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No D.&O. Liability Risk? Wouldn't That Be Nice

By Michael W. Peregrine – June 16, 2011

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Serving at the top has little liability risk? How is that again?

The notion that officers and directors face little liability risk is part of a broader critique of boardroom and corporate suite accountability. And to a certain extent, it is understandable. Attempts to assign responsibility for the recession-prompting corporate excesses have generally failed, at least in the minds of many observers. Where, indeed, was the board?

According to this argument, the business judgment rule is near-sacrosanct. Delaware standards for proving director oversight liability are virtually insurmountable. Federal law, judicial decisions and even best practices do not provide clear incentives for proper fiduciary conduct. Governance laws seem stacked in favor of corporate leadership. In this system, bad performance seems almost bulletproof.

It is a very seductive argument. The problem is it is just not completely accurate.

Indeed, maybe the real question is not whether the government is doing too little to assure corporate leadership accountability, but whether it may be starting to do too much. Sounds crazy? Well, talk to your peers in health care. They will tell you. Increased government application of the Responsible Corporate Officer Doctrine threatens to recast the discussion of corporate officer-director liability in that sector. And if it spreads to other industries, we are talking a whole new liability ballgame — one that will prompt competent, qualified leaders to quickly head for the sidelines.

RCOD, as the Responsible Corporate Officer Doctrine is known, is a decades-old strict liability theory interpreted by the government as permitting, in certain circumstances, civil and/or criminal pursuit of officers and directors for certain types of legal violations — even if they had no involvement with, or knowledge of, the challenged conduct. You read that right — liability may apply even if the individual had no awareness of, or participation in, the problematic concerns.

This is as shocking as it sounds — and it is made worse by the fact that it is based on two separate Supreme Court decisions, issued years apart, with harsh fact patterns that disturb the conscience. Historically, RCOD theories have been applied to pursue liability under state and federal laws intended to protect the public welfare — e.g., food and drug laws, environmental laws, and even securities laws. Most recently, the government has increased its civil and criminal application of RCOD to the health care industry, including medical device companies, pharmaceutical companies and hospitals and health systems.

This increased reliance on RCOD theories in health care reflects a broader enforcement focus on holding individuals responsible for corporate noncompliance. Sounds good in theory? The government will follow

organizational conduct right up the corporate ladder — in the field, in the corporate suite, or in the board room — in order to find responsible parties. Its view is that attributing responsibility to the highest corporate levels — even without the need to establish intent or personal involvement — will serve to enhance compliance with health care laws. Gee, you think?

I can hear the response. Good, it's about time, their feet should be held to the fire! But let's lay down those pitchforks for a second. It is one thing to hold officers and directors accountable for illegal conduct related to their conscious actions or inactions. It's an entirely different thing to hold them accountable for matters they should have known about, merely by virtue of their position. You were on the bridge (i.e., in the boardroom or corporate suite) when bad stuff occurred, so you are taking the fall. That's motivation in the extreme, especially in the case of a large corporation with multiple levels of management and multiple operating sites. Would you want to be held to such a standard, especially when there may be criminal implications? Not me — I'm out of here.

The liability risk is exacerbated by the absence of any clearly established guideposts that corporate officers and directors can use to structure their conduct and protect themselves from RCOD exposure. That's the deal — it is strict liability. While the courts, and some regulatory agencies, have identified an "impossibility defense," there is almost no useful guidance on how this defense can be satisfied. What's an officer or director to do? What comfort can they be given?

Right now, RCOD appears limited mainly to the health care sector. Yet its "public welfare" base keeps the window opened for application to other industries. If the government indeed is committed to an enforcement policy that will climb the corporate ladder in search of accountability, then it is fair to be concerned that RCOD concepts may be applied beyond health care. After all, "public welfare" is a pretty vague term. The potential for regulatory mischief is high.

So, sure, by most traditional standards — federal law, Delaware courts, best practices — the likelihood of personal liability for officer or board service may seem remote. Now you may need to suffer through years of headaches, angst, depositions, reputational challenges and jousts with the insurance carrier. You may be forced to resign from other boards. These "soft tissue" costs are very real. Ultimately, though, you will get off the hook. That's the conventional thinking. Well, RCOD is unconventional. It is extreme. It is more than a bit unfair. It is a very credible fiduciary liability risk for officers and directors of health care companies. You cannot have a real discussion about officer-director liability profiles without recognizing the risk of an expanded application of RCOD. And that's a real liability worry.

Not convinced? Well, just ask the four former senior Synthes executives who are awaiting sentencing in federal court in Philadelphia after they pleaded guilty to charges stemming from RCOD violations. The government is seeking prison time.