Rather, their "wrongness" stems from the fact that the law bans them. Speed limits and disclosure requirements are examples of mala prohibita.

We argue that the distinction between business risks and legal risks should apply with more force to violations of mala in se prohibitions. Corporate fiduciaries should do their utmost to avoid morally repugnant actions and omissions and should not expose their corporations to the risk of violating such prohibitions. At the same time, the law should be more forgiving of risk taking in the realm of mala prohibita. Here, corporate fiduciaries should be given more leeway, though not a carte blanche, in deciding whether to expose the corporation to the risk of violating a mala in prohibitum prohibition. Our proposed distinction not only tracks common moral precepts but may also be justified on informational grounds. Mala in se prohibitions that form the core of our criminal law system are readily ascertainable for the most part. Moreover, the twin bedrock principles of criminal law—legality and lenity—require criminal prohibitions to be clear and unambiguous.[104] Relatedly, criminal prohibitions are subject to restrictive interpretation and in cases of doubt ought to be construed in favor of the defendant.[105] This interpretive principle further helps dispel the uncertainty actors face.

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[101]*See* Stuart Green, *Why It's a Crime to Tear the Tag Off a Mattress: Overcriminalization and the Moral Content of Regulatory Offenses*, 46 EMORY L. J. 1533, 1560-61 (1997). *See also see* Mireille Hildebrandt, *Justice and Police: Regulatory Offenses and the Criminal Law,* 12 NEW CRIM. L. REV 43, 45 (2009). Regarding the distinction in criminal law, *see* Herbert Wechsler, *The Distinction Between Mala Prohibita and Mala In Se in Criminal Law*, 30 COLUM. L. REV. 74 (1930). Regarding the ramifications of the distinction on moral culpability, *see* Michael L. Travers, *Mistake of Law in Mala Prohibita Crimes*, 62 U. CHI. L. REV. 1301, 1322-24 (1995). Regarding the correlation between regulatory infractions and criminal violation and the *mala in se* and *mala prohibita* distinction, *see id.* at 1301-31.

[102] A. R. Duff, *Crime, Prohibition, and Punishment,* 19 J. OF APPLIED PHIL. 98 (2009); Green, *supra* note 101, at 1570-74.

[103] Duff, *id*.; Green id.

[104] *Babbitt v. Sweet Home Chapter of Communities for a Great Or*., 515 U.S. 687, 704 n.18 (1995); *United States v. Lanier*, 520 U.S. 259, 265 n.5, 266 (1997); Lawrence M. Sloan, *Law Language and Lenity*, 40 WM & MARY L. REV. 57, 58 (1998). *See also* Clavin Jefferies, Jr., *Legality, Vagueness and the Construction o Penal Statutes*, 71 VA. L. REV. 189 (1985) (supporting a narrower use of the principle of lenity). For general discussion regarding judges' interpretation of penal statues, *see* Livingston Hall, *Strict or Liberal Construction of Penal Statutes*, 48 HARV. L. REV. 748 (1935).

[105] *See* Sloan, id.; Zachary Price, *The Rule of Lenity as a Rule of Structure*, 72 FORDHAM L. REV. 885, 909 (2004).

Consequently, directors and officers need not engage in complex interpretative challenges when faced with mala in se prohibitions. The same is not true for mala prohibita norms. Many of these norms originate in administrative laws, regulations and rulings. The multiple sources of mala prohibita norms make it more difficult for corporate actors to ascertain that they identified all the relevant norms that apply to their decisions. Moreover, mala prohibita norms are less accessible to lay-persons and even people trained in the law.[106] For instance, the contours of many tax law provisions and regulations cannot be read with pinpoint precision and thus it is nearly impossible to verify in advance whether a certain course of action constitutes a tax violation.[107] Finally, the principle of lenity does not ordinarily extend to administrative prohibitions.[108] Hence, they need not be drafted with the same level of clarity, as criminal law prohibitions.

B. Likelihood of the Risk

The second dimension along which we propose classifying risks concerns their likelihood, or probability, of occurring. Specifically, we argue that legal risks should be broken down into three broad levels: remote, reasonable and substantial. This tripartite distinction has not been devised by us. It is taken from the Generally Accepted Accounting Principles ("GAAP") that have been adopted by the SEC.[109] The terms "remote," "reasonable" and "probable" under the GAAP denote levels of probability that a risk will transpire and inflict a loss on the corporation. These three categories are utilized for determining whether a potential loss ought to be disclosed and reported under securities regulations. [110] The probability thresholds employed by the GAAP are arrayed on a continuum, ranging from "remote" to "reasonable" to "probable.[111] Although the GAAP do not provide precise numerical values for each category, in

[106] Travers, *supra* note 101, at 1301-02; Susan Dimock, *Contractarian Criminal Law Theory and Mala Prohibita Offences*, SSRN, 151, 152 (2014) ("When non-experts think about criminal law, the specific examples of criminal offences they most readily identify are undoubtedly mala in se: murder, rape, robbery, kidnapping, and the like.").
[107] Travers *id*. at 1304 ("Congress, the Court reasoned, did not intend that a person should become a criminal by reason of a bona fide misunderstanding of the tax laws, especially in light of their complexity.").
[108] See *Babbitt v. Sweet Home, supra* note 104 ("We never suggested that the rule of lenity should provide the standard for reviewing facial challenges to administrative regulations whenever the governing statute authorizes criminal enforcement."). *See also* Julian R. Murphy, *Lenity and the Constitution: Could Congress Abrogate the Rule of Lenity?*, 56 HARV. J. LEGIS. 423. 448 (2019)
[109] DELOITTE, *SEC's Focus on Compliance With Loss Contingency Disclosure, Financial Reporting Alert* 11-1 https://www2.deloitte.com/us/en/pages/audit/articles/financial-reporting-lert-11-1.html.
[110] Contingencies (Topic 450) – Disclosure of Certain Loss contingencies, PROPOSED ACCOUNTING STANDARD UPDATE, July 20, 2010.
[111] *Id*.

practice, a "remote" risk is deemed as a risk whose probability of occurring and inflicting a loss on the corporation is 0.3 or lower, a "reasonable" risk is associated with a probability that is higher than 0.3 but lower than 0.7, and a probable risk is one whose likelihood of eventuating is 0.7 or higher.[112] We do introduce one important modification into the GAAP. Since we believe that any risk whose likelihood of occurring is higher than 0.5 is not reasonable, for the purpose of our analysis we define reasonable risk as one whose probability of occurring is between 0.3 and 0.5, and any risk that falls in the range of 0.5 and 1 as probable.

Combining the two proposed distinctions yields six classes of legal risk: (a) remote administrative risk; (b) remote criminal risk; (c) reasonable administrative risk; (d) reasonable criminal risk; (e) probable administrative risk; and (f) probable criminal risk. Having devised taxonomy of legal risks and a matrix for classifying them, our next tax is to tailor a unique liability regime for each risk category. It is to this task that we now turn.

C. New Liability Regimes

It should be noted at the outset, that we do not seek to modify the law as it applies to the liability of corporations, only as it applies to the personal liability of directors and officers. In the latter context, our proposal harnesses liability regimes that should be familiar to our readers, such as the business judgment rule and enhanced scrutiny. The use of familiar liability forms reduces the transition costs associated with our proposal by allowing judges to employ legal machinery with which they are familiar. It also lowers information costs for directors, officers and legal counsels.

i. Remote Administrative Risk

Our first category, remote administrative risk, applies to decisions giving rise to a relatively low risk of a violation of an administrative norm that is not part of the penal code. The violations that fall into this category are the least severe and morally repugnant from a societal standpoint and the probability of their occurrence is low. Accordingly, we propose that the liability of directors and officers for assuming remote risks with respect to regulations be governed by the BJR. The BJR immunizes business decisions from judicial review, if they are informed, adopted in good faith,

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[112] DELOITTE, *A Roadmap to Accounting for Contingencies and Loss Recoveries*, 2019, p. 21 https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/Roadmaps/us-aers-roadmap-to-accounting-for-contingencies-and-loss-recoveries.pdf.

and without a conflict of interest.[113] When these conditions obtain, courts will not review the substance of the decision and will not subject directors and officers to personal liability even if it turns out that the decision occasioned a significant loss on the firm. The business judgment rule has been adopted to give managers and directors leeway in making business decisions.[114] Since business decision often implicate a certain level of legal risk, we are of the opinion that the business judgment rule should also cover decisions involving low probability legal risks that may lead to relatively low levels of social harm that are inexorably intertwined with business decisions.

That said, because we view legal risk more harshly than pure business risk, we post an additional precondition that must be satisfied for the BJR to apply. To qualify for the protection of the business judgment rule we would require directors and officers to satisfy one additional requirement: that they acted on the advice of a competent legal expert who certified that the risk implicated was (a) remote; and (b) regulatory in nature. We would also require the legal counsel of the board to review the opinion and approve of it.

If these requirements are met, a court will only examine the procedural elements of the decision. Inter alia, the court will query whether the legal expert had sufficient expertise in the relevant legal field; whether she was independent; and, whether she was provided with all of the relevant information. If the answers to all these questions is affirmative, and the legal expert classified the potential risk generated by the decision a remote administrative risk, fiduciaries would be shielded from any personal liability, even if ex-post a court determines that their decision has violated an administrative norm. As an illustration of our proposed regime, consider the following example. Assume a company, Smart Micro Processors Inc. (SMP), was subject to cyberattack. The attack targeted its intellectual property, specifically its know-how. The data was stolen but not corrupted. Thereafter, SMP's executives hold a conference call with the board to discuss whether the attack has to be reported. The CEO assesses that most likely the cyberattack will not cause a serious

[113] *Figge v. Bergenthal*, 130 Wis. 594, 615, 624-25, 109 N.W. 581 (1907) ; *Theis v. Durr*, 125 Wis. 651, 659, 104 N.W. 985 (1905); *Polacheck v. Michiwaukee Golf Club Land Co*., 198 Wis. 78, 82, 223 N.W. 233 (1929) ("courts will not interfere in the internal management of corporate affairs in the absence of allegations clearly disclosing abuse of power by corporate officers, bad faith or willful abuse of discretion or positive fraud").

[114] *Yates v. Holt-Smith*, 2009 WI App 79, 22, 319 Wis. 2d 756, 768 N.W.2d 213 ("business judgment rule is designed to limit judicial involvement in business decision-making so long as a minimum level of care is exercised in arriving at the decision").

harm since the company does not face serious competition given its unique technology. She also estimates that if the attack is reported it will cause serious reputational harm to the company causing the shares to drop by 20%, without any substantive reason. The board decides not to disclose.[115] Under our proposed regime, if the board's decision had been based on an expert opinion that non-disclosure exposes the company to a remote risk of a regulatory infraction, the officers and directors will be protected by the BJR.

ii. Remote Criminal Risk

Our second category, remote criminal risks, covers policies and decisions that involve a relatively low risk of breaking the law, yet the relevant legal norm is a criminal prohibition. As we explained, criminal prohibitions should be given special deference and potential violations of criminal norms should be treated most severely. For this reason, we would only allow corporate directors and officers to consider courses of action that might give rise to a violation of a criminal prohibition if and only if the probability of the violation is remote *and* the company is in possession of either a written expert opinion or a pre-ruling letter from an administrative agency stating the planned course of action is legal.[116]

If these twin conditions obtain, we propose that the liability of the directors and officers responsible for the decision implicating a remote criminal risk would be evaluated under the enhanced business judgment rule (or, as it is sometimes called, enhanced scrutiny) standard of review. Under this standard, directors and officers would be sheltered from liability if they can prove that their actions were reasonable and that the expected loss was proportionate to the expected benefit.

To satisfy the first prong of the enhanced scrutiny test—namely, that the contested decision was reasonable—directors and officers would need to produce either a written expert opinion that states

[115] Such decision in not unprecedent. As Sam Young has noted, while studies estimate that around 90% of companies are targeted by cyberattack, nearly 40% of the public companies have not mentioned cybersecurity issues in their SED filings. *See* Sam Yong, *Contemplating Corporate Disclosure Obligations Arising from Cybersecurity Breaches*, 38 J. CORP. L. 659, 667 (2013).

[116] Example of administrative pre rulings are the issuance of Private Letter Rulings by the I.R.S, issuance of No-Action letters by the Securities Exchange Commission, issuance of Standard Interpretation Letters by the Occupational Safety and Health Administration and the issuance of Business Review Letters by the Department of Justice Antitrust Division. Regarding the utilization of pre ruling by administrative agencies and their pros and cons vis a vis other administrative tools, *see* Yehonatan Givati, *Game Theory and the Structure of Administrative Law*, 81 U. CHI. L. REV. 481, 484-491 (2014).

that the risk involved in the decision is remote or an administrative pre-ruling to this effect.[117] As before, we would require the legal opinion to be authored by a renown legal expert whose reputation in the relevant area is indisputable. Here too, the opinion ought to be reviewed and endorsed by the firm's legal counsel before the management and board rely on it. Alternatively, the directors and officers can seek a pre-ruling from the relevant administrative agency prior to proceeding with their plan. An administrative pre-ruling would almost invariably satisfy the reasonableness requirement of the enhanced scrutiny test. We are even willing to adopt a rebuttable presumption to this effect. That said, administrative pre-rulings are rather rare and are difficult to secure. As Professor Yehonatan Givati has noted, even when pre-rulings can be obtained in principle, the attendant process is both expensive and time consuming.[118] Hence, pre-rulings do not offer a viable solution to firms' need to move expeditiously.

The second prong of the enhanced scrutiny test—namely, proportionality between the expected loss and the expected benefit, is designed to ensure that the management's plan or course of action was supposed to result in a profit of the shareholders.[119] This condition provides an important check on firms' management as it forces them to verify that the expected gains from their actions outweigh the expected costs. If the expected costs are high the gains expected gains must be even higher. The proportionality requirement thus ensures internalization of the potential costs of firms' actions on the public. In keeping with this important principle, we would require the management and the board to adduce evidence demonstrating that the potential loss they envisioned bore proportionality to the possible benefit they foresaw.

In order to illustrate the remote criminal risk category, consider the following example. The firm Antica Zeneca developed a very effective flu vaccine, which received FDA approval. The company has found evidence that the vaccine may also have limited efficacy against Covid-19, but never applied for FDA approval for that use. The use of an FDA approved drug for addressing a different health issue than that for which the drug was approved by the FDA is permitted by law,

[117] *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).
[118] Yehonatan Givati, *Resolving Legal Uncertainty: The Fulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137 (2009).
[119] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-955 (Del. 1985); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 361 (Del. 1993) ("... the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances").

but the company is not allowed to promote and market the drug for the non-approved usage.[120] Due to the enormous demand for Covid-19 vaccines, the executives of Antic Zeneca decide to invite hundreds of doctors to an enormous global conference on the anti-COVID-19 effect of its vaccine, based on their assessment that the event would dramatically increase the usage of the vaccine and generate billions of dollars in additional revenues. When the executives present the plan to the board, the board fears that if the use of the vaccine would spread significantly, the FDA and DOJ may view the conference as an act of illegal promotion of a drug for off-label purposes. Yet, this is a very remote concern because the organization of a scientific conference probably does not come within the plain meaning of the words an "advertising matter, or oral or written statements,"[121] The organization of a conference does not seem to constitute an act of "advertising" or a "statement" of the company. The company estimates that there is only 0.1 probability that the conference would be deemed illegal, in which case a penalty of 100 million dollars would be assessed against it. Recall that the expected benefits from the conference run in the billions. Without our proposal, it is most likely that the board would not authorize the conference, due to the remote chance it will face personal liability. Under our novel liability regime, the board would ask for an opinion from a legal expert and is she similarly assess the probability of the risk at 0.3 or lower, as she should, it is most likely that the board would approve the conference. If subsequently derivative actions are commenced against the executives and board members of the company, they would benefit from the legal defense of the enhanced BJR and should be able to easily demonstrate that their decision was reasonable, and that the expected risk was proportionate to the expected benefit. Our proposed regime would most likely alter the decision of the board and thereby increase the gains to shareholders.

[120] The legal constraint on the promotion of non-labeled drug mainly stems from the labeling requirement prescribed by law that the instructions on the label must be sufficient to allow practitioners to "use the drug safely and for the purposes for which it is intended." *See* 21 U.S.C. § 352(f). Thus, if the manufacturer intends doctors to prescribe the drug for a particular use for which the label does not provide adequate directions, it violates the legal labeling requirement. According to FDA regulations, any promotional statement of the drug maker for the off-labeled use are evidence for its intended usage (21 CFR § 201.128). *See also* Kathryn Bi, *What Is "False of Misleading" Off-Label Promotion*? 82 U. CHI. L. REV. 915, 981 (2015)

[121] 21 CFR § 208.128.

iii. Reasonable Administrative Risk

Our third category, reasonable regulatory risk, covers decisions and policies that may result in a regulatory infraction with a probability of 0.3 to 0.7. Regulatory infractions are considered less severe than criminal violations. Yet, in this case, the risk level is substantial, and the law should reflect this fact. Accordingly, we propose that the personal liability of directors and officers for decisions involving a reasonable risk of a regulatory infractions be governed by a liability regime that falls somewhere in between the enhanced scrutiny and entire fairness tests, while borrowing elements from both.[122] The enhanced scrutiny test places the burden on directors and officers to show that their decision was reasonable and that the expected benefits from it exceeded the expected costs. If the management and board meet this burden, they will be entitled to the protection of the BJR and the court will not substantially review their decision. Under the entire fairness test, the most stringent review standard in corporate law, directors and officers must show that both the process that led to the decision and the decision itself were optimal. Unlike the enhanced scrutiny standard, the entire fairness test involves substantive review of the firm's decisions.

Our suggested regime is a hybrid of the two tests. Under it, directors and officers who assumed a reasonable regulatory risk would be sheltered from liability if they prove that the decision was reasonable, and its foreseen benefits were greater than the expected costs. In addition, the board and management would have to show that they relied on an expert opinion or an administrative pre-ruling that it is more likely than not that their decision would not be considered a regulatory infraction—that is, that the risk is lower than 0.5.

Even so, the judicial review in this case will not be purely procedural. Rather, it will incorporate substantive oversight of the legal opinion on which the board and management relied, as well as

[122] A model for such mid-level liability regime, is the one adopted by the Delaware Chancery Court in *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 52 A.3d 761 (Del. Ch. 2011). The court had reviewed the special committee's approval of a transaction in which a firm purchases a private firm from its controlling shareholder. Unlike the subsequent decision in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), which focused in its review of the special committee approval on its formal structure and procedure, and shielding fiduciaries from liability by finding the structure and procedure adequate, in *Southern Peru*, the court reviewed the dynamic of the decision, examining whether it reflected an independent decision, not limiting itself to a formal review.

careful examination of the underlying process that led to the decision.[123] Although the scrutiny we propose does not amount to a full entire fairness review, it empowers the court to second-guess the management and the board.

The regime we envision is illustrated via the following example.[124] Assume that Wonsanto Inc. is a public company. Wonsanto's marqee product is "Woundup," the bestselling herbicide on the market. To boost the sales of "Woundup" the company offered millions of dollars in rebates to hundreds of thousands of consumers. Due to an outmoded accounting system, the company could not accurately account for the amounts it offered in rebates, which prompted a concern of a possible violation of the SEC's accounting rules and as well as of a misstatement of profits. To extricate itself from its predicament, the company decided to report the same liability for rebates as in the previous quarter, even though it knew that the figure was much higher. At the company's request, an external legal expert delivered a written opinion to the company, stating that the measure likely complies with SEC regulations and that therefore the level of risk involved is lower than 0.5. The plan has been carried out and the company's shares went up. Subsequently, when a journalist reported the story, the shares plummeted and a group of shareholders brought a class action against the company and its executives and directors, claiming that they knowingly inflated the company's profits.

In our example, the director and officers of the company relied on an expert opinion they received from a renowned accounting firm. Yet, in order to avoid liability, they will also bear the burden of showing that their actions were reasonable and that the expected benefits therefrom exceeded the foreseeable costs. That is, that the expected reputational losses that were averted because of the decision were greater than the expected administrative fine that might have been levied on the firm. All aspects of the decisions, including the quality of the expert report, would be subject to

[123] *See id.* regarding the *Southern Peru* standard of judicial review. Even though in respect to the review of approvals of independent committees, a more lenient standard of review has been adopted subsequently in the *Kahn v. M & F Worldwide Corp* decision (*id.*), the probability of illegality justifies the harsher *Southern Peru* standard of review. The court will not only examine the formal independence of the legal expert, but also conduct a substantive review of the decision in order to examine whether it reflects thorough independent judgement.

[124] The example was inspired administrative enforcement case that was brought by the SEC against the Monsanto company and was settled in 2016. See https://www.sec.gov/news/pressrelease/2016-25.html. We changed many of the underlying facts.

substantive review and if a court finds that one of the conditions was not met, it could impose personal liability on the directors and officers.

iv. Reasonable Criminal Risk

Our fourth category, reasonable criminal risks, covers decisions that may lead to the imposition of criminal liability on the firm with a probability of 0.3 to 0.7. Because of the special gravity society attributes to criminal violations and the fact that in the cases falling into this category that probability of such a violation is not negligible, we believe that an expert legal opinion should not provide officers and managers protection against derivative actions. If a court finds ex post that a criminal legal norm has been violated, officers and managers would be exposed to personal liability for violating their duty of care, even if they based their decision on an expert legal opinion that purports to legitimize the decision.

In order to illustrate the implications of our proposed liability regime in the case of reasonable criminal risk, consider the case of a RR Co., a U.S. multi-national corporation that constructs railroads. It cooperates with local companies in a foreign country to construct a new railroad which requires the approval of the zoning committee for national projects. RR Co. will receive $500 million dollars and make a net profit of $200 million if the project is approved. The chairman of the committee approaches the CEO of RR Co., informing her that there seems to be a majority for approving the project, but he cannot know when the decision will be made. Following the conversation, the CEO suggests to the board that RR should send an agent to the chairman who will provide him $50,000 in cash and promises to provide an additional $50,000 if a decision is reached within two months. Both the board and the CEO understand that this decision involves a serious legal risk of violating the Foreign Corrupt Practices Act (FCPA), which prohibits U.S. business from securing contracts by bribing foreign officials.[125] At the same time, the FCPA permits payments to officials that are not intended for obtaining business, but are solely for *expediting* decisions.[126] The executives and board members intend the payment to expedite the

[125] The Foreign Corrupt Practices Act of 1977 (FCPA), Pub. L. 95-213, 91 Stat. 1494 (1977), 15 U.S.C. §§78dd-1, et seq.
[126] SEC, *Investor Bulletin: The Foreign Corrupt Practices Act – Prohibition of the Payment of Bribes to Foreign Officials*, (2011) https://www.sec.gov/investor/alerts/fcpa.pdf. (The FCPA does not apply to any "facilitating or expediting payment," the purpose of which is to expedite or secure the performance of a "routine governmental action").

decision, but understand that prosecutors and judges may view this payment as intended to obtain business since that the payments preceded the decision and the "informal update" of the chairman may be construed as an invitation for a bribe.

Under our proposed liability regime, an expert legal opinion that sanctions the actions of RR Co. would not provide shelter to its management and board. The legal expert must be aware of the significant legal risk implicated in this case and rate it as a probable legal risk. Accordingly, fiduciaries will be exposed to personal liability due to their violation of the duty of loyalty in such cases. As a result, it is most likely that fiduciaries will refrain from taking such legal risks.

It should be noted that even if a company somehow succeeds in obtaining a legal opinion that misrepresents the risk as remote, it will not help its management and board. Recall that under our proposal, in cases of criminal violations, a court is expected to engage in a substantive review of the expert opinion. Consequently, it would reject the risk rating of the expert and proceed to impose personal liability on the board and management, and when appropriate, on the legal expert as well. Hence, our system cannot be easily manipulated. The decisions of the directors and officers and the informational basis on which they were made would always be subject to ex post judicial scrutiny.

v. Probable Administrative Risk

The fifth category, probable administrative risk, applies to decisions which will likely lead the firm to violate an administrative norm. In such cases, the high risk of a violation, 0.7 or higher, will eliminate any legal protection to the fiduciaries involved, even though the administrative violations are considered less severe than criminal ones. Accordingly, fiduciaries would be exposed to personal liability for violating their duty of care if the risk materializes and a court finds that firm has violated an administrative norm. No expert opinion would help the board and management in this case.

The operation of our proposed regime is illustrated by the following example. Assume that ZeroTax Inc. is a holding company that owns U.S. and foreign subsidiaries. ZeroTax Inc., wishes to minimize its tax liability by allocating as many costs as possible to its U.S. subsidiary, a practice known as "transfer pricing." Aggressive transfer pricing policy may be deemed as tax evasion punishable by administrative fines.[127] Aware of this risk yet determined not to pay taxes, ZeroTax Inc.'s management seeks an expert opinion letter from a tax law professor in support of its plan. Given the aggressive nature of ZeroTax Inc.'s strategy, no letter would help fend off the personal liability of the directors and officers.[128] Since in ZeroTax Inc.'s case the end (not paying taxes) justifies the means, it is willing to assume a probable risk of breaking the law. Given the probability of the risk, the management and board can seek no safe harbor from personal liability. Obviously, no expert letter should change the analysis and if the company somehow succeeds in convincing an expert to misstate the probability of the risk involved, a court should reject the expert's analysis, set the risk correctly and on its own and proceed to impose liability of the directors and officers.

vi. Probable Criminal Violation

The sixth category, probable criminal risk, covers decisions that are likely to lead the firm to violate a criminal legal prohibition. As we already explained, we are of the opinion that there should be no protection for directors or officers for decisions involving reasonable criminal risk. A fortiori, directors and officers should be granted no protection in cases of probable criminal risk. Stated affirmatively, directors and officers would be held personally responsible for losses resulting from criminal violations, where the risk of loss was probable. Accordingly, if a corporate executive or the board is of the opinion, based on her own understanding or an expert opinion, that a certain cause of action involves a probable criminal violation, she should resolutely oppose it or face the consequences.

The following example provides an illustration of how board members ought to act when it becomes aware of an activity that involves probable criminal risk. Imagine a chemical company, Chem Co., that discharges waste discharges into the city's sewage system. The federal Water Pollution Control Act prohibits discharging pollutants into the water of the U.S. from any point,[129] without a permit issued under the National Pollutant Discharge Elimination System NPDES).[130]

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[127] PWC, *International Transfer Pricing - United States*, 816, 834 (2013/14) https://www.pwc.com/gx/en/international-transfer-pricing/assets/united-states.pdf. ("The US Competent Authority has stated that transfer pricing penalties will not be subject to negotiation with tax treaty partners in connection with efforts to avoid double taxation").

[128] 26 CFR § 601.201

[129] 33 U.S.C. § 1251

[130] 33 U.S.C. § 1311(a), 1342

Under the NPDES, Publicly Owned Treatment Works (POW) determine pretreatment requirements for industrial users.[131] Chem Co.'s permit provides that the level of phosphorous in its wastewater cannot exceed 10mg/L. Chem Co. decides to use the maximal level of phosphorous stipulated in its permit in its wastewater. The company's compliance officer informed the board that, as a precautionary measure, she decided to increase discharges of clean water during the periods of municipal inspections to ensure that the company does not exceed its phosphorous discharge level under the permit. The board expressed concern that the practice might constitute a criminal offense under the FWPCA,[132] but the compliance officer emphasized that the company's practice would not count as an intentional violation because it is most likely that the phosphorous discharges do not exceed the permitted level. The compliance officer further noted that if the company added clean water to its discharges all year round, there would be no violation at all. Assume that the board remains skeptical and requests an opinion from a legal expert, who opines that the spilling of extra water is likely to be interpreted as an indication that the company knew that it violated the terms of the permit and, therefore, there is a probability of over 0.8 that it will be criminally indicted. Under our proposed regime, the board must advise that the practice of adding clear water to the wastewater in order to depress the level of phosphorous be discontinued immediately and find another way to address the phosphorus problem.

CONCLUSION

In his bestselling book, AGAINST THE GODS: THE REMARKABLE STORY OF RISK, Peter Bernstein argued that what separates modern times from past eras is our ability to manage risk.[133] Although Bernstein does not address legal risk specifically and focuses on risk more generally, his book and its core thesis are very much in line with the general project of this Article. Our goal in this Article has been two-fold. First, we set out to investigate the possible reasons for corporate law's disparate treatment of business risk and legal risk. While corporate law shelters directors and officers from personal liability for losses which resulted from materialized business risks, it exposes them to full

[131] 33 U.S.C. § 1342(b)(8); 40 C.F.R. § 403.8.
[132] 33. U.S.C. § 1319(c)(2)(A).
[133] PETER BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 1-3 (1998).

civil and criminal liability for harms that result from legal risk-taking. This stark contrast between the law's approach to these two kinds of risk struck us, as well as other commentators, as a non-trivial puzzle. After all, legal risk cannot be completely avoided in the legal world and careful management of small legal risks can yield high returns for shareholders.

In our attempt to explain the law's approach to legal risk, we critically reviewed all existing justifications for the current legal regime and ultimately found them unpersuasive. We, thus, proceeded to develop a novel justification that explains the law's uncompromising approach to legal risk in the corporate context. We argued that because of the exposure of board members to personal liability for losses resulting from legal risk, board members would veto all policies and decisions implicating legal risk, minimal though it may be. Aware of this disposition, managers, whose compensation is often tied to performance and are therefore more risk-seeking, would prefer not to raise policies and decisions that implicate legal risk to board discussion. This, however, works to the detriment of shareholders who are deprived of the protective mechanism of board overview with respect to legal risk. Legal risks, by contrast to business risks, largely escape board scrutiny.

While the justification we developed has stronger explanatory power than prior justifications, we nonetheless felt that the current legal approach to legal risk is too extreme. This led us to the second, more significant contribution of the Article. We constructed a new comprehensive legal framework for evaluating decisions involving legal risk. Our thinking was motivated by the modern philosophy toward risk—namely, that all risks can be managed. Consistent with the conviction, we divided legal risks into two categories of severity: risks involving criminal prohibitions and risks pertaining to non-criminal norms. We then further classified legal risk based on its probability of occurrence, differentiating among remote, reasonable and probable risks. The combination of our two matrixes resulted in six different classes of legal risks. Finally, we designed a unique liability regime for each class of risk. The framework that we designed would allow corporate executives and directors to address low and reasonable level of legal risk in a responsible way that would benefit shareholders, without eroding respect for law and morality.