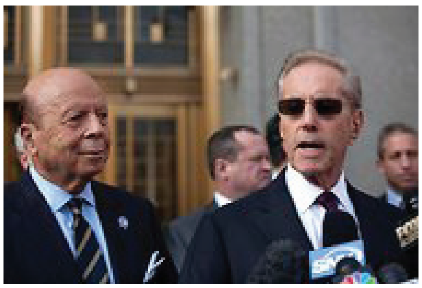
DealBook The New York Times

The 'I Know Nothing' Defense

By Michael W. Peregrine – March 21, 2012



Allison Joyce/Reuters

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The time-honored "I know nothing" defense has less credence for officers and directors of corporations. That is at least one message from the settlement announced Monday between Irving H. Picard, the trustee overseeing recovery for the victims of the Bernard L. Madoff fraud, and the Mets owners Fred Wilpon and Saul Katz.

Before the settlement, Mr. Picard was pursuing a suit accusing the two of being willfully blind to signs that Mr. Madoff was running a scam. Mr. Wilpon and Mr. Katz had argued that they "knew nothing" of Mr. Madoff's fraud even though they were close friends of Mr. Madoff's before he pleaded guilty to the Ponzi scheme.

The image of Sergeant Schultz, the bumbling prison camp guard from "Hogan's Heroes," has always been good for a boardroom chuckle, but being liable for "willful blindness" remains a serious issue from a corporate governance perspective.

Willful blindness is an aggressive doctrine, applied to place blame in both civil and criminal cases. The latest settlement may embolden its future use in a fiduciary duty cases, increasing the pressure on officers and directors.

It's a seductive theory of liability, because it is subject to a highly subjective analysis, especially in cases where the facts look bad and real harm has occurred. This is particularly the case with officers and directors — and the buck has to stop at someone's desk. As the thinking goes, "Hey, you were the chief executive or chairman – you had to have known. Or if you didn't, were you choosing to turn a blind eye?"

To paraphrase Judge Jed S. Rakoff, who was overseeing the Madoff proceedings, willful blindness takes place when participants know the odds are high that if they paid attention, they may learn something that may make their actions improper or illegal.

Recent judicial decisions suggest such a doctrine can be applied in limited ways — to situations involving something similar to actual knowledge of the relevant facts, and deliberate action to avoid confirming a high likelihood of wrongdoing. In other words, willful blindness is a world of difference from mere negligence or recklessness. In such cases, a high burden of proof is justifiably required.

The doctrine takes on a different perspective in the current corporate environment, where finger-pointing and attempts to assert individual responsibility continue to be the order of the day. This is especially the case where regulators increasingly seek to hold corporate officers and directors responsible for an organization's wrongdoing. In addition, public opinion also seeks to place the blame, and punishment, for the problems and fraud that have come to light in the wake of the financial crisis and recession.

Even the extension of business judgment rule protection to corporate officers has recently been questioned by federal courts. There is increasingly a pitchfork mentality when it comes to the liability profile of officers and directors.

Seen through this lens, the Mets-Madoff settlement may lead to aggressive use, if not actual abuse, of the willful blindness doctrine.

It could be implied that the Mets owners settled the Madoff trustee's case because they did not want to take their chances with the jury on the willful blindness allegations – in spite of Judge Rakoff's public skepticism that the trustee could prevail at trial. A case involving unsympathetic defendants, a relationship with the disgraced Mr. Madoff, bad facts and a slippery theory of liability all seem to have combined to prompt a settlement.

But willful blindness could be used as a sledgehammer against the leadership of a corporation in legal or financial distress, even if the officers and directors appear to have acted responsibly.

Such a precedent could be counterproductive for corporate governance. If more cases use willful blindness theories, it could prompt extreme but understandable overreaction by officers and directors. They will be increasingly motivated to refer even marginally suspicious developments to risk management. "I'm not getting tagged with this one; pass it right to legal," or so the thinking may go.

The result is that "covering one's tail" may become more standard fiduciary conduct, and the oversight process will become clogged by information overload. This may have the perverse result of limiting the ability of the lawyers and compliance officers to catch the "really big one" amid excessive officer and director disclosure.

As we look at the evolving liability issues for corporate directors and executives, the settlement with the Mets will further stir the already turbulent waters of fiduciary risk. Excessive caution may lead to boardroom and compliance stagnation. The public policy benefits of sharpened governance oversight will be overwhelmed by the governance costs of perceived self-protection.

Carlos Beltran famously took a called strike three on a close pitch in the final game of the 2006 NLCS, with drastic implications for the Mets' future. Here, the settlement by Mr. Wilpon and Mr. Katz was a swing at another kind of close pitch, and the implications may be similarly drastic — not only for the Mets, but also for corporate governance.

Mr. Peregrine's views do not necessarily reflect the views of McDermott Will & Emery or its clients.