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Words That Wound: Defining, Discussing, and Defeating Bankruptcy “Corruption”

A. MECHELE DICKERSON †

INTRODUCTION

“Corruption” is a powerful word, which may explain why the typical reaction to *Courting Failure*¹ begins, and often ends, with a passionate discussion of whether bankruptcy judges are corrupt. Many respond to the book by attacking the author’s integrity because they perceive the book as an unfair attack on the integrity of the bankruptcy bench. It is unfortunate that the discourse over bankruptcy venue for large corporations has been so personal because it creates an atmosphere that makes it virtually impossible to rationally discuss the topic. Moreover, in such an atmosphere, the accuracy and usefulness of LoPucki’s raw data or statistical runs is largely discounted, overlooked, or just plain ignored because of the controversy over the politically loaded term “corruption.”

This Article attempts to re-characterize the notion of “corruption” and then briefly discusses some of the conclusions LoPucki reaches that could be fairly criticized. The Article then departs from a strict review of LoPucki’s book by arguing that one way to decrease the undeniably corrupt management practices that caused the downfall of the large firms discussed in *Courting Failure* is by giving

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1. LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* (2005).

corporate boards greater incentives to monitor those practices.

I. DEFINING CORRUPTION

One reason *Courting Failure* has been so controversial is because of LoPucki's decision to use, yet imprecisely define, the term "corrupt." Indeed, the strongly negative reaction to the book's premise (and to the author) results from the negative connotations associated with that term.² While corrupt has several meanings, most people likely perceive that it means to become tainted, rotten, morally debased, or to change from good to bad in morals, manners, or actions.³ LoPucki never explicitly defines corrupt that way, but instead appears to define corruption as the process whereby courts first decide to "change what they are doing to make themselves more attractive to forum shoppers" and, then, fail to apply the law to the facts of the case.⁴ Even this definition is problematic because adopting new procedures and making rulings that may not be favorable to some creditors simply does not equate to being rotten or morally depraved.

Bankruptcy judges, like all judges, are often required to interpret or apply murky rules of procedure. Not infrequently, they must choose which seemingly conflicting rule or procedure they should apply. That a bankruptcy court (or district) adopts new, streamlined procedures (like the ones originally used only in the Delaware courts) in response to criticisms that its existing procedures are inefficient or otherwise discourage attorneys from filing large cases in the court/district does not mean that any individual judge is corrupt or cannot still apply the law to

2. See Charles J. Tabb, *Courting Controversy*, 54 BUFF. L. REV. 467, 469-71 (2006) (chronicling criticisms of the book and its author).

3. See WEBSTER'S NEW WORLD DICTIONARY 313 (3d ed. 1988). Common synonyms for corrupt include: debauched, decadent, degenerate, degraded, depraved, perverse, perverted, reprobate, and warped. Other words that come to mind when the term is used include: crooked, cutthroat, dishonest, unethical, unprincipled, unscrupulous, contaminated, evil, immoral, nefarious, sinful, and wicked. *Id.*

4. LOPUCKI, *supra* note 1, at 137.

the facts.⁵ Moreover, this definition of corruption assumes that all of the Delaware procedures courts adopted (like approving fee applications with national billing rates) and the rulings competing courts made in large cases (like approving key employee retention plans) are inconsistent with the Bankruptcy Code ("Code") or the bankruptcy rules.

Since the author chose the word "corruption," and sincerely believes that this wounding word is the correct one to use,⁶ having a fuller—and perhaps more nuanced—definition would have avoided some of the vitriolic attacks on the book and its author. Another common definition for corrupt could have been used to describe current Chapter 11 practices without creating such an uproar: to alter from the original or correct form or version.⁷ Few would argue that the Chapter 11 process now (with significantly more 363 sales, Chief Restructuring Officers ("CROs"), examiners, and concentrated large case filings in New York and Delaware) functions the same way it did in 1978 or even 1998. Thus, even if Delaware and New York cases do

5. Delaware procedures that were adopted by "competing" courts include providing omnibus hearings to facilitate the schedules of out-of-town lawyers, hearing first-day matters on the first day, and increasing predictability by issuing memos that explain how particular matters will be handled. *See id.* at 79.

6. LoPucki analogizes the process whereby court competition drives professional fees up (not down) to the increased costs associated with providing a bribe to a corporate purchasing agent. *See id.* at 141. This likely did not help endear the author to his critics. *See also* Lynn M. LoPucki, "Corruption" *Is the Right Word*, BCD NEWS & COMMENT, July 19, 2005, at 23 ("'Corrupt' is an accurate description of both the choices and the judges who made them.")

7. Computer software programs routinely use the term "corrupt" in error messages. When I used a dial-up internet service (NetZero), I frequently got the following error message: "Your copy of the NetZero software has been corrupted. Please reinstall the software in order to correct this problem." I did nothing to corrupt the software. Indeed, after my first (long and arduous) reinstallation of the software, I realized that I could just ignore this message, log on, and surf the web notwithstanding the purported "corruption." Corruption in this sense is also used to describe copies of medieval manuscripts. Because there were no printing presses in the Middle Ages, whenever someone needed a copy of a printed work, a scribe would need to copy it out by hand. This caused textual variations since the scribes would make mistakes or would deliberately add or remove text. *See* Bella Millett, *Mouvance and the Medieval Author: Re-Editing Ancrene Wisse*, in *LATE-MEDIEVAL RELIGIOUS TEXTS AND THEIR TRANSMISSION: ESSAYS IN HONOR OF A. I. DOYLE*, 9-20 (A. J. Minnis ed., 1994); *see also* <http://www.soton.ac.uk/~wpwt/mouvance/mouvance.html>; <http://rrp.stanford.edu/project.html>. I thank my colleague, Emily Kadens, for this observation.

not have higher filing rates because of competition, or if every bankruptcy judge is a virtuous, dedicated public servant, few would dispute that large Chapter 11 cases now are different from the ones originally envisioned by Congress.

It is not surprising that judges and bankruptcy practitioners alike have taken offense to the use of the term "corrupt" because it has such negative overtones that LoPucki could have neutralized by offering a full and precise definition. If LoPucki had defined and used the term corrupt to mean change, rather than crooked, he likely would have avoided the emotional grief, while at the same time remaining consistent with his findings and conclusions.

II. CRITIQUE OF *COURTING FAILURE*

A. *Probabilities v. Certainties*

Because so many of his empirical findings are quite powerful, it is unfortunate that, at times, LoPucki makes assertions that would be better couched as probabilities. The book examines both things that can be empirically shown (what judges have done) and things involving human behavior that cannot be empirically proven (*why* judges do what they do). LoPucki occasionally makes assertions that either are not or cannot be empirically supported. Likewise, he occasionally posits what *would* have happened if the judge in a particular case had not taken a certain course of action that he characterizes as participating in the competition.

For example, LoPucki suggests that judges want high-profile cases because they want to work with the best bankruptcy professionals and attain the status, power, and "celebrity" associated with presiding over a high-profile case.⁸ While this may be true, it cannot be empirically proven.⁹ Similarly, LoPucki asserts that the managers of

8. LOPUCKI, *supra* note 1, at 20.

9. Cf. Gregory Mitchell, *Tendencies Versus Boundaries: Levels of Generality in Behavioral Law and Economics*, 56 VAND. L. REV. 1781, 1797-98 (2002) (noting that discussions of how people act requires some recognition of "individual or situational variation in behavior . . ."). Moreover, suggestions that judges would willingly ignore the law simply to solicit an invitation to

Enron, Global Crossing, and Adelphia would have suffered a much harsher fate if a trustee had been appointed because the trustee would have demanded that the corrupt managers return funds to the company.¹⁰ Empirical data certainly can prove that judges in New York and Delaware rarely appoint trustees in large cases (or appoint them less than judges in non-competitive venues). While this data might suggest that the courts' reluctance to appoint trustees creates an appearance of impropriety or bias, the data do not prove that the judges in fact acted improperly or were biased. Likewise, the data cannot prove what would have happened if a trustee had been appointed nor can the data prove *why* judges may have decided not to act or rule in a certain way. Despite this, LoPucki states that court competition "had precluded that solution [appointing a trustee]" because judges would not dare appoint a trustee and risk having the case placers refuse to place large cases in their courts.¹¹

While that might be true, those courts rationally could have decided to focus on reorganizing or restructuring those companies rather than overseeing a trustee's attempts to sue the directors or officers because of their corrupt conduct. Moreover, because many of the officers and directors were being investigated by numerous state and federal agencies, and had been sued,¹² it was not

speak at a luxury resort or because they want to shape their obituary before they die provides fodder for the supporters of the current (lax) venue laws. LoPucki, *supra* note 1, at 20 ("When a bankruptcy judge dies, the obituary will likely mention the big cases over which the judge presided—assuming, of course, there were any."); *see also* American Bankruptcy Institute's 7th Annual New York City Bankruptcy Conference—Venue Debate (May 9, 2005), http://abiworld.org/Content/NavigationMenu/News_Room/Research_Center/LoPucki_Venue_Debate_at_New_York_City_Conference/LoPucki_Venue_Debate_at_New_York_City_Conference.htm (last visited Apr. 11, 2006).

10. LoPUCKI, *supra* note 1, at 150.

11. *Id.* at 13-14, 151.

12. *See* Ben White, *WorldCom Ex-Leaders Reach Deal in Lawsuit*, WASH. POST, Mar. 19, 2005, at E1 (discussing \$55.25 million class-action settlement involving eleven former WorldCom directors and \$168 million settlement involving Enron directors). *See generally In re Adelphia Commc'ns Corp.*, 327 B.R. 143 (Bankr. S.D.N.Y. 2005) (approving settlement between debtor, United States Department of Justice, the Securities and Exchange Commission, and members of the family of Adelphia's founder and former CEO). As a result of shareholder lawsuits and other litigation in Enron, banks and investment firms have agreed to pay more than \$8 billion to settle lawsuits or regulatory

unreasonable for the courts to focus on the firm instead of the firm's former managers.¹³ In short, while it is possible that the New York bankruptcy courts refused to appoint a trustee to avoid being viewed as "toxic," there is an equally plausible explanation for their behavior that has nothing to do with competition or corruption.¹⁴

B. *The Evils of Forum Shopping*

LoPucki concedes that forum shopping exists in all courts and that there are multiple reasons for venue shopping in bankruptcy cases.¹⁵ While forum shopping is a practice that is disfavored by the courts and widely

complaints. See Bob Keefe, *AOL Turns Spam Loot Into Prizes Via Lawsuit*, AUSTIN AM.-STATESMAN, Aug. 17, 2005, at C1. In addition, a number of Enron and WorldCom officials have either been charged with crimes or sentenced to jail because of various crimes related to their fraudulent activities involving those firms. See Alexei Barrionuevo, *2 Enron Chiefs are Convicted in Fraud and Conspiracy Trial*, N.Y. TIMES, May 26, 2006, at A1 (discussing Lay and Skilling convictions); Leon Lazaroff, *Ebbers Found Guilty*, CHI. TRIB., Mar. 16, 2005, at 1 (discussing Ebbers' conviction and pending trials of Enron's Ken Lay and Jeffrey Skilling).

13. Congress responded to the failure to appoint a trustee in these high-profile cases by giving the United States Trustee the authority to move for the appointment of a trustee if the debtor's officers or directors "participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." 11 U.S.C. § 1104(e) (2000), *amended* by The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1405, 119 Stat. 215.

14. Similarly, LoPucki states that courts are "slow to interfere" with certain 363 sales that he characterizes as self-dealing because the court "needs the support of the case placers to maintain its flow of new cases." LOPUCKI, *supra* note 1, at 139. Again, while this is one explanation, courts might also have approved such sales because no one objected to them. LoPucki also states that certain judges were not reappointed because they refused to join the competition. *Id.* at 21-22, 44. While the people the author interviewed (many of whom presumably demanded confidentiality) may be able to prove that statement, LoPucki does not. Likewise, LoPucki states that case placers prevented future cases from being filed in New York after a judge there appointed a trustee in the Eastern Airlines case. *Id.* at 58. Again, while it may be possible to prove this, LoPucki fails to do so.

15. Shoppers seek good judges who are familiar with large reorganizations, venues that are convenient to debtors' counsel, and judges who will rule favorably on fee applications, motions to extend exclusivity, and other matters important to the case placers. *Id.* at 39-40.

condemned by commentators,¹⁶ it is an established part of the adversarial process and some would argue that an advocate who fails to engage in forum shopping exposes himself to a malpractice claim.¹⁷ Certainly, courts should not actively compete for cases by making rulings that are contrary to the law. Yet, it is not unusual for a court's docket to change after it adopts procedures used in other courts. For example, the Eastern District of Virginia was long known as the "rocket docket" because of the streamlined procedures it used, especially involving discovery.¹⁸ Attorneys in intellectual property (IP) cases often chose to file in that district because of the short length of time the cases would take to go to trial.¹⁹ Once other courts adopted similar procedures, lawyers began to forum shop and file IP lawsuits in those courts as well.²⁰

LoPucki seems to suggest that forum shopping outside of bankruptcy cases is significantly different, and his biting criticism of bankruptcy courts would suggest that those courts are under a greater duty to restrain shoppers than are federal district or state courts.²¹ That is, unlike the bankruptcy courts' purportedly competitive behavior, LoPucki maintains that non-bankruptcy courts are not

16. See, e.g., *Yee v. City of Escondido*, 503 U.S. 519, 538 (1992) ("Forum-shopping is thus of particular concern."); *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 154 (1987) (discussing potential dangers of forum shopping); Mary Garvey Algero, *In Defense of Forum Shopping: A Realistic Look at Selecting a Venue*, 78 NEB. L. REV. 79, 80 (1999); Kevin M. Clermont & Theodore Eisenberg, *Exorcising the Evil of Forum-Shopping*, 80 CORNELL L. REV. 1507, 1507 (1995).

17. Alan B. Morrison, *Removing Class Actions to Federal Court: A Better Way to Handle the Problem of Overlapping Class Actions*, 57 STAN. L. REV. 1521, 1524, 1530 (2005).

18. See Jerry Markon, *A Double Dose of Molassas in the Rocket Docket*, WASH. POST, Oct. 3, 2004, at C4.

19. See Sandra Torry, *On the Fast Track with Alexandria's 'Rocket Docket,'* WASH. POST, Dec. 10, 1997, at F7.

20. See Tresa Baldas, *IP Hotbed-For Now*, NAT'L L.J., Dec. 20, 2004, at 26; Steven E. Bizar & Paul D. Weiner, *Arbitration is Not Always Quick*, NAT'L L.J., Nov. 17, 2003, at 23 (discussing the Eastern District of Virginia's reputation as a "rocket docket" and listing courts that adopted similar efficient procedures); Helen Coster, *Harvesting IP Gold in East Texas*, AM. LAW., Aug. 2003, at 52; Glen A. Ousterhout, *Proposing a Post-Grant Review*, NAT'L L.J., Jan. 24, 2005, at S1.

21. LOPUCKI, *supra* note 1, at 137.

attempting to attract cases and may not know that forum shopping is taking place.²² He also asserts that these other judges are not issuing rulings that are contrary to existing law or ratcheting up what they are willing to offer simply to cater to certain lawyers.²³ That is, of course, possible. It is hard to imagine, however, that judges who have an increase in certain types of cases filed in their courts after they adopt procedures used in courts that are known to hear those cases have no idea why those cases suddenly appeared in their courts. The media regularly reports forum shopping involving certain jurisdictions²⁴ and notes that some courts have adopted procedures to make them "unique" and (one assumes) attractive to certain litigants. One wonders whether lawyers involved in those cases wouldn't also contend that these courts are making certain rulings or otherwise engaging in at least a subtle form of competition to get (or keep) certain cases.²⁵

It is possible (maybe even likely) that some bankruptcy courts adopted certain procedures to signal that they would offer case placers the same "deal" that Delaware and New York courts purportedly offered. But, bankruptcy courts could have also adopted those procedures because they genuinely believed the adoption was needed to make case

22. *Id.*

23. *Id.*

24. See Nathan Koppel, *Lone Star Rising*, AM. LAW., Mar. 2004, at 67, 70; Kenneth J. Parsigian, LEGAL OPINION LETTER, *Foreign Nations' Tobacco Suits Don't Belong in U.S. Courts*, June 23, 2000. For a particularly humorous forum shopping opinion involving a case transferred from the federal district court that encompasses Brazoria County, Texas, see *Republic of Bol. v. Philip Morris Cos.*, 39 F. Supp. 2d 1008 (S.D. Tex. 1999) ("the Court is virtually certain that Bolivia is not within the four counties over which this Court presides, even though the words Bolivia and Brazoria are a lot alike and caused some real, initial confusion until the Court conferred with its law clerks. Thus, it is readily apparent, even from an outdated globe such as that possessed by this Court, that Bolivia, a hemisphere away, ain't in south-central Texas, and that, at the very least, the District of Columbia is a more appropriate venue (though Bolivia isn't located there either).").

25. Pamela MacLean, *Gang Case Challenges Broad Discovery Rules*, THE RECORDER, Aug. 24, 2005, at 1 (a criminal defense counsel suggested that the Eastern District of Virginia has certain policies that are pro-government and that, in the rocket docket, "the government holds great sway, and judges let them run rampant over the defense."); see also Charles S. Fax, *Specialized Court Starts to Operate*, NAT'L L.J., July 28, 2003, at 19; William C. Smith, *Md. Panel Urges Biz Court*, NAT'L L.J., Nov. 27, 2000, at B1.

filings more efficient. In any event, the fact that one district would adopt procedures used in, and publicized by, another district is not uncommon and is not improper even if the adopting/competing court suddenly became popular with certain litigants. While bankruptcy judges obviously should not issue rulings that are contrary to the law, the fact that they adopt procedures used in other courts and, in the process, attract new cases to their courts makes them no more corrupt than the federal district courts who engage in similar practices. Moreover, as long as the adopting/competing courts continue to apply the law that is binding in their circuit, it is not clear why they should be deemed corrupt simply because they are being competitive.

C. *Telling a Coherent Story*

LoPucki bolsters his principal contention that the bankruptcy courts are engaging in competitive behavior by attempting to make every court decision or action fit neatly into the competition story. In so doing, he either ignores or downplays actions that courts or case placers made if those actions were inconsistent with the competitive theory. For example, LoPucki never explains why the Houston judge would not have “fought” to keep the Continental case,²⁶ if courts so desperately want big cases.²⁷ Nor does he explain why the New York judge would have made such a “bad” ruling in the LTV case, since one would assume the judge knew that such a ruling would displease the case placers.²⁸ Similarly, LoPucki states that the judge in the Kmart case was too embarrassed to rule that certain managers could keep certain bonuses, which makes little sense if competing judges will really do anything to keep the case placers happy.²⁹ Likewise, assuming it is true that case placers avoided New York because of its lottery system,³⁰ it makes

26. LoPUCKI, *supra* note 1, at 60-62.

27. It is possible that his decision to concede defeat to Delaware pre-dated the start of the true competition.

28. LoPUCKI, *supra* note 1, at 68.

29. *Id.* at 154.

30. LoPucki argues that case placers preferred filing cases in Delaware because the New York courts used an unpredictable lottery system to assign cases to judges. *Id.* at 75. LoPucki also suggests that it was widely known that the New York lottery was rigged in favor of one particular judge. *Id.* at 46-47. If

no sense that they would continue to favor Delaware after the district court revoked the automatic reference and caused cases to be decided randomly by both district court judges and visiting bankruptcy judges.³¹ LoPucki also does not convincingly explain why the Delaware district court judges issued rulings to ensure that Delaware remained a favored bankruptcy venue.³² Most district court judges presumably do not lie awake at night dreaming of ways to increase their bankruptcy docket. Moreover, LoPucki does not present any evidence that these district court judges generally are corrupt or otherwise were competing to get certain types of cases in their courts. Indeed, unless they are just competitors at heart (which could be the case), or they receive some type of a kickback, it is unclear why these district courts would compete so aggressively for bankruptcy cases.

Finally, a main theme of LoPucki's book is that competitive courts are reluctant to appoint a trustee for fear of being blacklisted or being branded a "toxic" court.³³ Indeed, LoPucki crucifies the New York courts for their failure to appoint trustees in Enron, Global Crossing, Adelphia, and WorldCom. These courts get no credit, however, for appointing examiners, CROs, or fee examiners/committees. LoPucki also fails to mention whether parties other than the case placers sought the appointment of the examiners or fee committees or participated in the selection of the CRO. Nor does he explore in depth what benefits these entities added to the cases³⁴ or why the case placers would not have reacted

true, this ostensibly gave New York the same predictability that Delaware offered. *See id.* at 75.

31. *Id.* at 88.

32. *Id.* at 87, 95-96.

33. *Id.* at 14, 23, 250.

34. The longest discussion of examiners involves the Enron examiner, though the discussion generally is limited to presenting the examiner's findings (ostensibly to prove that a trustee was needed to pursue actions against the former managers) rather than explaining whether the court's decision to appoint an examiner was consistent with the competition theory. *See id.* at 149. Likewise, LoPucki does not indicate whether the CRO in Enron (Steven Cooper) added any value to the case and, instead, portrays Cooper as a lackey picked by Lay to ensure that no one went after Lay or other Enron executives. While LoPucki states that Cooper owed his job, and thus his allegiance, to Lay, he does not provide any evidence to prove that Lay facilitated Cooper's hiring or

negatively to these appointments and, consequently, branded those judges as toxic. If case placers really pick courts based solely on whether the court will protect the managers and generally let the managers and lawyers have their way in cases, then they should have stopped placing cases in New York after the Enron judge appointed the examiner who performed a voluminous investigation³⁵ or after the judges in Enron and WorldCom appointed CROs (who largely displaced the managers). Likewise, even if LoPucki's characterization of fee examiners/committees (that they fail to control professional fees) is correct, it is hard to imagine that the case placers would be happy with a judge who appointed someone to scrutinize their fees.³⁶

D. Reasonable Minds Might Differ

As long as there is judicial discretion, there will be a perception of abuse. Rather than suggesting that certain court practices create an appearance of impropriety or abuse, LoPucki flatly declares that competition has corrupted the bankruptcy courts.³⁷ In fact, LoPucki appears unwilling to acknowledge that reasonable, non-corrupted minds might differ about the legitimacy of the practices he condemns and brands as unlawful.

Bankruptcy courts fairly could be criticized for approving a fee application that is bloated (i.e., double or over billing), has too many lawyers on the case, or includes excessive expenses.³⁸ But, LoPucki seems to criticize courts' routine approval of fee applications simply because the

that Cooper's future employment as a CRO depended on what actions he took (and refused to take) against Lay. *Id.* at 11, 146. Fee examiners/committees are briefly mentioned when LoPucki suggests (but does not explain in detail) that they (like courts) also do not control professional fees. *Id.* at 143.

35. For a discussion of the examiner's work (and fees) in Enron, see David Barboza, *Lawyer Proves a Thorn for Enron's Partners*, N.Y. TIMES, Sept. 21, 2002, at C1; Carrie Johnson, *Enron Bankruptcy Examiner's Fees Soar*, WASH. POST, Dec. 30, 2003, at E1.

36. If, as LoPucki suggests, the court "that got Enron—and handled it to the satisfaction of the Enron lawyers and executives who chose the court—would get many more," it is especially surprising that a court that wanted to remain competitive would appoint either an examiner or a fee committee to scrutinize the managers' or lawyers' behavior. LOPUCKI, *supra* note 1, at 9.

37. *Id.* at 137-81.

38. *Id.* at 1.

lawyers requested their national, customary billing rates.³⁹ The fact that courts refuse to impose fee caps is not a per se indication that they are corrupt. In fact, most courts, United States Trustee's offices, and a growing number of academic commentators have concluded that national law firms should be compensated at their customary billing (i.e., the national) rates rather than the rates charged in the area where the case is filed.⁴⁰ Similarly, while paying "critical vendors" is a highly controversial practice that may have gotten out of control at times, a court's decision to allow such payments may not be motivated solely by its desire to remain competitive. Indeed, even the Seventh Circuit's opinion in the Kmart case, which is highly critical of critical vendor payments, does not categorically bar such payments in bankruptcy.⁴¹

LoPucki also criticizes judges (especially those in New York and Delaware) for failing to perform a true feasibility analysis in cases—especially in "prepackaged cases."⁴² It is not clear, however, what judges should do if they are presented with uncontroverted evidence that supports feasibility. It would be odd to require judges, *sua sponte*, to reject uncontroverted evidence in large cases or to routinely appoint an examiner in such cases to consider the plan's feasibility if the evidence is uncontroverted. Similarly, LoPucki criticizes courts for approving 363 sales at purportedly inadequate prices.⁴³ He does not sufficiently explain, however, what courts should do if there are no objections to the sale. He also fails to consider that the

39. *Id.* at 44, 141-43.

40. See *In re Taxman Clothing Co.*, 49 F.3d 310, 315-16 (7th Cir. 1995); *In re Busy Beaver Bldg. Ctrs., Inc.*, 19 F.3d 833 (3d Cir. 1994) (permitting lawyers to charge bankruptcy clients the same fees paid by non-bankruptcy clients); *In re Atwell*, 148 B.R. 483, 488-89 (Bankr. W.D. Ky. 1993); Ayer, et al., *Basics of Professional Retention and Compensation*, AM. BANKR. INST. J., Feb. 2005, at 1; Hon. Roger M. Whelan, et al., *Professional Compensation Reform: New Ideas or Old Failings*, 1 AM. BANKR. INST. L. REV. 407 (1993). Moreover, disputes over whether lawyers should be paid at their full market rate or at a reduced rate are not limited to bankruptcy cases. See, e.g., Jim Chen, *The Price of Macroeconomic Imprecision: How Should the Law Measure Inflation?*, 54 HASTINGS L.J. 1375, 1418 (2003).

41. *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

42. LOPUCKI, *supra* note 1, at 107.

43. *Id.* at 167-80.

number of 363 sales at inadequate prices may be increasing because of syndicated loan debt, claims trading, and vulture investors—market factors that are beyond the control of bankruptcy judges.

Finally, it is not clear that courts' decisions to approve retention plans were based *solely* on their desire to remain competitive. As an initial matter, bankruptcy courts essentially inherited the bloat of corporate retention programs because, as LoPucki notes, this practice existed and thrived outside of bankruptcy.⁴⁴ It is plausible that courts concluded that refusing to approve such plans would give competent, non-corrupted managers an incentive to abandon the firm once it entered bankruptcy.⁴⁵ Moreover, though Congress has now substantially limited the amount of pre-petition compensation managers can retain as retention bonuses or loans, it did not ban retention payments outright.⁴⁶

E. *The Controversy Clouds the Data*

The controversy over the word "corrupt" and LoPucki's inability to support his claims about judges' motivations with empirical data has led many to overlook a troubling trend involving bankruptcy cases that may now be exacerbated by recent amendments to the Code. Many Chapter 11 critics argue that "faster is better" because creditors are harmed the longer a company remains in bankruptcy.⁴⁷ LoPucki's data suggests, however, that the opposite conclusion is more accurate.

LoPucki's discussion of the phenomenally high refiling rate of prepackaged bankruptcies⁴⁸ belies the notion that it is always more efficient for cases to be resolved quickly.

44. *Id.* at 152-53.

45. See A. Mechele Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck?*, 11 AM. BANKR. INST. L. REV. 93 (2003) (discussing factors courts consider when approving retention plans).

46. See 11 U.S.C. § 503(c) (2000), which limits a court's ability to allow insiders to keep retention payments.

47. See generally A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 30-33 (2003) (discussing criticisms of lengthy Chapter 11 cases).

48. LOPUCKI, *supra* note 1, at 160.

Indeed, whether one agrees with LoPucki's claim about the effect that competition has on prepackaged plans (i.e., that courts refuse to critically examine prepacks for fear of being labeled a toxic court), it is hard to dispute the data on the significantly higher rate of refilings for prepackaged plans—especially plans filed in Delaware and New York.⁴⁹

Recent revisions to the Code do not explicitly expand a debtor's ability to file a prepackaged plan. However, Congress clearly intended to make it harder for cases to remain in Chapter 11 for prolonged periods of time. That these recent amendments⁵⁰ are consistent with the "quicker is better" mantra is cause for concern because there appears to be little data to support that mantra. Moreover, LoPucki's data show that shorter bankruptcy cases (whether prepackaged or not) tend to fail at higher rates than cases that remained in bankruptcy for longer periods of time.⁵¹ The controversy over the term "corrupt" has, unfortunately, prevented any meaningful discussion of this conclusion or what (if anything) bankruptcy courts can do to slow down a case that is proceeding too quickly.

III. DEFEATING OFFICER AND DIRECTOR CORRUPTION

Not even LoPucki's most unforgiving critics can reasonably dispute his claim that many of the large, recent bankruptcy cases have involved corporate scandals of "unprecedented magnitude" that "struck the American economy" at the beginning of this decade. This claim is undeniable, regardless of one's view of purportedly corrupt bankruptcy judges, the need for revised venue rules, or the high refiling rates in Delaware and New York.⁵² One possible solution to several of the bankruptcy court practices that LoPucki views as corrupt is to give directors better incentives to protect firms from corrupt managers.

49. *Id.*

50. *See, e.g.*, 11 U.S.C. § 1121(d)(2) (2000), *amended by* Pub. L. No. 109-8, 119 Stat. 106, 113 (2005) (limiting a court's ability to extend the exclusivity period in all cases). Special time limits have also been placed on small business filings. *See* 11 U.S.C. § 1121(e) (2000), *amended by* Pub. L. No. 109-8, 119 Stat. 106, 113 (2005); 11 U.S.C. § 1129(e) (2000), *amended by* Pub. L. No. 109-8, 119 Stat. 113, 216 (2005).

51. LOPUCKI, *supra* note 1, at 117-18.

52. *Id.* at 145.

Reasonable minds might reach differing conclusions concerning whether the Enron, Adelphia, or WorldCom courts should have appointed a trustee. No reasonable mind could disagree that the directors of those firms failed to detect, and ultimately prevent, the abuses that occurred pre-petition. Why or how directors failed to detect or prevent fraud has been asked numerous times⁵³ (well before *Courting Failure* was published), and the answers most often given are not unrelated to LoPucki's corruption theme: greed, laziness, and incompetence.

Some corporate directors may just be greedy, lazy, incompetent,⁵⁴ or otherwise incapable of understanding the complexities of the financial transactions they are asked to approve.⁵⁵ However, it is hard to believe that all corporate directors are corrupt or that greed, sloth, or incompetence alone would cause people with impeccable business credentials to consistently, systematically, or intentionally

53. See, e.g., Patrick McGeehan, *Guard Dogs Without Teeth: Fund Scandal Puts Focus on Trustees*, N.Y. TIMES, Nov. 9, 2003, § 3, at 1 (questioning how "accomplished trustees" were blind to illegal acts committed by the founder and then chair of a major mutual fund); Larry D. Thompson, Senior Fellow, The Brookings Inst., Chautauqua Inst. Lecture: The Corporate Scandals, Why They Happened and Why They May Not Happen Again (July 13, 2004), <http://www.brookings.edu/views/speeches/thompson/20040713.htm>.

54. See W. Steve Albrecht, et al., *Fraud and Corporate Executives: Agency, Stewardship and Broken Trust*, 5 J. FORENSIC ACCT. 109, 123 (2004); Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 359 (2001) (discussing incompetent management); Charles M. Elson, *Enron Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 163 (1996) (suggesting that management's ability to decide which directors get to consult, or how much to give to the director's charity of choice as "side-bribes"); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1242 (2002) (discussing "soft conflicts," such as significant charitable contributions to an institution where a director may have a strong affiliation"); Reed Abelson, *One Enron Inquiry Suggests Board Played Important Role*, N.Y. TIMES, Jan. 19, 2002, at C1; Steve Kichen & Eric S. Hardy, *Corporate America's Most Powerful People*, FORBES, May 25, 1992, at 174 (discussing "boards of directors that shirk their job of holding the boss to account.").

55. For example, notwithstanding their financial sophistication, the Enron board overall appeared not to understand the economic rationale of some transactions nor the consequences or risks of those transactions. WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 23-24 (2002) [hereinafter POWERS REPORT], available at <http://files.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>.

harm a company. Such a facile explanation is implausible because directors of corporate boards value prestige and status and are alleged to be highly reputationally sensitive.⁵⁶

When faced with corporate scandals or directorial misconduct, legislators typically respond by proposing or enacting laws that increase directors' civil or criminal liability, or they mandate additional disclosures.⁵⁷ Such a response likely will not prevent future harm if the scandals were caused because corrupt directors could reap enormous financial gains or because otherwise fit directors unintentionally made bad decisions.⁵⁸ Likewise, the typical legislative response will not remove unfit (but not hopelessly corrupted) directors who intentionally make bad decisions.

After briefly describing directors' duties and potential liabilities under existing laws, the remainder of this Article explains why these laws do not adequately protect firms from corrupt directors or from directors who unintentionally harm firms. The Article argues that to

56. See Jayne W. Barnard, *Reintegrative Shaming in Corporate Sentencing*, 72 S. CAL. L. REV. 959, 967-68 (1999). Enron directors included Wendy Gramm (former Chair of the Commodity Futures Trading Commission and wife of the then Senator Phil Gramm), Lord John Wakeham (a former leader of the British Houses of Commons and Lords), Robert K. Jaedicke (the former Dean of Stanford Business School), and Paulo Ferraz Pereira (a former bank president). See Abelson, *supra* note 54, at C1. Similarly, WorldCom's directors included Judith Areen (the then Dean of Georgetown Law School), Carl J. Aycock (former Secretary and CFO of Master Corporation), Max E. Bobbitt (former president and CEO of Metromedia China Corporation), and Gordon S. Macklin (former president of the National Association of Securities Dealers). See Seth Schiesel, *Most of Board at WorldCom Resign Posts*, N.Y. TIMES, Dec. 18, 2002, at C7.

57. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18 U.S.C.) [hereinafter Sarbanes-Oxley Act]; Mutual Fund Investor Confidence Restoration Act of 2003, S. 1971, 108th Cong. (2003); Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. (2003); Mutual Fund Transparency Act of 2003, S. 1822, 108th Cong. (2003); Mutual Funds Integrity and Fee Transparency Act of 2003, H.R. 2420, 108th Cong. (2003).

58. For criticisms of the limitations of the Sarbanes-Oxley Act, see John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 304-05 (2004); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 47 (2003) (suggesting that the regulatory responses to corporate fraud "are unlikely to do much good and may do harm."). *But cf.* Thompson, *supra* note 53.

protect firms from corrupt or undeniably unfit directors (i.e., the greedy, lazy, or incompetent directors) and to decrease any pressure bankruptcy judges may feel to allow corrupt managers to continue to control firms in bankruptcy, the directors of all insolvent firms presumptively should be deemed "unfit" and barred from serving on current or future boards.

A. *The Role of the Board of Directors*

1. *Legal Duties.* Corporate directors have a duty to avoid self-dealing (i.e., the duty of loyalty) and a duty of care. They breach the duty of loyalty when they participate in a self-interested transaction or otherwise place their own interests ahead of the firm's interest.⁵⁹ The duty of care requires directors to act diligently and prudently in managing the firm's affairs and to avoid making irrational or harmful decisions. Though the duty of care primarily focuses on harmful decisions directors make, it also requires directors to act if due attention would prevent a loss.⁶⁰ In duty of care lawsuits, courts evaluate the information available to the directors, the harmful decision, and the good faith or rationality of the process they used to make the harmful decision.⁶¹ Directors who are sued for breaching the duty of care because they failed to prevent a loss generally can defend against that claim if they relied on information or opinions provided by firm employees, lawyers, and accountants, and have no reason to believe that such reliance is unwarranted.⁶²

Directors who breach their fiduciary duties may be fined. Lawsuits alleging that directors breached the duty of loyalty tend to be more successful than those alleging duty

59. *Ledbetter v. First State Bank & Trust Co.*, 85 F.3d 1537, 1540 (11th Cir. 1996); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

60. *Van Gorkom*, 488 A.2d 858. See generally William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002).

61. See *supra* note 60.

62. MODEL BUS. CORP. ACT § 8.30(d)–(e) (2002).

of care breaches⁶³ primarily because allegations that a director breached the duty of care are reviewed under the highly deferential business judgment rule. That is, unless the plaintiff proves that the directors acted in bad faith, directors generally will not be held liable for decisions they made if they used a rational, deliberately considered decision-making process.⁶⁴ Moreover, because many states' corporate charters protect directors from civil liability for failing to monitor the firm's activities,⁶⁵ the business judgment rule, until recently, ensured that successful suits against directors would be rare.⁶⁶

2. *Removing Directors Who Breach Duties.* Courts generally will not remove even corrupt directors from

63. See, e.g., Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 290-91 (1986).

64. The business judgment rule is designed to encourage directors to freely exercise their managerial discretion and to remove uncertainty from corporate transactions by avoiding an *ex post* appraisal of the managers' decisions. See *Cede & Co. v. Technicolor*, 634 A.2d 345, 360 (Del. 1993); *Van Gorkom*, 488 A.2d at 871, 873. Indeed, some suggest that this rule essentially eliminates liability in duty of care litigation. See, e.g., ROBERT CLARK, *CORPORATE LAW* § 3.4 (1986) (suggesting that mere mention of the rule brings a smile of relief to directors' faces); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 299-300 (1999) ("[I]n practice the duty of care is all but eviscerated by a legal doctrine known as the 'business judgment rule.'"); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1361-62 (1989) ("Courts accord near-complete deference to corporate decisions untainted by interest . . .").

65. Largely in response to *Van Gorkom*, 488 A.2d 858 (interpreted to significantly expand the director liability for breach of duty of care), states adopted "charter option" statutes that allowed corporations to include exculpatory clauses in their articles of incorporation that protected directors in breach of due care lawsuits. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2003); see also Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why Van Gorkom Still Rankles, Probably*, 96 NW. U. L. REV. 631, 649 n.73 (2002) (discussing states' adoption of charter option).

66. For example, in 2001, a total of 483 shareholder suits were filed in the United States, an increase of 282 over the number filed in the previous year. See PRICEWATERHOUSECOOPERS LLP 2001 SECURITIES LITIGATION SURVEY 1, http://www.pwc.com/gx/cfr/investigations/pwc_securitieslitigationstudy_2001.pdf. While securities class action filings have declined since 2001, early case dismissals have slowed considerably and there have been record-breaking settlements. See JOSEPH ALLERHAND & PAUL FERRILLO, WEIL, GOTSHAL & MANGES LLP, SECURITIES LITIGATOR SURVEY (2003-2004), [http://www.weil.com/wgm/cwgmhomep.nsf/Files/SecuritiesLitSurvey03-04/\\$file/SecuritiesLitSurvey 03-04.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/SecuritiesLitSurvey03-04/$file/SecuritiesLitSurvey 03-04.pdf).

current board service unless a statute specifically authorizes the removal.⁶⁷ State court judges have the authority to remove directors in more than half of U.S. states.⁶⁸ These statutes allow courts to remove directors if they find that directors engaged in fraudulent or dishonest conduct, grossly abused their position, intentionally inflicted harm on the corporation, were unable or unwilling to follow corporate directives or to transact business on behalf of the company, or if removal is in the best interest of the corporation.⁶⁹

Federal law also gives courts and agencies the authority to remove unfit directors.⁷⁰ The most well known debarring statute is the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act"),⁷¹ which gives courts the power to temporarily or permanently bar directors from serving as an officer or director of a

67. See *Harkey v. Mobley*, 552 S.W.2d 79 (Mo. Ct. App. 1977). *But see Brown v. N. Ventura Rd. Dev. Co.*, 216 P.2d 227 (Cal. Ct. App. 1963) (suggesting that a court would have the authority to remove directors without explicit statutory authority because they hold positions of trust). See generally Olga N. Sirodoeva-Paxson, *Judicial Removal of Directors: Denial of Directors' License to Steal or Shareholders' Freedom to Vote?*, 50 HASTINGS L.J. 97, 102-03 (1998).

68. See, e.g., ALA. CODE § 10-2B-8.09 (2003); CONN. GEN. STAT. § 33-743 (2003); HAW. REV. STAT. § 414-199 (2003); IDAHO CODE ANN. § 30-1-809 (2003); 805 ILL. COMP. STAT. 5/8-35 (2003); see also Sirodoeva-Paxson, *supra* note 67, at 104 n.29. Most state statutes are based on the Model Business Corporations Act. See MODEL BUS. CORP. ACT § 8.09 (2002).

69. See, e.g., ALA. CODE § 10-2B-8.09(a); CONN. GEN. STAT. § 33-743(a); HAW. REV. STAT. § 414-199(a); IDAHO CODE ANN. § 30-1-809(1); 805 ILL. COMP. STAT. 5/8-35(b); MODEL BUS. CORP. ACT § 8.09(a) (2002); see also Jayne W. Barnard, *When is a Corporate Executive "Substantially Unfit to Serve?"*, 70 N.C. L. REV. 1489, 1495-96 n.35 (1992) (citing cases).

70. For example, certain federal banking agencies can remove bank directors or officers if the removal is needed to protect the interests of the federally insured depository banking system. See 12 U.S.C. § 1818 (2000), *amended by* Pub. L. No. 109-173, 110 Stat. 3605, 3611 (2006) (granting the power to debar a bank official who has engaged or participated in any unsafe or unsound practices); 12 U.S.C. § 2264(b) (2000) (granting the power to debar certain officials involved with the farm credit system if they caused substantial financial loss or other damage); 7 U.S.C. § 499b (2000); 7 C.F.R. § 46.35 (2003) (granting the power to suspend, revoke or terminate the license of directors of firms who willfully and repeatedly violate the Perishable Agricultural Commodities Act).

71. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931, 933, 935 (1990) (codified as amended at 15 U.S.C. §§ 77t(e), 78u(d)(2)).

public company if (1) the director has violated certain federal securities laws,⁷² (2) the SEC shows that the director engaged in fraudulent or deceptive conduct, and (3) this fraudulent conduct establishes the director's "unfitness" to serve as a corporate officer or director. The following factors generally are applied when deciding whether a director is unfit: the magnitude or egregiousness of the underlying violation; whether the director has violated securities laws or breached fiduciary duties as an officer or director in the past; the director's role in the fraudulent conduct; the degree of the director's *scienter* in connection with the violation; the amount the director gained from the violation; the likelihood of renewed misconduct; and, the director's appreciation of his fiduciary duties.⁷³

Unfortunately, state and federal removal statutes fail to adequately protect firms from corrupt or otherwise unfit directors or give courts or agencies the authority to remove well-meaning directors who unintentionally harm firms. For example, though state courts can prevent an unfit director from being reelected for a period prescribed by the court,⁷⁴ they generally are unwilling to do so unless they conclude that the director is completely incompetent or is physically or mentally incapacitated.⁷⁵ In addition, state removal statutes (and the judicial interpretations of those

72. See 15 U.S.C. § 77q(a)(1) (2000) (making it unlawful for any person to "employ any device, scheme, or artifice to defraud . . ."); 15 U.S.C. § 78j(b) (2000) (making it unlawful for any person to use "any manipulative or deceptive device or contrivance in contravention" of SEC rules and regulations).

73. Though the term "unfitness" is not defined, many courts have adopted factors initially suggested in a law review article written by Professor Jayne Barnard. See Barnard, *supra* note 69, at 1492-93; see, e.g., SEC v. First Pac. Bancorp., 142 F.3d 1186 (9th Cir. 1998); SEC v. Patel, 61 F.3d 137, 141 (2d Cir. 1995); SEC v. Robinson, Fed. Sec. L. Rep. (CCH) ¶ 91,948 (S.D.N.Y. July 16, 2002). The Sarbanes-Oxley Act eliminates the "substantial" showing and now permits a bar based on any showing of unfitness. Federal courts are likely to continue to apply these same factors because the body of law that already exists evaluates directors' fitness based on these factors. Sarbanes-Oxley Act, *supra* note 57, at § 305 (codified at 15 U.S.C. §§ 78u(d)(2), 77t(e)).

74. MODEL BUS. CORP. ACT § 8.09(c) (2002); see also ALA. CODE § 10-2B-8.09(b) (2003); CONN. GEN. STAT. § 33-743(c) (2003); HAW. REV. STAT. § 414-199(b) (2003); IDAHO CODE Ann. § 30-1-809(2) (2003); 805 ILL. COMP. STAT. 5/8-35(b)(2) (2003).

75. Barnard, *supra* note 69, at 1496-97.

laws) fail to clearly or consistently articulate when removal is appropriate, and courts often fail to coherently define the type of misconduct that warrants removal.⁷⁶ Since a court is not likely to remove a director who thinks he is acting in the best interest of the firm, a director who believes that his decisions and his decision-making process benefit the firm has no reason to fear being removed from the board even if his decisions or decision-making process are flawed. Moreover, the director risks—at most—removal from only current board service because the state statutes do not give courts the authority to prevent the unfit director from joining another board.

Like the state removal statutes, federal laws also are of limited use in protecting businesses. The federal removal statutes apply only to public banks or federally-regulated entities and, thus, offer no protection for the shareholders or creditors of private businesses. Moreover, because the Remedies Act has a *scienter* requirement, directors who make bad decisions but do not intend to harm the business could not be barred from current or future board service even under the law widely viewed as the strongest debarment statute.

Many question the competence of courts to make decisions that could (and arguably should) be made by private actors.⁷⁷ However, relying on shareholders to

76. For example, New York authorizes courts to remove directors and officers if the case is brought by the attorney general or by a shareholder that owns 10% of the outstanding shares. N.Y. BUS. CORP. LAW §§ 706(d), 716(c) (McKinney 1986 & Supp. 1998). California, however, provides for judicial removal of directors only in suits brought by shareholders that own 10% of the outstanding shares. CAL. CORP. CODE § 304 (West 1990). Some older decisions allowed even corrupt shareholder-directors to reelect themselves as directors. See *Atkins v. Hughes*, 282 P. 787, 790 (Cal. 1929) (allowing shareholders who were controlled by fraudulent directors to continue to reelect the fraudulent directors); *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P.2d 66, 77 (Cal. Dist. Ct. App. 1952) (stating that the court will not remove directors for acts committed during their tenure in office if they are subsequently reelected by the shareholders).

77. In general, shareholders have the authority to remove directors with or without cause unless the articles of incorporation provide for removal only for cause. MODEL BUS. CORP. ACT § 8.08(a) (2002); see also Jayne W. Barnard, *The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them*, 65 NOTRE DAME L. REV. 32, 45 (1989) (discussing whether the forced removal of directors or officers is consistent with the view that “judges are ill-suited to evaluate managerial competence.”); Ralph

remove corrupt or otherwise unfit directors is unlikely to be effective due to the problems just discussed. Shareholders also will find it hard to remove corrupt or unfit directors because of the difficulty and expenses associated with both acquiring information about a director's prior board service and with mounting a campaign to prevent an arguably unfit director from sitting on a board frustrates the problem.⁷⁸ Moreover, as the next section shows, because some directors may make bad decisions, but are not corrupt in the morally debased sense of the term, existing laws are especially unlikely to give them an incentive to make better decisions (including a decision to better monitor corrupt officers).

B. *Behavioral Influences on Directors*

Insights from the behavioral law and economics literature may help explain why otherwise competent and well-meaning directors may unintentionally make bad decisions.⁷⁹ Psychological studies⁸⁰ suggest that overconfidence is a common human tendency, and that highly successful people are especially likely to overestimate their ability to control their environments and

A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 457 (1989) ("Application of the [business judgment] rule requires judicial deference to corporate decisions and thus non-interference by the court.").

78. Removing corrupt directors is unlikely to increase notwithstanding the obligations imposed by the very law that was enacted in response to the corporate scandals at the beginning of this decade (the Sarbanes-Oxley Act) because this legislation does not require businesses to give shareholders additional information about a potential director's past board service. Given this, it will continue to be burdensome, expensive, and rare for shareholders to successfully remove corrupt or unfit directors.

79. I am not suggesting that all directors have psychological biases. Instead, I suggest that the law must confront the insights provided by behavioral studies both to determine whether psychological biases cause directors to unconsciously make decisions that harm the business and to consider whether a non-traditional legal sanction is needed to help directors overcome those biases.

80. Though this section of the Article cites sources that rely on psychological studies, I am not suggesting that those studies were designed to replicate, in a controlled laboratory experiment, the behavior of directors. Instead, I cite to the behavioral traits identified in these studies to suggest that reasons other than greed, sloth, or incompetence may cause directors to make poor decisions and that failing to consider these traits when considering laws designed to penalize certain conduct may decrease the laws' effectiveness.

to prevent harm.⁸¹ The problem of the “overconfidence bias” is well-documented and, over the last few years, has been explored in detail in the law and behavioral science literature.⁸² An actor is susceptible to this bias if he believes that the likelihood that a negative event will happen to him is less than the likelihood that it will happen to someone else, or if he thinks that it is more likely that a positive event rather than a negative event will happen to him. The overconfidence bias causes people who are actually informed of the likelihood of harm to make incorrect decisions and appears even in sophisticated actors who know the actual probability distribution of an event.⁸³

People also have a tendency to take credit for the good things that happen in their lives but deny responsibility for the bad events that occur. They tend to attribute positive outcomes to their own personal qualities, while negative outcomes are attributed to bad luck or exogenous factors.⁸⁴ Similarly, most people, especially successful ones, have an enhanced sense of their ability to control events in their lives and often assume that people fail or are otherwise unsuccessful only because they are lazy or have a

81. See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 807 (2001).

82. See Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051 (2000); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003).

83. See Jolls, *supra* note 82, at 1659 nn.22-23 (citing studies); Korobkin & Ulen, *supra* note 82, at 1091-93 (citing psychological studies); Jeffrey J. Rachilinski, *The “New” Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739, 758 (2000); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1183 (1997) (discussing common behavioral biases). Thus, regardless of a person’s educational level or social status, if he is susceptible to the overconfidence bias, he likely will make bad decisions. At least one source suggests that overconfidence is dominantly a male trait which, if true, would suggest that the trait is even more likely to affect boards which remain largely male. See Brad M. Barber & Terrance Odean, *Boys will Be Boys: Gender, Overconfidence, and Common Stock Investment*, 116 Q. J. ECON. 261 (2001).

84. See SHELLEY E. TAYLOR, *POSITIVE ILLUSIONS: CREATIVE SELF-DECEPTION AND THE HEALTHY MIND* 16 (1989).

questionable work ethic.⁸⁵ This tendency, combined with the overconfidence bias, encourages people to accept too many risks based on their belief that adverse results are unlikely to occur and, even if a bad event does occur, they have the power to prevent any resulting harm.⁸⁶ Since directors are well educated and have succeeded professionally (perhaps because of their willingness to take greater risks), they may be more likely to be overconfident about their ability to make correct decisions.⁸⁷

Behavioral studies also suggest that people make "path dependent" choices. That is, once people form a certain belief, they often become inattentive to new information that contradicts that belief.⁸⁸ With their prior beliefs and decisions as an "anchor," people become overcommitted to those decisions even if subsequent information suggests that they should question the earlier decisions.⁸⁹ Likewise, because anchoring causes present decisions and choices to be constrained by prior decisions, people often attempt to justify and rationalize the continuing validity of prior

85. See *id.* at 25; see also Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717, 723 (2000); Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679, 1689 (1998).

86. See Hillman, *supra* note 85, at 723.

87. See Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 146 (2002) (suggesting that "[i]llusions of control and overoptimism are associated with a variety of positive outcomes: greater willingness to take risk, more persistence in the face of adversity, etc." and that being "unrealistically confident, within moderation, can lead to greater success, even if it also leads to more mistakes as well.").

88. Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LIT. 11, 26 (1998). This might also explain why some bankruptcy judges may have continued to approve of certain practices (like paying "critical" vendors ahead of other unsecured creditors or approving overly generous retention bonuses plans) even after the chorus of critics suggested that those practices were not justified under existing laws.

89. See Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 5 (2002) (noting that "many directors of large corporations are outsiders who have full-time jobs elsewhere" and have little time to devote to running the company); Langevoort, *supra* note 81, at 811.

decisions even though an objective observer would question the reasonableness of those decisions.⁹⁰

Behavioral studies also indicate that most actors have the tendency to cut corners and make quick decisions on too little information if they genuinely believe their decisions ultimately will lead to a successful result, and they think that reasonable people would make the same decision.⁹¹ An overconfident group, like a board of directors, also may engage in "groupthink" especially if the board is fairly cohesive. Groupthink occurs when the group's solidarity is challenged by an external influence, and the group responds by closing ranks and clinging to a collegial status quo rather than attempting to respond to the challenge.⁹²

Of course, recognizing that behavioral biases may affect directors' abilities to make sound business decisions does not explain how laws should be revised to respond to those biases. At a minimum, considering those biases will help explain why competent, well-meaning directors may

90. See Rabin, *supra* note 88, at 26 (noting that "fresh" thinkers may be better at seeing solutions to problems than people who have meditated at length on the problems, because the fresh thinkers are not overwhelmed by the 'interference' of old hypotheses."). A similar bias, called the "optimism commitment whipsaw," prevents people from abandoning a failing course of action. Instead, it causes them to take even greater risks to further the committed course of action. Even if the decisions were good ones when originally made, the unwillingness to re-evaluate those decisions ultimately causes harm once an unexpected event occurs (such as a downturn in the economy). See Donald C. Langevoort, *Seeking Sunlight In Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 481-83 (2001) (discussing how sunk cost trap and over-optimism bias may affect corporate officers' decision-making process); O'Connor, *supra* note 82, at 1253, 1278 (discussing group tendency to throw good money at bad problems).

91. See Langevoort, *supra* note 90, at 482. This may explain why the Enron board so quickly waived Enron's conflict of interest rules with respect to financial activities of the CFO, Fastow. If they felt time was of the essence or they were overly optimistic about Fastow's ability to increase Enron's earnings, they may have been willing to overlook what appeared to be a clear conflict of interest in his dealings with Enron. See O'Connor, *supra* note 82, at 1268-69, 1296-97. This may also explain why bankruptcy judges make some of the rulings LoPucki brands as corrupt. Because bankruptcy courts want firms to successfully reorganize under Chapter 11, it is possible that some may authorize critical vendor payments or approve retention plans or bonuses if they conclude that the alternative is a failed reorganization.

92. See Bainbridge, *supra* note 89, at 32; O'Connor, *supra* note 82, at 1257-93.

unintentionally make harmful decisions,⁹³ and laws that fail to consider those biases may not give directors an incentive to change how they make decisions. Stated differently, if directors will not acknowledge that their decisions or decision-making process are unreasonable, irrational, or illegal, they will not be deterred by a civil fine that likely will be covered by director and officer liability insurance.

C. *Debarring Directors of Insolvent Firms*

Corrupt, greedy, or lazy directors (who may think they are unlikely to be caught) or incompetent or behaviorally-impaired directors (who may not comprehend that their actions are wrong) would have an incentive to change their behavior only if the potential sanction is significant and cannot be covered by insurance or otherwise passed on to the shareholders.⁹⁴ There should be a rebuttable presumption that the directors of insolvent⁹⁵ firms are unfit for board service and should be barred from current and future boards. This presumption would give directors a greater incentive to loosen the grips failed managers have on their jobs and their companies,⁹⁶ both before and after a bankruptcy filing. While serving on the board of an insolvent company should not be a per se disqualifier for future board service, a firm's insolvency is an appropriate triggering event because investors, creditors (especially unsecured creditors), and employees inevitably are harmed by a firm's insolvency. In addition, presumptively declaring

93. Or, why ethical and otherwise competent bankruptcy judges allow some practices that may appear to be corrupt to an outsider observer like LoPucki.

94. Directors typically can seek direct payment under a director and officer (D&O) liability insurance policy if the firm does not, or cannot, fully reimburse or indemnify them for litigation expenses relating to their duties as directors of the firm. See Nan Roberts Eitel, *Now You Have it, Now You Don't: Directors' and Officers' Insurance After a Corporate Bankruptcy*, 46 LOY. L. REV. 585, 588 (2000); Melanie K. Palmore, Comment, *"Insured vs. Insured" Exclusions in Director and Officer Liability Insurance Policies: Is Coverage Available When Chapter 11 Trustees and Debtors-in-Possession Sue Former Directors and Officers?*, 9 BANKR. DEV. J. 101, 105-06 (1992).

95. For the purposes of the proposed unfitness test, I define insolvent to mean any business that files a bankruptcy petition, is placed in a receivership, or lacks the current ability to pay its debts.

96. LOPUCKI, *supra* note 1, at 139, 143-51.

directors unfit and removing them from board service also would alleviate the competitive pressure judges face when deciding whether to allow those managers to control the firm during the bankruptcy proceeding. This would also eliminate the appearance that courts are allowing managers to escape the consequences of their pre-petition harmful conduct.

The primary goal of a disqualification sanction should be to protect future businesses from intentional harm. Thus, the debarring authority should not automatically debar directors⁹⁷ simply because they served on the board of an insolvent company or because the authority wants to punish them for actions that already are punishable under other civil or criminal statutes.⁹⁸ There should be an irrebuttable presumption that a director is unfit to serve on current or future boards only if the debarring authority concludes that a director of an insolvent business is corrupt, greedy, lazy, or incompetent, and poses a risk of continuing to engage in harmful conduct. Although it is practiced in other nations, the debarment sanction should not be used simply to punish directors whose behavioral flaws or lax oversight may have caused the company's insolvency.⁹⁹

97. It would be unwise to enact, and difficult to rationalize, a law that automatically barred all directors of insolvent businesses from current or future board service if they did not benefit from the misbehavior and did not intentionally cause harm to the firm. For example, it would be inappropriate to bar a director from current or future board service who unintentionally engaged in a single act of misconduct (for example, breaching the duty of care) but did not profit from the misconduct. The debarring authority should have the power to debar directors from current or future board service only upon motion of an interested party, which would include a bankruptcy trustee or examiner, a receiver, a creditor, a shareholder, or the court sua sponte.

98. Thus, if the director or officer already could be barred from serving as a director under the Remedies Act, there would be no need to bring a debarment action based on the proposal discussed in this article. See Carrie Johnson, *Ex-Enron Official Pleads Guilty*, WASH. POST, May 20, 2004, at E4 (discussing terms of guilty plea by Enron insider for insider trading which included returning retention bonus and debarment from serving as an officer or director of a public company).

99. See A. Mechele Dickerson, *The Many Faces of Chapter 11: A Reply to Professor Baird*, 12 AM. BANKR. INST. L. REV. 109, 128 n.95 (2003) (discussing director liability under non-US laws). For a more comprehensive discussion of director liability under British and Australian law, see Vanessa Finch, *The Recasting of Insolvency Law*, 68 MOD. L. REV. 713 (2005); Paul James *et al.*, *Insolvent Trading—An Empirical Study* (Univ. of Melbourne Legal Studies Research, Working Paper No. 72, 2004), www.ssrn.com/abstract=555892.

When deciding how to determine whether to grant a motion to declare a director unfit and remove her from current or future board service, a state or federal court or agency (the "debarring authority")¹⁰⁰ should apply the factors courts consider when deciding whether to disqualify directors who have violated federal securities laws.¹⁰¹ Specifically, the debarring authority should consider:

- the nature of the misconduct that caused the firm's insolvency;
- whether the director knowingly or willingly participated in the harmful conduct;
- whether there is recidivist behavior, i.e., repeat violations of the law, service on the board of more than one insolvent business, or multiple past breaches of fiduciary duties;
- the amount of loss the insolvency caused creditors or investors; and
- whether, or how much, the director profited as a result of the firm's insolvency.

Clearly, corrupt directors who intentionally delay a bankruptcy filing to give themselves (or corporate officers) additional time to exercise stock options, take out loans from the firm, give themselves bonuses, collect consulting fees, or otherwise loot the company, should be deemed unfit because of greed.¹⁰² In contrast, if a director joined the

100. Laws should be implemented by the U.S. Congress (for example, as part of the Federal Bankruptcy Code or federal securities laws) and by the individual states to prevent a disqualified director from moving from state to state to avoid a state bar. This would also prevent a disqualified director from serving on the board of a private company when he has been disqualified from serving on the board of a publicly traded company.

101. See Jayne W. Barnard, *Rule 10b-5 and the "Unfitness" Question*, 47 ARIZ. L. REV. 9, 41-58 (2005) (discussing which violators of Rule 10b-5 should be deemed unfit).

102. The facts surrounding the Enron filing demonstrate that directors may have delayed the filing to protect their pecuniary interests as many of them netted millions by strategically exercising stock options and then selling shares. See Michael Duffy, *What Did They Know and...When Did They Know It?*, TIME, Jan. 28, 2002, at 16. To decrease the likelihood of removing generally fit directors who, because of behavioral biases, believed they could save the firm, courts should ask whether the directors delayed filing a bankruptcy petition (or resisted a receivership) and whether the delay or resistance was intentional, negligent, or resulted from behavioral biases.

board of an insolvent firm before it filed for bankruptcy but after the harmful acts occurred, the director should not be barred from current or future board service. A director who engaged in (or failed to perform) acts due to a behavioral bias but did not intend to harm the firm should be treated differently from corrupt directors. These directors should be allowed to remain on current or future boards if they can convince the court that they pose no future risk to businesses because, for example, the firm has created an effective corporate compliance program, or the director consents to serving only on boards that have such programs. Directors also should be allowed to serve on boards if they have taken other steps, including participating in more extensive board training, to ensure that they are fit to serve on a board.

1. *Benefits of Debarring Directors.* Allowing a debarring authority to bar unfit directors should protect the public by deterring future misconduct by both an individual misbehaving director (i.e., specific deterrence) and by the potentially misbehaving directors of other businesses (i.e., general deterrence).¹⁰³ Moreover, while LoPucki cites no proof that Ken Lay actually participated in the decision to hire his replacement (an experienced turnaround manager), having the “Ken Lays” of the business world and the directors who allowed them to commit allegedly fraudulent acts declared unfit would help reduce the appearance that bankruptcy courts are letting corporate thieves control the firm’s bankruptcy case.¹⁰⁴ Permitting debarring authorities to declare directors unfit and disqualify them from future board service also would indirectly serve as a financial penalty, since debarred directors would be forced to forfeit future directors’ fees. Also, being labeled unfit might impair their own future employment opportunities.¹⁰⁵

103. See Barnard, *supra* note 69, at 1494-95 (discussing the effect of specific and general deterrence).

104. LOPUCKI, *supra* note 1, at 145-48.

105. While outside corporate directors typically do not derive their principal income from directors’ fees, they nonetheless can earn fees and benefits that exceed \$100,000 annually. See Neil Weinberg, *Blame the Board*, FORBES, May 10, 2004, at 120 (reporting \$138,000 as the average annual compensation for independent directors at Cendant in 2004). Although the total annual compensation for directors in 2001 was approximately \$41,000, Enron directors were paid in excess of \$300-400,000 in cash and stock that year. See

Because a director's reputation may be one of his most important assets and companies choose their chief officers and board members largely based on their reputations, the fear of being labeled unfit would give most directors an incentive to make better decisions.¹⁰⁶ That is, the risk of a "shaming" sanction that labels a director as unfit should encourage directors to avoid making decisions that presumptively trigger the sanction.¹⁰⁷ If the sanction is widely publicized,¹⁰⁸ it also should serve as a deterrent to directors who have behavioral traits that might cause them to unintentionally harm the firm. To be sure, even commentators who have advocated shaming sanctions concede that it is "hardly an exact science."¹⁰⁹ Despite this, a shaming sanction that also imposes a financial loss should be more effective in protecting future businesses than imposing monetary damages because a shaming sanction can more easily be tailored to the nature of the

KORN/FERRY INT'L, 28TH ANNUAL BOARD OF DIRECTORS STUDY 17 (2001); Abelson, *supra* note 55, at C1; Editorial, *'Yes Men' Make Up Boards That Miss Enron-Type Failings*, USA TODAY, Feb. 21, 2002, at 16A [hereinafter *Yes Men*]. Other firms had similar or sometimes significantly higher compensation plans for their directors. See Gary Strauss, *Corporate Perks Add Zing to Juicy Jobs on Boards*, USA TODAY, Apr. 17, 2000, at 3B (reporting \$645,700 annual fee to Microsoft directors, \$386,320 to Dell directors, and \$341,900 to Goldman Sachs directors).

106. Of course, market controls may not always prevent directors from making bad decisions because not all markets are efficient and information about the past acts of directors is often not readily available to shareholders who would be required to vote to remove the arguably unfit director. See, e.g., Diedre A. Burgman & Paul N. Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the Trans Union Case*, 11 J. CORP. L. 311, 354-58 (1996); Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 851-53 (1993). See generally Cohen, *supra* note 54.

107. In theory, directors who intentionally harm businesses will be shunned by their peers for violating cultural norms and will feel guilt or shame. See David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1821 (2001).

108. Directors of successful firms often are recognized and commended in the popular press and this recognition both enhances the directors' self-esteem and leads to potentially more lucrative social or professional opportunities. See Louis Lavelle, *Best and Worst Boards*, BUS. WK., Oct. 7, 2002, at 104. Ironically, in 2000, the *Chief Executive* magazine ranked Enron's board among the top five boards. *Yes Men*, *supra* note 105, at 16A.

109. Skeel, *supra* note 107, at 1854.

directors' misbehavior.¹¹⁰ In addition, it is virtually impossible for directors to pass the cost of a shaming sanction on to the company or its shareholders. Because most large and mid-sized businesses carry director and officer liability insurance that directors can use to pay civil fines, unless directors are implicated in aberrational cases like Enron or WorldCom, directors likely will not be forced to bear the full costs associated with a financial penalty for breaching a state fiduciary duty law.¹¹¹ In contrast, even if a firm agrees to pay the directors' costs to defend against a motion to debar, if the director is found unfit to serve on a current or future board, the firm cannot absorb that cost because a personal shaming sanction is something only the individual director can "pay."

While directors should not be discouraged from having a trusting relationship with managers,¹¹² they should routinely seek external assistance when they are asked to approve unusual financial transactions. The risk of being labeled unfit, and the desire to have a defense to such an action, should cause directors to demand more detailed information about the company's true financial condition

110. See *id.* Even if shunning or shaming may sometimes enforce business norms, without legal sanctions, they are unlikely to modify the behavior of corrupt directors, especially if they can reap enormous profits from their decisions. Indeed, just as market pressures are unlikely to prevent directors from engaging in misconduct if the benefits of the misconduct are significant, norms are unlikely to prevent directors from taking (or refraining from taking) actions that harm the business if the financial benefit of betrayal substantially outweighs the costs associated with violating those norms. See Blair & Stout, *supra* note 64, at 318-19 (questioning effectiveness of trust and integrity to prevent directors from behaving in opportunistic ways); see also Coffee, *supra* note 58, at 34 (suggesting that the increasingly lucrative consulting income auditors hoped to receive from clients may have caused their "normal desire to preserve their reputational capital for the long run [to] become subordinated to their desire to obtain extraordinary returns in the short run by risking that reputational capital.").

111. See Bernard S. Black, et al., *Outside Directors and Lawsuits: What are the Real Risks?*, MCKINSEY Q., Autumn 2004, at 70, available at <http://ssrn.com/abstract=590913>; Lucian Bebchuk, *What's \$13 Million Among Friends*, N.Y. TIMES, Jan. 17, 2005, at A17.

112. While it is unclear whether board friendships threaten board independence and pose harm to shareholder interests, adversarial relationships between boards and firm officers generally are counterproductive. See Langevoort, *supra* note 81, at 813. But cf. O'Connor, *supra* note 82, at 1246 (suggesting that "Fictive Friendships" among board members creates a social norm that prevents them from challenging managers).

and the risks associated with certain acts.¹¹³ The threat of being found unfit will also give them an incentive to seek advice from neutral, external financial experts,¹¹⁴ to insist that a director with a certain type of expertise be added to the board, or to create a formal corporate compliance program.¹¹⁵ Ultimately, this should help bridge the inherent information disparity between the officers and the directors—a disparity that will be especially wide if directors are financially unsophisticated or otherwise prone to defer to management decisions.¹¹⁶

113. Many directors tend to be highly deferential toward the company's officers and often will not carefully monitor the officers unless there is some type of crisis. See, e.g., JAY W. LORSCH WITH ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 41-49 (1989); Alexei Barrionuevo, *The Rise of the Boards*, N.Y. TIMES, Mar. 15, 2005, at C1 (quoting the former head of the Securities and Exchange Commission that board members traditionally were "reluctant to challenge chief executives and their strategies.").

114. Directors already seek (then use as a liability shield) the advice of investment bankers when considering whether a merger or takeover is "fair" to shareholders and obtain "solvency opinions" when they seek additional capital or are in merger discussions. See, e.g., *Bayer Corp. v. MasoTech, Inc.*, 269 F.3d 726, 734 (6th Cir. 2001); *Brandt v. Hicks, Muse & Co.*, 208 B.R. 288 (Bankr. D. Mass. 1997); see also Helen M. Bowers, *Fairness Opinions and the Business Judgment Rule: An Empirical Investigation of Target Firms' Use of Fairness Opinions*, 96 NW. U. L. REV. 567, 569-70 (2002); William J. Carney, *Fairness Opinions: How Fair are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 525 (1992).

115. See *In re Caremark Int'l Inc.*, 698 A.2d 959, 970 (Del. Ch. 1996) (concluding that directors have a duty to assure that a competent corporate information and reporting system is in place and that the failure to create one may subject a director to liability). These programs also protect firms who are convicted of violating criminal laws since firms can decrease their sentences if they can prove that the business had a well-designed and effective compliance program. See U.S. SENTENCING GUIDELINES MANUAL § 8A1.2 (2002).

116. Officers, like directors, likely will be concerned about their reputation and may be more reluctant to accurately portray the company's finances if they fear that an accurate portrait may jeopardize their compensation or tenure with the company. See Christine E. L. Tan, *The Asymmetric Information Content of Going-Concern Opinions – Evidence from Bankrupt Firms With and Without Prior Distress Indicators* (Apr. 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=313025. See generally ABA Task Force on Corporate Responsibility, *Preliminary Report of the ABA Task Force on Corporate Responsibility*, 58 BUS. LAW. 189, 201 (2002) (recommending that boards maintain a program of director training and education and that they adopt procedures to evaluate the effectiveness of meetings and the information flow to directors).

2. *Risks of Debarring Directors.* Perhaps the most compelling argument against barring unfit directors from board service is the risk that this sanction will cause desirable directors to refuse board service, will skew decisions by forcing directors to be overly cautious, or will cause the costs of directors and officers insurance to skyrocket.¹¹⁷ While the risk of disqualification does not appear to have altered the willingness of directors to serve (or the decisions they made while serving) on the boards of non-US businesses,¹¹⁸ the chilling effect is a legitimate concern. Directors tend to hold prominent positions with other companies and appear to overreact to legal interventions to avoid being subjected to prolonged litigation. Given this, they may become overly cautious even if they believe they have done nothing wrong because they

117. When state courts appeared willing to increase director liability in breach of care lawsuits (during the height of the D&O insurance crisis in the mid-1980s) and when the SEC proposed additional disclosure requirements for audit committees, directors reportedly resigned or were less willing to join corporate boards. See, e.g., DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 2174 nn.1837-39 (5th ed. 1998); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORDHAM L. REV.* 437, 459-60; Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 *EMORY L.J.* 163, 305 (1997); Palmore, *supra* note 94, at 104; Ramesh K. S. Rao et al., *Fiduciary Duty à la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 *J. CORP. L.* 53, 57, 61 (1996); Gregory S. Rowland, *Earnings Management, The SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 *COLUM. L. REV.* 168, 202 n.144 (2002). Recently, some potential directors appear to have resisted joining boards in the wake of the Enron and WorldCom scandals, and D&O insurance premiums appear to have increased as well. See Christopher Oster, *Directors' Insurance Fees Get Fatter*, *WALL ST. J.*, July 12, 2002, at C1; Susan Stellin, *Directors Ponder New Tougher Rules*, *N.Y. TIMES*, June. 30, 2002, at BU16; Stephen Taub, *Enron Insurance Fallout: D&O Premium Surge*, *CFO Online*, Feb. 22, 2002, <http://www.cfo.com/Article?article=6697>. It is unclear, however, whether the multi-million dollar settlements the Enron and WorldCom directors paid out of their own pockets have deterred competent directors from serving on boards, or whether directors view the Enron and Worldcom settlements as aberrational. See Ben White, *Directors Run Risk of Paying Penalties Out of Their Pockets*, *WASH. POST*, Jan. 20, 2005, at E1.

118. A survey of disqualified directors suggests that the potential bar to board service had no chilling effect on directors' willingness to serve or their willingness to take risks while serving largely because most directors were unaware that they could be disqualified for their conduct. See Andrew Hicks, *Disqualification of Directors: No Hiding Place for the Unfit?*, 59 *RES. REP.* 1, 10 (1998).

want to avoid the delays associated with litigation, the exposure of potentially embarrassing facts, and the shame associated with potentially being labeled unfit.¹¹⁹

To be sure, companies need directors who are willing to take reasonable risks because risks are an essential condition for promoting and advancing corporate profits. Moreover, a proposal to label the directors of all insolvent firms as unfit would be draconian and most certainly would cause some qualified individuals to refuse to serve on boards.¹²⁰ If, however, directors understand the factors that would cause them to be found unfit for future board service and they know the defenses they can raise to an unfitness charge, fit directors (or behaviorally-impaired directors who may unintentionally harm firms) can predict *ex ante* when they run the risk of being deemed unfit for service. Given this, and assuming most directors are rational, the debarment risk should not cause a fit, rational director to either refuse to serve on boards or to make overly cautious decisions.¹²¹

In addition to the potential chilling effect, barring directors from current and future board service will increase both public and private costs. Public costs would include those associated with the initial debarment process itself,¹²² the cost to maintain a filing registry (or a series of

119. See Langevoort, *supra* note 81, at 823.

120. Given the homogeneity of most corporate boards, an unintended consequence of this proposal may be that some "traditional" directors (*i.e.*, white males in their fifties) may refuse to serve on boards which may open up board opportunities for more racial minorities and women. See generally O'Connor, *supra* note 82, at 1246 (discussing homogeneous, "clubby nature" of corporate boards).

121. Some commentators have questioned whether the Enron and WorldCom directors' settlements would discourage otherwise qualified people from serving on corporate boards. See Bebchuk, *supra* note 111, at A17; White, *supra* note 117, at E1; White, *supra* note 12, at E1; see also E. Norman Veasey, *A Perspective on Liability Risks to Directors*, DIRECTORS MONTHLY, Feb. 2005, at 1 where the former chief justice of the Delaware Supreme Court argues that directors' personal wealth rarely will be at risk because of the business judgment rule and because they can protect themselves with their own diligence and independence.

122. It would not be cost-prohibitive to require trustees to file a brief report noting that they have no reason to believe the directors are unfit. However, one of the reasons I do not suggest that the law require trustees or receivers to submit a detailed report on the fitness of directors in each case, even if there is

registries) to record the names of all debarred directors, and the costs incurred to sanction a director who violates a bar order. Private costs would include the costs businesses will incur to investigate whether potential directors are fit or have been barred from board service, the directors' costs to defend against an unfitness finding and debarment, the costs associated with creating or enhancing corporate compliance programs, and the costs to hire external experts.

Although the process of barring unfit directors from serving on future boards would not be cost-free, not debarring directors also imposes costs. Existing laws allowed the directors involved with the recent corporate accounting scandals discussed in *Courting Failure* to make decisions that harmed those companies, and some of those directors still remain on other corporate boards.¹²³ Moreover, as LoPucki stresses, there are direct and indirect costs associated with the bankruptcy proceedings themselves.¹²⁴ The existing proposal obviously will not eliminate all costs created by insolvency proceedings. However, the risk of being found unfit for service should decrease the number of overall inefficient insolvencies by forcing competent directors to pay greater attention to the management of their business (by, for example, considering

no indication that the directors appear to be unfit (as is required under British law), is to curtail administrative costs. Cf. Sarbanes-Oxley Act, *supra* note 57, § 307 (requiring lawyers to report evidence that a company or its agents have materially violated securities laws or breached fiduciary duties even if the lawyer has not concluded that any actual wrongdoing has occurred).

123. See Ben White, *Blame for Scandals Entering the Boardroom*, WASH. POST, Jan. 7, 2005, at E1 (noting that some former Enron and WorldCom directors continued to serve on the boards of Owens Corning, Lockheed Martin Corp., and Wyeth).

124. Direct costs are the transaction costs of the bankruptcy case, primarily lawyer, accountant, and other professional fees. See Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. REV. 581, 607 (1993). LoPucki observes that these costs can be substantial, though they appear to be considerably less than earlier suspected. See LOPUCKI, *supra* note 1, at 140, 143; see also Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 AM. BANKR. L.J. 509, 515 (2000) (concluding that direct costs in large reorganizations are approximately two percent of firm assets); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (placing costs at three percent of assets).

ways to prevent an insolvency) or by preventing corrupt or otherwise unfit directors from serving on boards (and, thus, protecting future solvent businesses from these directors).¹²⁵ Either result should ultimately lead to a decrease in the costs associated with future business insolvencies.

CONCLUSION

Whether or not you agree with LoPucki's basic premise that bankruptcy courts have been corrupted by competition for big cases, it is undisputed that his book has had a dramatic effect on the bankruptcy dialogue about venue for large cases. Hopefully, the conversation will move beyond the wounding word "corrupt" and will focus on identifying the costs and benefits associated with the changes that have taken place in Chapter 11 since 1978. Likewise, the publicity surrounding *Courting Failure* and its controversial claims hopefully will cause legislators to consider additional ways to defeat corrupt management practices.

125. The risk of being debarred for failing to protect the firm's interests hopefully will cause directors to file earlier bankruptcy petitions. Even if a firm files a Chapter 11 reorganization petition, but ultimately liquidates in Chapter 11, an earlier filing should better preserve the value of the firm and allow it either to be a more successful reorganization (which will benefit employees, trade creditors, suppliers, and the local community) or a more efficient liquidation that provides a higher return for creditors. See Dickerson, *supra* note 47, at 30 n.109; see also H.R. REP. NO. 95-595, at 233-34 (1978), as reprinted in 1978 U.S.C.C.A.N. 5963, 6193 ("One of the problems that the Bankruptcy Commission recognized in current bankruptcy and reorganization practice is that debtors too often wait too long to seek bankruptcy relief.").