

2012

## Toward a Public Enforcement Model for Directors' Duty of Oversight

Renee M. Jones

Michelle Welsh

Follow this and additional works at: <https://scholarship.law.vanderbilt.edu/vjtl>



Part of the [Commercial Law Commons](#), and the [Securities Law Commons](#)

---

### Recommended Citation

Renee M. Jones and Michelle Welsh, Toward a Public Enforcement Model for Directors' Duty of Oversight, 42 *Vanderbilt Law Review* 343 (2021)

Available at: <https://scholarship.law.vanderbilt.edu/vjtl/vol42/iss2/1>

This Article is brought to you for free and open access by Scholarship@Vanderbilt Law. It has been accepted for inclusion in Vanderbilt Journal of Transnational Law by an authorized editor of Scholarship@Vanderbilt Law. For more information, please contact [mark.j.williams@vanderbilt.edu](mailto:mark.j.williams@vanderbilt.edu).



## Toward a Public Enforcement Model for Directors' Duty of Oversight

*Renee M. Jones\**

*Michelle Welsh\*\**

### ABSTRACT

*This Article proposes a public enforcement model for the fiduciary duties of corporate directors. Under the dominant model of corporate governance, the principal function of the board of directors is to oversee the conduct of senior corporate officials. When directors fail to provide proper oversight, the consequences can be severe for shareholders, creditors, employees, and society at large.*

*Despite general agreement on the importance of director oversight, courts have yet to develop a coherent doctrine governing director liability for the breach of oversight duties. In Delaware, the dominant state for U.S. corporate law, the courts tout the importance of board oversight in dicta, yet emphasize in holdings that directors cannot be personally liable for oversight failures, absent evidence that they intentionally violated their duties.*

---

\* Associate Professor, Boston College Law School, A.B., Princeton University, J.D. Harvard Law School.

\*\* Senior Lecturer, Workplace and Corporate Law Research Group, Monash University, Australia, B.A., L.L.B., L.L.M, Monash University, Ph.D. University of Melbourne. This Article benefited from comments from participants at the Conference on Corporate Governance and Business Ethics at Notre Dame Law School, the Panel on New Corporate Governance at the 2011 Annual Meeting of the Law and Society Association, and the Vanderbilt Law and Business Workshop. We would also like to thank Lisa Fairfax, Brian Galle, Ray Madoff, Dana Muir, Vlad Perju, and Brian Quinn for helpful comments on early drafts of this manuscript.

We argue that some form of external enforcement mechanism is necessary to ensure optimal conduct from corporate leaders. Unfortunately, the disciplinary force of shareholder litigation has been vitiated by procedural rules and doctrines that make it exceedingly difficult for plaintiffs to prevail in derivative litigation. Because private shareholder litigation no longer fulfills its traditional role, the need exists for alternative mechanisms for director accountability.

We look to Australian corporate law for solutions to the problem of enforcing the duty of oversight. Australian corporate law encompasses a range of enforcement mechanisms for directors' duties. The Australian Securities and Investments Commission (ASIC) has power to sue to enforce directors' statutory duties. ASIC can seek a range of penalties for breach of duty, including pecuniary penalties and officer and director bars. ASIC has prevailed in a number of high-profile actions against directors of public companies in recent years. Despite the relative rigor of enforcement in Australia, capable directors continue to serve and its economy has thrived.

The Article explores several possibilities for incorporating public enforcement into the U.S. corporate governance system. We consider SEC enforcement of fiduciary duties and enforcement by states' attorneys general. We also consider empowering state judges to impose bars on future service, as an alternative to tort-based damages awards. Regardless of the exact model of public enforcement, the reforms advanced here would help provide for greater director accountability and thus better motivate directors to perform their duties responsibly.

## TABLE OF CONTENTS

I.	INTRODUCTION .....	345
II.	THE FAILURE TO ENFORCE OVERSIGHT DUTIES IN THE UNITED STATES.....	351
	A. <i>The Monitoring Model of Corporate Governance</i> .....	351
	B. <i>Enforcing the Duty to Monitor</i> .....	353
	1. <i>The Derivative Suit</i> .....	353
	2. <i>Oversight Duties and Good Faith</i> .....	356
	C. <i>The Economic Consequences of Oversight Failures</i> .....	359
III.	ASSESSING DEFENSES OF THE LAX DIRECTOR LIABILITY REGIME .....	363
	A. <i>Common Defenses of Delaware's Lax Liability Regime</i> .....	363
	B. <i>Law Compliance Literature</i> .....	366

	1.	Flaws in the Norms Governance Hypothesis for Those Motivated by Normative and Social Factors.....	368
	2.	Flaws in the Norms Governance Hypothesis for Those Motivated by Calculated Factors.....	369
	3.	Multiple Motivating Factors.....	369
	C.	<i>Toward an Ideal Enforcement Regime</i> .....	370
IV.		PUBLIC ENFORCEMENT OF DIRECTORS' DUTIES IN AUSTRALIA.....	372
	A.	<i>The Development of Australia's Corporate Law Regime</i> .....	372
	B.	<i>The Basic Structure of Australian Corporate Law</i> .....	373
	1.	Sanctions for Breach of Duty.....	375
	2.	Prohibition on Indemnification and Company-Provided Insurance.....	377
	3.	The Rationale for the Civil Penalty Regime.....	377
	C.	<i>Enforcing the Duty of Care in Australia</i> .....	379
	1.	ASIC's Enforcement Record.....	381
	a.	The James Hardie Group.....	382
	b.	Other ASIC Cases.....	384
	2.	Assessing the Impact of ASIC Enforcement.....	386
V.		ENVISIONING PUBLIC ENFORCEMENT OF DIRECTORS' DUTIES IN THE UNITED STATES.....	390
	A.	<i>Some Advantages of Australia's Enforcement Regime</i> .....	392
	1.	Pecuniary Penalties.....	392
	2.	Disqualification Orders.....	393
	B.	<i>Implementing Public Enforcement</i> .....	394
	1.	Federalism Constraints.....	394
	2.	SEC Enforcement.....	395
	3.	State Enforcement.....	399
	a.	Administrative Action.....	399
	b.	Judicial Remedies.....	401
	C.	<i>Federalism's Conundrum</i> .....	402
VI.		CONCLUSION.....	403

## I. INTRODUCTION

The precipitous collapse of many of our major financial institutions has revealed significant flaws in the U.S. corporate

governance regime. Public inquiries into the failure of Bear Stearns, Lehman Brothers, and Citigroup consistently portray directors as oblivious to the scope of the risks their firms had undertaken. Directors remained blind to significant departures from approved risk management guidelines and failed to detect flaws in financial reporting practices that led to systematic underreporting of leverage and the concealment of devastating losses.

Since the 2008 financial collapse, Congress and financial regulators have adopted major reforms designed to prevent the recurrence of such calamities. Similarly, in 2002, Congress, the SEC and self-regulatory organizations adopted reforms aimed at preventing future financial frauds. Despite these major federal reform initiatives, a basic corporate governance problem remains unresolved. The 2001–2002 corporate governance scandals and the 2008 financial crisis have laid bare a basic reality. Directors are not providing the kind of corporate oversight that forms a fundamental tenet of the monitoring model of corporate governance.

The director's role as corporate monitor serves as an article of faith among most corporate theorists. Prestigious institutions, from the American Law Institute to the Business Roundtable, embrace the monitoring model. The monitoring model forms the basis of the Sarbanes-Oxley reforms that sought to strengthen the hand of independent directors vis-à-vis corporate management. Likewise, state judges, who act as principal enforcers of fiduciary duties, consistently emphasize the importance of board oversight. In judicial opinions and outside commentary, judges urge directors to pay attention, stay informed, and act as vigilant monitors of the conduct of corporate managers.

Despite broad acceptance of the monitoring model, courts have yet to develop a coherent doctrine governing director liability for the breach of oversight duties. In Delaware, the dominant state for U.S. corporate law, courts curiously tout the importance of board oversight in dicta, yet emphasize in holdings that directors cannot be personally liable for oversight failures, absent evidence that they intentionally violated their duties.<sup>1</sup> While setting a high bar for liability, courts have offered little guidance about the kinds of facts that would satisfy this arduous standard.

Many commentators defend this laissez-faire approach to enforcing directors' duties.<sup>2</sup> They argue that the law should stand

---

1. See, e.g., *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006) (affirming that a necessary condition for director oversight liability is "intentionally fail[ing] to act in the face of a known duty to act").

2. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90–98 (1991) (arguing that market discipline usually serves an adequate alternative to director liability for breach of fiduciary duty); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and*

aside to let private forces such as the market and social norms promote responsible conduct among corporate officials. These commentators maintain that a rigorous liability regime would harm shareholder interests by discouraging risk taking and deterring qualified directors from serving.<sup>3</sup> The risk of unfair hindsight bias, litigation costs, and shareholders' asserted ability to limit their risk exposure through portfolio diversification serve as further rationales for shielding directors from liability.<sup>4</sup>

Another reason courts refrain from enforcing the duty of oversight is that the penalties seem harsh when compared to an outside director's degree of responsibility for the alleged harm.<sup>5</sup> To avoid reaching what is perceived as an unjust result, courts have too often spared directors from any consequence for their failure to perform their core function.<sup>6</sup> This unwillingness to enforce the duty to monitor leaves directors with little guidance on the content of their duties, contributing to the kind of board passivity associated with recent corporate collapses.

When directors fail to provide proper oversight, the consequences can be severe for corporations, investors, employees, and society at large. Although markets and social factors can influence director behavior, some form of external discipline is necessary to ensure optimal

---

*the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1622 (2001) (arguing that firms exist to replace legal governance with non-legally-enforceable governance mechanisms).

3. See Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1140 (2006) ("[T]he limited out-of-pocket risk that we observe may well be sensible from a policy perspective."); cf. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996) ("[A] demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class . . . since it makes board service by qualified persons more likely . . .").

4. See E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1422-35 (2005) (describing the problems of encouraging risk aversion and hindsight bias as justifications for deference to director decisions).

5. See Renee M. Jones, *Law, Norms and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 148-50 (2006) (discussing judicial nullification of corporate law rules); see also Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 663-66 (1996) (discussing the impact of draconian damages in the context of securities litigation).

6. See John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 317 (1981) (discussing the "tendency of the law to nullify extreme penalties and to distort the substantive law in an effort to avoid punishments that do not fit the crime"); Langevoort, *supra* note 5, at 655 (noting that because directors are poorly situated to monitor, large damages awards against outside directors may not provide effective deterrence).

conduct. The shareholder lawsuit was created to serve this function.<sup>7</sup> Unfortunately, the disciplinary force of shareholder litigation has been vitiated by procedural rules and doctrines that make it exceedingly difficult for plaintiffs to prevail in derivative litigation. Because private shareholder litigation no longer fulfills its traditional role, the need exists for alternative mechanisms for director accountability.

We look to Australian corporate law for possible solutions to the problem of enforcing the duty of oversight.<sup>8</sup> U.S. and Australian corporate law both emerge from the “Anglo-American” common law tradition. Thus, the United States and Australia share the same basic corporate governance structure. Like the United States, Australia has a highly developed economy with sophisticated trading markets, characterized by dispersed share ownership.<sup>9</sup> In recent decades however, Australia has revamped its corporate law system, confronting the difficulties that federalism posed to maintaining uniform national standards and bolstering mechanisms for enforcing the obligations of corporate officers and directors.<sup>10</sup> Thus, despite a shared legal tradition, enforcement practices in Australia now diverge significantly from U.S. custom.<sup>11</sup>

---

7. See JAMES D. COX & THOMAS L. HAZEN, BUSINESS ORGANIZATION LAW 442 (3d ed. 2011) (“Shareholder derivative suits are the principal remedy by which defrauded minority shareholders may call directors, officers, promoters and controlling shareholders to account for mismanagement, diversion of assets, and fraudulent manipulation of corporate affairs.”); Ann M. Scarlett, *A Better Approach for Balancing Authority and Accountability in Shareholder Derivative Litigation*, 57 U. KAN. L. REV. 39, 57 (2008) (“Shareholder derivative litigation constitutes the formal method of accountability in the corporate context.”).

8. We draw a comparative portrait between the United States and Australia with a simple and pragmatic purpose. Our goal is to discern possible solutions to a set of seemingly intractable problems by studying how a different approach to enforcing directors’ duties has fared abroad. We find the Australian comparison fruitful because that country has implemented several policies that U.S. commentators often assert would have disastrous impact on our economy. Thus, Australia can serve, in a manner, as a laboratory for testing some of the strongest arguments invoked in defense of the United States’ lax director liability regime.

9. Share ownership is more concentrated in Australia than in the United States. See Jennifer G. Hill, Ronald W. Masulis & Randall S. Thomas, *Comparing CEO Employment Contract Provisions: Differences Between Australia and the United States*, 64 VAND. L. REV. 559, 561 (2011) (characterizing shareholding ownership in U.S. capital markets as dispersed while acknowledging that this is not the case in Australia). However, recent studies show that share ownership in both countries is more concentrated than commonly believed. *Id.* at 561 n.7.

10. See *infra* note 148 (discussing the evolution of a national corporate law regime in Australia).

11. For prior articles that compare directors’ duties and enforcement in the United States and Australia, see Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385 (2006); John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229 (2007); Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT’L L.J. 367 (2005) [hereinafter Hill, *Regulatory Responses*]; Jennifer G. Hill, *Subverting*

The Australian example matters in part because its financial regulatory system has drawn the attention of commentators in the United States and throughout the world. Its “twin peaks” approach to financial regulation has been held up as a model for global financial reform initiatives.<sup>12</sup> Under twin peaks, responsibility for financial regulation is divided according to regulatory objectives, with a systemic risk regulator and a business conduct regulator.<sup>13</sup> The twin peaks approach figured prominently in former Treasury Secretary Henry Paulson’s “Blueprint” for financial reform and in the Group of 30’s similar set of recommendations.<sup>14</sup> Although the Blueprint and the G-30 report recommend that the United States adopt a version of the twin peaks model, these proposals pay little heed to important differences in the authority of the Australian Securities and Investments Commission (ASIC) when compared with the U.S. financial regulators.

In Australia, ASIC functions as the business conduct regulator.<sup>15</sup> ASIC has the power to sue to enforce the statutory duties of all corporate directors and can seek a range of penalties including pecuniary penalties and officer and director bars. In recent years, ASIC has prevailed in a number of high-profile actions against directors of public companies. Yet, despite the relative rigor of Australia’s enforcement system, the parade of horrors that commentators insist would follow from imposing liability on outside directors has not occurred. In fact, Australia has fared far better than

---

*Shareholder Rights: Lessons from News Corp.’s Migration to Delaware*, 63 VAND. L. REV. 1 (2010); Cindy A. Schipani, *Defining the Corporate Directors’ Duty of Care Standard in the United States and Australia*, 4 AUSTL. J. CORP. L. 152 (1994).

12. See MICHAEL TAYLOR, TWIN PEAKS: A REGULATORY STRUCTURE FOR THE NEW CENTURY 1 (1995) (proposing a financial regulatory structure designed around the twin peaks of prudential regulation and investors and consumer protection); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 715, 782 (2009) (endorsing the “twin peaks” model as part of a new financial regulatory structure).

13. This contrasts with the functional model in place in the United States where regulatory authority is allocated according to business function with multiple regulators overseeing various aspects of the operations of large financial conglomerates. See GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE 14–15, 34–35 (2009), available at <http://www.group30.org/images/PDF/The%20Structure%20of%20Financial%20Supervision.pdf> (describing the U.S. approach to financial regulation as functional with some aspects of an institutional model).

14. See DEPT OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 141–50 (2008), available at <http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf> (discussing the benefits of twin peaks’ “objectives based” approach to financial regulation); GRP. OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 34 (2009), available at [http://www.group30.org/images/PDF/Financial\\_Reform-A\\_Framework\\_for\\_Financial\\_Stability.pdf](http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf) (arguing for a variant of the twin peaks approach to financial supervision).

15. *Australian Securities and Investments Commission Act 2001* (Cth) s 1(1) (Austl.).

the United States in the wake of the recent global financial crisis.<sup>16</sup> Unlike the United States, no major Australian banks failed during the crisis.<sup>17</sup>

This Article explores several possibilities for implementing public enforcement of directors' duties in the United States. We first consider SEC enforcement of fiduciary duties. We then assess enforcement by states' attorneys general. We also consider empowering state judges to impose sanctions for oversight breaches, such as a bar on future service, as an alternative to tort-based damage awards. Although we acknowledge obstacles to adopting a public enforcement regime in the United States, the proposed reforms are less radical than they may appear at first blush.

The SEC already has power to bring enforcement actions against directors for conduct that in substance constitutes a breach of fiduciary duty. Similarly, state regulators enjoy power to enforce the duties of directors of nonprofit corporations.<sup>18</sup> Because ample precedent exists for public enforcement of fiduciary duties, expanding regulators' authority to enforce the duties of directors of business corporations would be a logical extension of existing law and practice.

This Article proceeds in five parts. Part II examines the U.S. corporate governance system and outlines obstacles to enforcing directors' oversight duties. The Article connects the failure of American courts to enforce the duty of oversight with a culture of inattention and passivity that seems to pervade the contemporary corporate boardroom. Part III addresses the main arguments courts and scholars invoke to defend the lax director liability regime. It examines the various factors that motivate individuals to comply with their legal obligations by surveying existing literature on law compliance. It concludes that although social and normative factors influence compliance, a need still exists for external accountability mechanisms for corporate directors. Part IV provides an overview of Australia's corporate law enforcement regime, focusing on public enforcement actions by ASIC. Part V then identifies elements of

---

16. The global financial crisis had less of an impact in Australia than it did in many other countries. For example, Australia managed to avoid a recession and the current seasonally-adjusted unemployment rate is 5.1 percent. *Labour Force, Australia, Jul 2011*, AUSTL. BUREAU STAT., <http://www.abs.gov.au/AUSSTATS/abs@.nsf/allprimarymainfeatures/8E87BDF474F2BD55CA2579040013C94D?opendocument> (last updated Sept. 11, 2011).

17. The reasons that Australia managed to avoid the fallout of the global financial crisis lie beyond the scope of this Article. We simply note that Australia has experienced greater economic stability than the United States despite maintaining a more rigorous corporate regulatory regime. For a discussion of some reasons why Australia fared comparatively well in the global financial crisis, see generally Elizabeth F. Brown, *A Comparison of The Handling of The Financial Crisis in the United States, The United Kingdom, and Australia*, 55 VILL. L. REV. 509 (2010).

18. See JESSE DUKEMINIER ET AL., *WILLS, TRUSTS, AND ESTATES* 785–86 (8th ed. 2009) (discussing attorney general oversight of charities).

Australia's public enforcement system that merit consideration in the United States. It highlights the bar on future service as a remedy that would enhance the accountability of corporate officials. It also explores several possible approaches to adopting such reforms and addresses likely obstacles to implementation. Part VI concludes.

## II. THE FAILURE TO ENFORCE OVERSIGHT DUTIES IN THE UNITED STATES

### A. *The Monitoring Model of Corporate Governance*

In the United States, corporate statutes vest directors with the power to manage the business and affairs of the corporation.<sup>19</sup> Because directors have the legal power to direct a corporation's affairs, they also bear the burden of exercising such power responsibly. Thus corporate law imposes fiduciary duties of loyalty and care on directors. In the modern corporation, directors delegate their management power to officers who run the day-to-day affairs of the corporation. Although such delegation is proper, directors are expected to oversee the conduct of senior officers in their execution of management functions. Thus, in theory at least, directors remain responsible for anything that goes wrong on their watch.

Although this delegation of authority is the accepted norm, the legal regime still expects directors to do "something." Exactly what this "something" entails can be difficult to discern, as a wide gap exists between ideal director conduct expressed by popular "best practice" standards, and the minimum level of performance necessary to shield directors from liability for a corporation's losses.<sup>20</sup> Although the precise steps a director must take to fulfill his duties in any given context remains unclear, courts and commentators agree on the general contours of a director's obligations.

The most significant obligation of the modern corporate director is to oversee the conduct of corporate executives.<sup>21</sup> This oversight

---

19. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2011) ("The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.").

20. See Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 438 (1993) ("[S]tandards of review in corporate law pervasively diverge from the standards of conduct.").

21. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.02 (Revisions to the Proposed Final Draft 1992) (discussing the oversight functions and responsibilities of a board of directors); BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 7 (2010), available at [http://businessroundtable.org/uploads/studies-reports/downloads/2010\\_Principles\\_of\\_Corporate\\_Governance\\_1.pdf](http://businessroundtable.org/uploads/studies-reports/downloads/2010_Principles_of_Corporate_Governance_1.pdf) (describing the roles of corporate directors and

duty is broad, but can be divided into several distinct components. First, at a minimum, directors must pay some attention to the corporation's affairs. They must understand the business, review financial statements, and attend board meetings.<sup>22</sup> Directors should participate actively in meetings by reviewing relevant documents and asking questions before making important decisions.<sup>23</sup> If at any time directors sense that something is awry, they must inquire further, and consult experts or hire lawyers if necessary.<sup>24</sup>

Courts also expect the board to monitor the corporation's compliance with law. Directors must establish a monitoring system designed to prevent, detect, and correct a corporation's violations of law.<sup>25</sup> In addition to monitoring law compliance, directors bear responsibility for overseeing the corporation's financial reporting system. Although directors do not prepare or audit financial reports, they must oversee the work of the audit firm. The Sarbanes-Oxley Act of 2002 affirms directors' obligations in this regard.<sup>26</sup> Sarbanes-Oxley makes clear that directors must hire the auditors, set their compensation and meet regularly with them to discuss the company's most significant financial reporting issues.<sup>27</sup> The audit committee of the board of directors bears the bulk of this responsibility.<sup>28</sup>

More recently, courts and scholars have begun to focus on directors' responsibility for overseeing corporate risk.<sup>29</sup> Although risk

management); COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES ¶ 2.7 (2011), available at <http://www.cii.org/UserFiles/file/council%20policies/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2012-21-11%20FINAL.pdf> (describing the board's role in risk oversight).

22. *Francis v. United Jersey Bank*, 432 A.2d 814, 821–23 (N.J. 1981); see also *Hoye v. Meek*, 795 F.2d 893, 896–97 (10th Cir. 1986) (holding director liable for failing to monitor the actions of bank president, who was also his son); FRANKLIN A. GEVURTZ, *CORPORATION LAW* 280 (2d ed. 2010) (“The vast majority of opinions, however, are consistent with *Francis* in demanding that directors pay some attention to their role.”).

23. *COX & HAZEN*, *supra* note 7, at 203.

24. See *Hoye*, 795 F.2d at 896 (“Where suspicions are aroused, or should be aroused, it is the directors’ duty to make necessary inquiries.”); *Francis*, 432 A.2d at 823 (“[T]he fulfillment of the duty of a director may call for more than mere objection and resignation. Sometimes a director may be required to seek the advice of counsel.”).

25. See *Stone v. Ritter*, 911 A.2d 362, 368–69 (Del. 2006) (endorsing and applying *Caremark*’s legal compliance rule); *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (stating that corporate boards must “assur[e] themselves that information and reporting systems exist in the organization” in order to satisfy their obligation to be reasonably informed).

26. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

27. *Id.* § 301 (codified at 15 U.S.C. § 78j-1 (2006)).

28. *Id.*

29. See, e.g., Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 967–68 (2009) (examining liability of corporate directors for failures in risk management during the 2008 financial crisis); Franklin A. Gevurtz, *The Role of Corporate Law in Preventing a Financial Crisis: Reflections on In re Citigroup Inc. Shareholder Derivative Litigation*, 23 MCGEORGE PAC. GLOBAL BUS.

management does not fall squarely within directors' traditional duties, the financial crisis has highlighted the importance of director engagement on this issue.<sup>30</sup> Commentators have also taken note of how executive compensation schemes seem to promote a short-term focus, creating incentives for managers to take unreasonable risks in pursuit of short-term gains.<sup>31</sup> The prevalence of incentives to engage in reckless risk taking increases the need for directors to closely monitor operational risk.

### B. Enforcing the Duty to Monitor

#### 1. The Derivative Suit

In theory, a director's failure to fulfill his fiduciary duty exposes him to personal liability for any damages the corporation or its shareholders suffer as a result of the breach. The derivative lawsuit gives shareholders power to bring a suit in the name of the corporation for breach of fiduciary duty.<sup>32</sup> Traditionally, the derivative suit has served as the principal mechanism for enforcing directors' duties.<sup>33</sup> For a variety of reasons, however, the shareholder suit has ceased to function as an effective disciplinary tool. First, a range of judicial doctrines, procedural rules, statutory protections, and contractual arrangements protect directors from any real risk of personal liability.<sup>34</sup> In addition, Delaware courts have imposed a low substantive standard when assessing director performance.

---

& DEV. J. 113, 113–20 (2010) (discussing the role of excessive risk in Citigroup's near collapse); Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 54–57 (2010) (reviewing recent literature on oversight liability suits); Eric J. Pan, *Rethinking the Board's Duty to Monitor: A Critical Assessment of the Delaware Doctrine*, 38 FLA. ST. U. L. REV. 209, 225–31 (2011) (assessing a board's duty to monitor business risk).

30. See, e.g., *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 123 (Del. Ch. 2009) (assessing a *Caremark* claim against directors for their alleged failures to properly monitor the riskiness of subprime mortgage investments).

31. See, e.g., Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 262–67 (2010) (describing how bankers' compensation structures encourage excessive risk taking); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 362–64 (2009) (proposing a requirement that executives retain all equity compensation awards until two to four years following termination of employment in order to discourage short-term risk taking); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1226–41 (2011), available at <http://ssrn.com/abstract=1546229> (proposing debt-based compensation to discourage short-term risk taking).

32. GEVURTZ, *supra* note 22, at 407–08.

33. See Scarlett, *supra* note 7, at 57 (characterizing shareholder derivative litigation as the “formal method of accountability in the corporate context”).

34. See Black, Cheffins & Klausner, *supra* note 3, at 1059–62 (presenting an empirical study demonstrating the rarity of out-of-pocket payments by outside directors); Lynn A. Stout, *On Proper Motives of Corporate Directors (or, Why You Don't*

The business judgment rule offers directors an initial layer of protection from personal liability. Under the business judgment rule, courts refrain from second-guessing directors' decisions untainted by self-dealing, illegality, waste, or fraud.<sup>35</sup> Thus, directors will not be held to account for ill-advised decisions, so long as a rational basis for the decision can be found.

In addition, special procedural rules that apply in derivative litigation make it exceedingly difficult for plaintiffs to prevail on their claims. The demand requirement mandates that plaintiffs first make demand on the board to take corrective action or plead that such a demand would be futile.<sup>36</sup> In cases where plaintiffs establish demand futility, the board of directors can still wrest control of the litigation by appointing a special litigation committee to assess the wisdom of pursuing the claims.<sup>37</sup> Such committees typically conclude that continuing the litigation is not in the corporation's interest and move to dismiss the lawsuit on that basis.<sup>38</sup> In general, Delaware courts have been deferential to the conclusions of the special litigation committee.<sup>39</sup> However, in several high-profile cases, the courts rejected the special committee's motion to dismiss, concluding that the committee members were not sufficiently independent of the directors being sued.<sup>40</sup>

The most significant barrier to director liability for oversight failures are exculpatory provisions adopted in every state that

*Want to Invite Homo Economicus to Join Your Board*), 28 DEL. J. CORP. L. 1, 7 (2003) (arguing that corporate directors rarely have to pay damages in a breach of duty case).

35. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds* by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

36. *Id.* at 814–15. To successfully plead demand futility, plaintiffs must allege with particularity facts demonstrating that a majority of the directors had an interest in the challenged transaction or that their decision is not otherwise protected by the business judgment rule. If the court determines the plaintiffs have not properly pled demand futility, their claims will be dismissed. *Id.*

37. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981) (“The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation’s best interest.”).

38. GEVURTZ, *supra* note 22, at 434 (“Special litigation committees usually have concluded that the derivative suits which the committees looked into were not in the corporation’s best interest.” (citations omitted)); Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1786 (2010) (“By and large, the SLCs in my study recommended dismissal of the claims.”); cf. Minor Myers, *The Decisions of the Corporate Special Litigation Committees: An Empirical Investigation*, 84 IND. L.J. 1309, 1311 (2009) (“SLCs do not uniformly decide to dismiss derivative litigation. They sought some form of formal relief much more frequently than heretofore recognized: approximately forty percent of the time, SLCs pursued or settled claims against one or more defendants.”).

39. GEVURTZ, *supra* note 22, at 454–57 (describing Delaware courts’ approach to evaluating recommendations of special litigation committees).

40. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 921 (Del. Ch. 2003) (denying the special litigation committee’s motion to terminate litigation for lack of impartiality); *Biondi v. Scrushy*, 820 A.2d 1148, 1165 (Del. Ch. 2003) (concluding that the special litigation committee could not meet its burden to prove independence).

immunize directors from liability for the breach of the duty of care.<sup>41</sup> In Delaware, for example, § 102(b)(7) of the Delaware General Corporation Law allows corporations to eliminate directors' personal liability for breach of fiduciary duty other than breach of the duty of loyalty, intentional misconduct, knowing violations of law, improper dividends, and acts and omissions "not in good faith."<sup>42</sup> Although the interpretation of the term "good faith" has attracted significant scholarly attention, recent Delaware cases make clear that liability for oversight failures will not lie, absent a director's intentional dereliction of duty.<sup>43</sup>

Additional contractual arrangements further insulate directors from any negative consequence of their oversight failures. Under standard indemnification provisions, corporations pay all costs associated with defending suits brought against directors in their official capacity.<sup>44</sup> Any judgments and settlements that cannot lawfully be indemnified can be covered by director and officer liability policies purchased by the corporation.<sup>45</sup> Although indemnification and insurance provisions limit payments in certain circumstances, most cases are settled in a manner that ensures that such exclusions are never triggered.<sup>46</sup>

---

41. See Anne Tucker Nees, *Who's the Boss? Unmasking Oversight Liability Within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 218–19 (2010) (describing the prevalence and operation of statutory exculpation provisions).

42. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). Section 102(b)(7) authorizes inclusion in the corporate charter of:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

*Id.*

43. See, e.g., *Stone v. Ritter*, 911 A.2d 362, 369–70 (Del. 2006) (stating that a necessary condition for director oversight liability is "intentionally fail[ing] to act in the face of a known duty to act").

44. See, e.g., DEL. CODE ANN. tit. 8, § 145(a) (2011) ("A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding . . . by reason of the fact that the person is or was a director, officer, employee or agent of the corporation . . ."); see also Black, Cheffins & Klausner, *supra* note 3, at 1083–84 (noting that under Delaware law corporations may indemnify directors for damages, settlements and legal expenses as long as the director acted in good faith).

45. See DEL. CODE ANN. tit. 8, § 145(g) (allowing Delaware corporations to purchase D&O insurance); Black, Cheffins & Klausner, *supra* note 3, at 1085 (noting that almost all companies provide insurance for their officers and directors that cover legal expenses, damages, and settlements).

46. See TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT* 49 (2010) (observing that the vast majority of shareholder claims settle without final

## 2. Oversight Duties and Good Faith

Due to the prevalence of exculpatory provisions in corporate charters, a director's failure to provide proper oversight will not result in personal liability under Delaware law unless the plaintiff can show that a director failed to act in good faith.<sup>47</sup> Delaware courts' interpretation of the term "good faith" has thus become the determinative factor for the viability of an enforceable duty of oversight. The phrase "good faith" is nowhere defined in the Delaware's corporate statute and courts have struggled to impart meaning to the term.

At one point, it appeared that a failure to act in good faith might include conduct that could be classified as "especially" gross negligence—conduct that was not a classic breach of the duty of loyalty but was culpable enough to merit legal sanction.<sup>48</sup> Delaware courts later clarified that they will not impose liability for inattentiveness or gross negligence unless plaintiffs can prove "bad faith" by showing that directors *intentionally* violated their duties.<sup>49</sup> Thus, under emerging good faith doctrine, even mechanistic efforts by boards to review monitoring systems can create a virtually impenetrable shield from liability, with little regard to the actual effectiveness of such systems.

The *Caremark* line of cases demonstrates the courts' effort to promote board oversight while at the same time declining to hold directors personally accountable for lapses in oversight.<sup>50</sup> *In re*

---

adjudication and that plaintiffs craft pleadings to avoid allegations of intentional fraud to avoid triggering policy exclusions).

47. Section 102(b)(7) can be invoked as an affirmative defense at a motion to dismiss. To survive the motion to dismiss, plaintiffs must plead "with particularity" facts showing that directors acted in bad faith—that they acted with intent to harm the corporation or knowingly and intentionally breached their duties. *See In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 135 (Del. Ch. 2009) (dismissing claims for failure to sufficiently plead facts that could support a finding that the directors acted or made material omissions in bad faith). Of course, it is not sufficient to simply plead "the directors knew they were breaching their duties." Instead, the plaintiff must allege facts that shed light on the directors' state of mind. This must be done without the benefit of discovery, which might allow plaintiffs to unearth documents that reveal the directors' state of mind or otherwise create a reasonable suspicion that the directors acted in bad faith.

48. *See* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 4–6 (2005) (noting that recent cases treat good faith as an "independent basis for decision" rather than merely a shorthand for duty of care); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 464 (2004) ("As a separate duty, good faith can attach to situations beyond those invoking loyalty concerns . . .").

49. *See* *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) ("[A] showing of bad faith . . . is essential to establish director oversight liability . . .").

50. *See* Jennifer Arlen, *The Story of Allis-Chalmers, Caremark and Stone: Directors' Evolving Duty to Monitor*, in *CORPORATE LAW STORIES* 323, 339–42 (J. Mark Ramseyer ed., 2009) (describing Chancellor William Allen's hope that, despite the

*Caremark International Inc. Derivative Litigation*<sup>51</sup> presents the modern formulation of a director's oversight duties by rejecting as outdated the Delaware Supreme Court's earlier pronouncement in *Graham v. Allis-Chalmers*.<sup>52</sup> In *Caremark*, the court asserted that directors have a duty to ensure that a monitoring system exists that is capable of providing directors with "timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."<sup>53</sup>

*Caremark's* assertion of the existence of a duty to monitor was mere dicta, as the judge was considering a motion to approve a settlement. While touting the importance of director oversight duties, the court concluded that no breach of duty had likely occurred, as the board had adopted a compliance program that nonetheless failed to prevent the legal violations.<sup>54</sup> Indeed, the directors were aware of the conduct that was the basis for federal sanctions. However, Chancellor Allen concluded that, because lawyers had advised the board that the practices in question were "contestable, [but] lawful," the board had likely fulfilled its duty to monitor.<sup>55</sup>

Under *Caremark*, a board's failure to create a monitoring system would constitute a breach of the duty of care, and as an unconsidered failure to act, would not be protected by the business judgment rule.<sup>56</sup> However, *Caremark* also provides that once a monitoring system is in place, the board's decisions as to the scope and adequacy of the system are business decisions that lie beyond judicial scrutiny, save for certain exceptions to the business judgment rule.<sup>57</sup> Thus, under *Caremark*, once a corporation has put a compliance system in place, courts will not hold directors responsible for damages even if the monitoring system fails.<sup>58</sup> Although *Caremark* was framed as a duty of care decision, the court invoked good faith as the standard by which to assess the board's process in adopting the monitoring

---

narrow standard of review it endorsed, his *Caremark* opinion "would alter directors' behavior through its moral suasion and associated impact on directors' norms").

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

52. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (holding that directors had no duty to "ferret out wrongdoing" and would not be liable for a corporation's violation of law unless they knew or should have known about the violations).

53. *Caremark*, 698 A.2d at 970.

54. *Id.* at 971-72.

55. *Id.* at 971.

56. *Id.* at 968-70.

57. *Id.* at 970.

58. *See Stone v. Ritter*, 911 A.2d 362, 370-73 (Del. 2006) (indicating that as long as the reporting system is reasonable, a board will not have to monitor every decision by its officers); *Caremark*, 698 A.2d at 970 (acknowledging that even good faith information and reporting systems sometimes will fail to reveal problems).

system.<sup>59</sup> Because a director's "acts or omissions not in good faith" are beyond the protection of an exculpatory provision, *Caremark* allowed for a theoretical risk of personal liability.

Years after the *Caremark* ruling, a series of decisions in the *Disney* litigation created uncertainty regarding whether a director's gross inattention to business matters could result in personal liability as a failure to act in good faith.<sup>60</sup> In 2003, the Delaware Chancery Court surprised observers when it denied a motion to dismiss a claim against Disney's directors for approving Disney president Michael Ovitz's employment agreement with its lucrative termination provisions.<sup>61</sup> The court concluded that the plaintiffs adequately pled that the directors failed to act in good faith by alleging that they paid insufficient attention to an important business matter, "adopting a 'we don't care about the risks' attitude concerning a material corporate decision."<sup>62</sup>

The 2003 *Disney* decision caused a stir, as the legal community had long presumed that § 102(b)(7) protected directors from personal liability for any lapses other than the breach of the duty of loyalty. In *Stone v. Ritter* however, the Delaware Supreme Court quelled any lingering fears among directors that the *Disney* decisions had raised. In *Stone*, the court announced that the duty to act in good faith was not an independent duty, but was instead a subset of the duty of loyalty.<sup>63</sup> The court ruled that oversight failures that amounted to the breach of the duty of good faith were nonexculpable breaches of the duty of loyalty.<sup>64</sup> However, the court also reiterated *Caremark*'s admonition that it would be extremely difficult for plaintiffs to succeed on such a claim.<sup>65</sup>

Thus under *Stone*, to prevail on an oversight claim, plaintiffs must show that directors failed to act in the face of a known duty to act, by demonstrating the board's "utter failure" to implement a monitoring and reporting system or a conscious failure to monitor or oversee the operation of such a system.<sup>66</sup> As put succinctly in *Stone*, plaintiffs must show not only that oversight failures led to corporate

---

59. See *Caremark*, 698 A.2d at 970 (emphasizing a director's obligation to "exercise a good faith judgment" that the corporation's information and reporting system is adequate).

60. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003).

61. *Disney*, 825 A.2d at 275.

62. *Id.* at 289.

63. *Stone*, 911 A.2d at 370.

64. *Id.*

65. See *id.* at 372 (noting with approval the description of an oversight claim in *Caremark* as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment"); Pan, *supra* note 29, at 232-33 (describing the practical difficulties of successfully arguing a failure to monitor claim).

66. *Stone*, 911 A.2d at 370.

losses, but that the directors knew that they were breaching their duties and simply did not care.<sup>67</sup> Despite arguably raising the bar for pleading a duty to monitor claim, the Delaware courts have offered little guidance as to how plaintiffs might successfully plead the required facts regarding the directors' state of mind.<sup>68</sup>

The Court of Chancery's more recent decision in *In re Citigroup Inc. Shareholder Derivative Litigation* underscores the challenges plaintiffs face in seeking to recover for directors' oversight failures.<sup>69</sup> In *Citigroup*, the plaintiffs alleged that Citigroup's directors failed to adequately monitor financial risks that brought the company to the brink of collapse.<sup>70</sup> The Court of Chancery dismissed the claim, concluding that because Citigroup had established an audit and risk management committee that met multiple times per year and was charged with monitoring corporate risk, the plaintiffs' oversight claim must fail.<sup>71</sup> The court declined to inquire as to whether the committee did anything useful, or whether despite the monitoring system, enough facts had come to the directors' attention to alert them that risk management policies needed to be adjusted.<sup>72</sup> Instead, the court concluded that despite the ostensible duty of oversight, Citigroup's directors were not responsible for the company's spectacular collapse.<sup>73</sup>

### C. The Economic Consequences of Oversight Failures

The need for an effective accountability mechanism for oversight responsibilities becomes stark when one considers the serious consequences that often flow from oversight failures. Many would argue that Citigroup's near collapse is an instance in which the absence of effective oversight led to catastrophic consequences for the firm, its investors, and the nation.<sup>74</sup>

As one of the world's largest financial conglomerates, Citigroup was highly profitable during the early and mid-2000s, reporting profits of about \$24 billion and \$21 billion in 2005 and 2006

---

67. See *id.* (“[I]mposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”).

68. Pan, *supra* note 29, at 211.

69. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

70. *Id.* at 111–12.

71. See *id.* at 128.

72. See Bainbridge, *supra* note 29, at 986 (describing the demands imposed on the board in *Citigroup* as “strikingly modest” and noting that “[t]he court did not drill down into the details of what the audit committee actually did with respect to risk management”).

73. *Citigroup*, 964 A.2d at 131 (“Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.”).

74. GEVURTZ, *supra* note 22, at 236–37 (noting the financial bailouts as an example of the societal impact of corporate failures).

respectively.<sup>75</sup> Its apparent success began to unravel in October 2007 when it suddenly announced the write-down of \$5.9 billion in assets.<sup>76</sup> Within a year, losses had mounted to more than \$65 billion, half of which were attributed to investments in mortgage-backed securities.<sup>77</sup> In the fall of 2008, Citigroup became the fourth major financial firm to require government rescue.<sup>78</sup>

A surfeit of evidence unearthed by journalists and government investigators suggests that Citigroup's directors and senior managers actively encouraged a high-risk strategy that included massive investments in subprime assets, including collateralized debt obligations (CDOs).<sup>79</sup> After urging this embrace of risk, the directors

---

75. CITIGROUP ANNUAL REPORT 2006, at 1 (2006), available at [http://www.citigroup.com/citi/fin/data/ar06c\\_en.pdf?ieNocache=702](http://www.citigroup.com/citi/fin/data/ar06c_en.pdf?ieNocache=702).

76. Eric Dash, *Banks Admit Loan Losses; Stocks Rally*, N.Y. TIMES, Oct. 2, 2007, at A1.

77. Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1. Other Wall Street firms experienced similar problems as the subprime mortgage market continued to falter. Merrill Lynch wrote off \$8.4 billion in late October 2007 and fired its CEO, Stanley O'Neal. Eric Dash, *The Price of Any Departure Will Be at Least \$159 Million*, N.Y. TIMES, Oct. 27, 2007, at A12. In March 2008, Bear Stearns was sold in a fire sale to JP Morgan Chase. Jenny Anderson, *Aftershocks of a Collapse, with a Bank at the Epicenter*, N.Y. TIMES, Mar. 18, 2008, at C1. Mortgage giants Fannie Mae and Freddie Mac were taken over by the government in September 2008, and other major banks, including Washington Mutual and IndyMac, failed or were rescued during the period. The crisis finally came to a head in September 2008 when Lehman Brothers declared bankruptcy and Merrill Lynch was rescued by Bank of America's acquisition. Eric Dash, *5 Days of Pressure, Fear and Ultimately, Failure*, N.Y. TIMES, Sept. 16, 2008, at A1; Eric Dash, *Purchase of Merrill Fulfills Quest for a Bank*, N.Y. TIMES, Sept. 15, 2008, at A18; Louise Story, *Regulators Seize IndyMac After a Run on the Bank*, N.Y. TIMES, July 12, 2008, at C5; Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES, Sept. 25, 2008 at A1.

On September 18, after rescuing insurance giant AIG, Treasury Secretary Henry Paulson asked Congress for authority to spend up to \$700 billion to purchase toxic assets from weakened financial firms. Congress passed the Emergency Economic Stabilization Act (known informally as Troubled Asset Relief Program or TARP) on October 3, 2008. Mark Landler & Edmund L. Andrews, *For Treasury Department, Now Comes Hard Part of Bailout*, N.Y. TIMES, Oct. 3, 2008, at A1. On October 13, Citigroup received \$25 billion in initial TARP funds. However, by November, the firm was still struggling, leading to a second round of TARP assistance in the form of a \$20 billion preferred stock purchase along with a federal guarantee of \$306 billion of assets on the firm's balance sheet. David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup*, WALL ST. J., Nov. 24, 2008, at A1.

78. Eric Dash, *U.S. Approves Plan to Help Citigroup Weather Losses*, N.Y. TIMES, Nov. 24, 2008, at A1.

79. Dash & Creswell, *supra* note 77, at A1. Citigroup had embarked on this high-octane strategy at the urging of Robert Rubin, chairman of the executive committee of the board of directors, who counseled CEO Charles Prince to embrace risk to enable the firm to match the performance of competitors such as Goldman Sachs and Morgan Stanley. *Id.*

failed to adequately monitor the implementation of the strategy.<sup>80</sup> Further, contemporaneous reports from regulators and public and private lawsuits had exposed serious weaknesses in Citigroup's risk management practices, internal controls, and ethical standards.<sup>81</sup> For example, in 2005 the Federal Reserve imposed a moratorium on additional acquisitions by Citigroup due to prolonged concerns about internal control weaknesses and poor risk management at the firm.<sup>82</sup> Likewise, the Office of Comptroller of the Currency repeatedly expressed concerns over Citigroup's lax risk management.<sup>83</sup> In addition, from 2001 through 2005, Citigroup paid billions of dollars to settle regulatory and private actions that highlighted management and ethical problems, including participation in the Enron frauds, financial analyst fraud, mortgage origination fraud, and more.<sup>84</sup>

Compounding the board's monitoring lapses, Citigroup's directors failed to react as evidence of weakness in real estate and subprime came to the fore. Instead, the firm continued its high-risk strategy focused on CDOs and securitizations, and in fact moved to enhance its exposure in that sector.<sup>85</sup> As the real estate market softened, Citigroup ramped up its subprime mortgage operations, churning out mortgage backed securities and CDOs without properly monitoring its exposure.<sup>86</sup> Reportedly, CEO Charles Prince did not become aware of the full extent of the firm's subprime exposure until September 2007 when it was too late for the firm to recover.<sup>87</sup>

These kinds of observations formed the gravamen of the plaintiffs' complaint in *Citigroup*, which the chancery court gave short shrift. Because Citigroup had established an audit and risk management committee, the court concluded that the plaintiffs could not demonstrate the "utter failure" to implement a monitoring system that *Caremark* and *Stone* require.<sup>88</sup> As to *Caremark*'s second prong of failing to heed red flags, the plaintiffs' efforts also faltered.<sup>89</sup>

---

80. See THE FIN. CRISIS INQUIRY COMM'N [FCIC], THE FINANCIAL CRISIS INQUIRY REPORT 137-39 (2011), available at <http://www.gpoaccess.gov/fcic/fcic.pdf> (showing that the Citigroup CDO group did not adequately assess risk).

81. For example, Citigroup paid \$2.65 billion to settle investor securities fraud claims in connection with the WorldCom failure. It also paid \$2 billion to settle Enron investors' claims. In addition, the firm paid \$400 million to settle federal and state claims in connection with analyst fraud and to settle regulators' mortgage fraud claims. See *id.* at 59-60, 137.

82. *Id.* at 137; see also Gevurtz, *supra* note 29, at 118-19 (stating that the failure Citigroup's internal risk controls contributed to the company's downfall).

83. FCIC, *supra* note 80, at 137, 198-99.

84. *Id.* at 60, 92, 137.

85. *Id.* at 195-99; Gevurtz, *supra* note 29, at 118-19.

86. Dash & Creswell, *supra* note 77, at A1.

87. *Id.*

88. *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 137 (Del. Ch. 2009).

89. *Id.* at 115, 124.

Although the plaintiffs pointed to a number of events and reports that should have alerted directors to looming problems, the court rejected their claim. Instead, the court concluded that the red flags cited were too broad and exogenous to Citigroup to put the board on notice of problems occurring at the firm.<sup>90</sup>

The court's analysis in *Citigroup* glosses over the fact that corporate law and best practice standards require directors to pay attention to corporate affairs and industry trends in addition to understanding the company's financial statements.<sup>91</sup> Thus, legitimate questions linger regarding Citigroup's directors' failure to respond to alarming news of softness in the real estate market, mounting mortgage losses at other banks, and the rapid deterioration in the value of its subprime assets.<sup>92</sup> An additional concern is whether the directors were aware of the scope of Citigroup's subprime exposure, and if not, why not. Such questions go to the heart of directors' oversight responsibilities, but the Delaware court spared the directors of any requirement to address these questions when it dismissed plaintiffs' claims.<sup>93</sup>

---

90. *Id.* at 128 ("The 'red flags' in the complaint amount to little more than portions of public documents that reflected the worsening conditions in the subprime mortgage market and in the economy generally.").

91. See *Hoye v. Meek*, 795 F.2d 893, 896–97 (10th Cir. 1986) (holding a director liable for breach of the duty of care for failing to monitor investment decisions, delegating too much authority, and failing to respond to the company's increasing exposure to risk); *Francis v. United Jersey Bank*, 432 A.2d 814, 826 (N.J. 1981) (holding that a director's obligations include "reading and understanding financial statements, and making reasonable attempts at detection and prevention of the illegal conduct of other officers and directors").

92. It is especially telling that soon after the cataclysmic events of 2007, Citigroup began to search for new directors with "expertise in finance and investments." *Citigroup Director Search*, CITIGROUP INC., <http://www.citigroup.com/citi/corporategovernance/directorsearch.htm>. (last visited Mar. 1, 2012).

93. A federal court assessing the culpability of Citigroup officials for financial disclosure violations reached different conclusions regarding certain Citigroup officials' responsibility for investors' losses. In *In re Citigroup Inc. Securities Litigation*, 753 F. Supp. 2d 206 (S.D.N.Y. 2010), the District Court for the Southern District of New York allowed several securities fraud claims against Citigroup and certain of its directors and officers to proceed. The court concluded that the plaintiffs had pled facts adequate to create a strong inference that directors Charles Prince and Robert Rubin acted with scienter in failing to disclose the extent of the company's subprime risk exposure. *Id.* at 237–38. Although Charles Prince was an insider, as a nonexecutive chairman, Robert Rubin was considered an outside director of Citigroup. *Id.* at 239.

The issues in the *Citigroup* securities litigation differed from the matter before the court in Delaware. However, in common was the question of scienter—defendants' knowledge with respect to material facts. In contrast to the Delaware decision, the federal district court concluded that plaintiffs had alleged enough facts to create a "strong inference" that the Citigroup defendants knew of the extent of Citigroup's subprime risks yet failed to disclose those risks to investors. *In re Citigroup*, 753 F. Supp. 2d at 237.

Similarly, in *In re Countrywide Financial Corp. Derivative Litigation*, 554 F. Supp. 2d 1044 (C.D. Cal. 2008), a district court in California excused demand for state-based

The point is not to argue that Citigroup's directors breached their oversight duties and should be held liable for their failures, but rather that by dismissing the complaint, the Delaware Chancery Court precluded reaching a conclusion on the matter. The dismissal on procedural grounds spared directors of the need to explain or justify their actions or inaction. Because of Delaware's hands-off approach to oversight liability, cases like *Citigroup* are rarely adjudicated and corporate directors are deprived of meaningful guidance about what their duties entail.<sup>94</sup>

### III. ASSESSING DEFENSES OF THE LAX DIRECTOR LIABILITY REGIME

#### A. Common Defenses of Delaware's Lax Liability Regime

Many corporate scholars have expressed concern about the absence of personal accountability in the U.S. corporate governance regime. Professor Geoffrey Miller recently labeled Delaware's fiduciary duty of care "broken" and called for judicial reforms that would provide more meaningful guidance to directors regarding their duties.<sup>95</sup> Similarly, Professor Donald Langevoort has lamented the fact that corporate executives rarely contribute personally to shareholder settlements despite the large fortunes they often amass at the corporate helm.<sup>96</sup> Other scholars have raised similar concerns, calling both for increased clarity from courts on the contours of directors' duties and a willingness to impose liability in appropriate cases.<sup>97</sup>

---

oversight claims against Countrywide directors, in which plaintiffs alleged the directors failed to monitor the bank's exposure to the subprime market and failed to respond to the sustained derogation of mortgage underwriting standards at the bank. For a further discussion of the *Countrywide* decision, see Pan, *supra* note 29, at 235–37.

94. See Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 329 (2010) (arguing that the lack of "realistic" opportunities for attorneys' fees and the likelihood of settlement prevents judges from offering opinions about the quality of management's decision-making processes, and there are, consequently, few cases and very little commentary).

95. See Miller, *supra* note 94, at 320 ("Delaware's duty of care is broken. Although the state purports to police against gross negligence by corporate directors, it does nothing of the sort . . . . Worse, the fantasy that Delaware monitors director performance creates an unhealthy misconception that someone is minding the store.").

96. Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 630 (2007) (arguing that executives responsible for corporate fraud should forfeit the wealth they obtained "as a result of their control over the firm during the time of the wrongdoing").

97. See, e.g., Rutheford B. Campbell, Jr., *Normative Justifications for Lax (or No) Corporate Fiduciary Duties: A Tale of Problematic Principles, Imagined Facts and Inefficient Outcomes*, 99 KY. L.J. 231, 233 (2010) (arguing for a robust fiduciary

Although some scholars have criticized Delaware's "good faith" jurisprudence,<sup>98</sup> the dominant position among U.S. corporate scholars is to defend the Delaware approach. Professors Brian Cheffins and Bernard Black provide an apt statement of the position:

[W]e suggest that the existing pattern of [minimal] liability risk could reflect sensible public policy. Reputational concerns can motivate outside directors to be vigilant even when they have little fear of ending up out of pocket in a lawsuit. Moreover, substantial liability risk could have negative corporate governance consequences. Capable people, fearing financial ruin, might decline directorships; boards could spend too much time on the wrong things; and boardroom decision-making could become counterproductively cautious.<sup>99</sup>

Professors Cheffins and Black's assertions echo a common refrain often repeated to defend Delaware's lax approach to enforcing fiduciary duties. Examples of such reasoning are evident in Chancellor Allen's landmark *Caremark* decision. In *Caremark*, Chancellor Allen asserted that there are "good policy reasons why it is so difficult to charge directors with responsibility for corporate losses for an alleged breach of care, where there is no conflict of interest or no facts suggesting suspect motivation involved."<sup>100</sup> A more vigorous director liability regime, he claimed, would harm shareholders because "directors will tend to deviate from [the] rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to *ex post facto* claims of derivative liability for any resulting corporate loss."<sup>101</sup>

Other corporate scholars maintain that liability for breach of the duty of care is unnecessary because extralegal forces such as social norms provide adequate constraints on board misconduct.<sup>102</sup> Such

---

standard for corporate managers); Lisa A. Fairfax, *Spare the Rod and Spoil the Director? Revitalizing Directors Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 395 (2005) ("Legal liability represents an essential mechanism for ensuring directors' fidelity to their fiduciary duties."); Jones, *supra* note 5, at 145–46 (calling on judges to impose penalties for breaches of fiduciary duty in appropriate cases); Elizabeth A. Nowicki, *Director Inattention and Director Protection under Delaware General Corporation Law Section 102(b)(7): A Proposal for Legislative Reform*, 33 DEL. J. CORP. L. 695, 697 (2008) (asserting that "the threat of punishment via personal liability exposure" has potential to be a powerful tool to combat director inattention).

98. See Nees, *supra* note 41, at 204–206 (criticizing Delaware doctrine on oversight liability); Pan, *supra* note 29, at 211 (same).

99. Cheffins & Black, *supra* note 11, at 1389.

100. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

101. *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

102. These arguments can be traced back to the so-called New Chicago School. Members of the New Chicago School sought to identify mechanisms that would allow the government to exploit the power of norms to elicit or reinforce desirable social conduct. They reasoned that if one could employ laws to manipulate social norms, there would be less need for direct legal commands or state imposed sanctions. *E.g.*, Jones,

scholars insist that we need not worry that fiduciary duties lack formal methods of enforcement, because the conduct of corporate officials can be appropriately constrained by social norms.<sup>103</sup> These theorists focus on two mechanisms by which a permissive corporate law regime might still motivate desirable director conduct. First, some speculate that when judges articulate aspirational standards even while declining to impose penalties for a breach, they appeal to directors' internal motivations to be "good directors."<sup>104</sup> These well-intentioned directors will be influenced by judicial pronouncements regarding suboptimal director conduct even when no legal consequences flow from failures in corporate oversight.<sup>105</sup>

Similarly, some commentators suggest that judges can shame directors when they criticize their conduct in opinions that ultimately conclude no breach of duty occurred.<sup>106</sup> For example, Professor Edward Rock has argued,

A system that relies on public shaming is perfectly suited to [the corporate] context[:]. The cost to the actor—the disdain in the eyes of one's acquaintances, the loss of directorships, the harm to one's reputation—may often be sufficiently great to deter behavior, even without anything more.<sup>107</sup>

This shame is thought to come from reading judges' caustic language knowing it may be reprinted in the *Wall Street Journal* or memorialized in corporate law casebooks and Lexis and Westlaw

---

*supra* note 5, at 121–23. For a broader summary and critique of corporate law and norms theories, see *id.* at 125–44.

103. See, e.g., Black, Cheffins & Klausner, *supra* note 3, at 12 ("If near-zero liability risk is optimal, it is in substantial part because other sources of incentives already do much to motivate outside directors to do a good job."); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1796–97 (2001) (arguing that directors will usually heed fiduciary duties despite the lack of legal incentives to do so); Rock & Wachter, *supra* note 2, at 1670–71 (asserting that corporate governance "works much better" when the duty of care is a non-legally-enforceable rule).

104. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1103–04 (1997).

105. The Delaware Chancery Court's trial opinion in the *Disney* litigation provides an example of this reasoning. Despite exonerating all of the defendants, Chancellor Chandler, and many contemporary commentators, invoked norms-based arguments to explain the decision's potential impact. See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 698 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("[T]he Opinion may serve as guidance for future officers and directors—not only of The Walt Disney Company, but of other Delaware corporations."); Sandeep Gopalan, *Shame Sanctions and Excessive CEO Pay*, 32 DEL. J. CORP. L. 757, 767 (2007) (suggesting that cases like *Disney* may make directors more conscious of their responsibilities even though the case did not hold the director liable); Martha Neil, *Disney Case Has No Storybook Ending*, 4 A.B.A. J. E-REPORT, no. 35, 2005, at 5 (stating that the *Disney* decision will lead directors to pay more attention to their duties).

106. Rock, *supra* note 104, at 1103; David A. Skeel, *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1823–26 (2001).

107. Rock, *supra* note 104, at 1104.

databases.<sup>108</sup> There is scant evidence that such shaming actually influences director conduct. In fact, the major corporate failures that have characterized the past decade suggest otherwise. Yet to some, the very possibility that this may occur helps to justify a lax director liability regime.<sup>109</sup>

### B. Law Compliance Literature

Norms governance claims figure prominently in the standard defenses for lax liability standards in corporate law. Yet, studies on the factors that motivate law compliance raise doubts as to whether norms alone, without support from law, are sufficient to motivate optimal levels of compliance. In 2001, Søren Winter and Peter May reviewed many of these studies and concluded that the factors motivating compliance fall into three broad categories: normative factors, social factors, and calculated factors.<sup>110</sup>

In their framework, a normative motivation toward compliance stems from an individual's "internalized values or moral reasoning,"<sup>111</sup> and an acceptance of the legitimacy and importance of the law.<sup>112</sup> An individual's general moral principles or sense of civic duty contribute to a normative willingness to comply with a given requirement.<sup>113</sup> So too does the individual's evaluation of the value of a given rule or regulation.<sup>114</sup>

External social factors motivating compliance stem from a desire to be respected and approved of by others.<sup>115</sup> The desire to avoid negative publicity associated with an enforcement action<sup>116</sup> and the consequential shame, guilt,<sup>117</sup> and disapproval<sup>118</sup> are important social

108. *Id.* at 1103; see also Jonathan A. Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1134 (2005) (noting that directors "do not like to be made the object of public scorn and ridicule").

109. Macey, *supra* note 109, at 1134.

110. Søren C. Winter & Peter J. May, *Motivation for Compliance with Environmental Regulations*, J. POL'Y ANALYSIS & MGMT. 675, 675 (2001).

111. Yuval Feldman & Doron Teichman, *Are All Legal Probabilities Created Equal?*, 84 N.Y.U. L. REV. 980, 993 (2009).

112. TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 25–26 (1990) (discussing the role of legitimacy in motivating law compliance); Winter & May, *supra* note 110, at 677.

113. Winter & May, *supra* note 110, at 677.

114. *Id.* at 678.

115. *Id.*

116. See Christine Parker & Vibeke Lehmann Nielsen, *How Much Does It Hurt? How Australian Businesses Think About the Costs and Gains of Compliance and Noncompliance with the Trade Practices Act*, 32 MELB. U. L. REV. 554, 593–94 (2008) (demonstrating that the greater the perceived risk of being caught in noncompliance by third parties, the higher respondents perceive both the costs and gains of compliance to be).

117. Feldman & Teichman, *supra* note 111, at 994.

factors motivating compliance.<sup>119</sup> Social factors differ from normative factors in that those motivated by social factors comply in order to gain approval, even when they do not have an internalized commitment to the particular requirement.<sup>120</sup> However, over time those motivated by social factors may internalize these values and become normatively committed to compliance.<sup>121</sup>

Calculated factors include the costs of compliance, likelihood of detection, and likely penalties. According to classic deterrence theory, the likelihood that an actor will comply with a rule can be determined by the expected utility of compliance versus noncompliance.<sup>122</sup> Central to the calculation of the cost and benefits of noncompliance is the role of enforcement and deterrence. As Winter and May argue, the cost–benefit “calculus is affected by likelihood of detection—and by the speed, certainty, and size of the sanction imposed. As such, the enforcement regime is, theoretically at least, an important component of calculations of expected utility.”<sup>123</sup>

The Winter and May framework helps to contextualize the norms governance hypothesis, which maintains that market and social sanctions are sufficient to deter misconduct and breach of duty by corporate officials. The norms governance hypothesis emphasizes the force of normative and social factors, but fails to take account of the influence of calculated factors. It therefore oversimplifies the relationship between law, norms, and the conduct of directors.

There are two principal reasons why the norms governance hypothesis falls short. First, it fails to take into account that the way persons motivated by normative and social factors perceive the law is influenced by the vigor with which the law is enforced. Secondly, the norms governance hypothesis does not adequately address how to manage those directors who are primarily motivated by calculated factors, in the absence of a realistic threat of formal sanctions.

---

118. John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 LAW & SOC'Y REV. 7, 8 (1991).

119. Vibeke Lehmann Nielsen & Christine Parker, *To What Extent Do Third Parties Influence Business Compliance?*, 35 J.L. & SOC'Y 309, 329 (2008). A study of attitudes toward compliance with Australian Trade Practices Law conducted by Parker and Nielsen found that Australian businesses are concerned about how any noncompliance may be viewed by various third parties including customers, shareholders, employees, and business partners. Christine Parker & Vibeke Lehmann Nielsen, *What Do Australian Businesses Really Think of the ACCC, and Does It Matter?*, 35 FED. L. REV. 187 (2007) (Austl.). While not statistically significant, the authors did find some evidence that these concerns may have some positive impact on some aspects of compliance. *Id.* at 234.

120. Winter & May, *supra* note 110, at 678.

121. *Id.*

122. *Id.* at 676.

123. *Id.*

### 1. Flaws in the Norms Governance Hypothesis for Those Motivated by Normative and Social Factors

As one of us has previously argued, the disciplinary power of norms alone cannot adequately regulate the behavior of corporate officials.<sup>124</sup> A normative motivation toward compliance stems from an individual's "internalized values or moral reasoning"<sup>125</sup> and an acceptance of the legitimacy and importance of the law.<sup>126</sup>

Perceptions of the law's legitimacy and import are shaped in part by enforcement practices. An individual's understanding of his or her moral obligations will be influenced by both the vigor with which the law is enforced, and the severity of sanctions that are imposed.<sup>127</sup> If the law is not enforced or penalties are negligible, observers will likely conclude that the standard does not really matter, and the failure to satisfy the standard becomes unproblematic from either a moral perspective or out of concern for reputation.<sup>128</sup>

Despite the important social message that enforcement policies convey, law and norms scholars maintain that the desire to avoid negative emotions or bad publicity associated with a corporate failure or disastrous decision can help motivate corporate officials to attend diligently to their duties, even though a breach will not likely result in formal sanctions.<sup>129</sup> This argument overlooks the reality that the impact of social factors will wane in situations where enforcement practices are lax, or where penalties for breach of duty are minimal. Thus, the risk exists that without external accountability mechanisms, certain undesirable conduct will become more commonplace and therefore more widely tolerated. In this way, acceptable norms of board conduct may be replaced over time with unacceptable norms.<sup>130</sup>

---

124. Jones, *supra* note 5, at 127.

125. Feldman & Teichman, *supra* note 111, at 993.

126. Winter and May, *supra* note 110, at 677.

127. Jones, *supra* note 5, at 130.

128. See Fairfax, *supra* note 97, at 428–32 (noting the failure of reputational concerns to appropriately motivate Enron's directors); Miller, *supra* note 94, at 328–29 (noting the failure of Delaware's judicial decisions to deliver clear moral messages).

129. See *supra* text accompanying notes 102–09.

130. Examples include mutual fund market timing, options backdating, subprime lending abuses, and other forms of fraud that directors and corporate officers readily overlooked, which soon became common practices in the affected industries. See Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 108, 117–19 (2004).

## 2. Flaws in the Norms Governance Hypothesis for Those Motivated by Calculated Factors

Even if normative and social factors do carry the disciplinary force that its proponents ascribe to them, not every corporate actor will be sufficiently motivated by normative and social factors. Some corporate actors are influenced more by calculated factors, and will disregard legal standards when the benefits of noncompliance outweigh the perceived costs. The norms governance hypothesis fails to grapple adequately with the problem of the recalcitrant actor.

For corporate officers and directors, the benefits of lax oversight may include the relatively minor benefit of the time saved as a consequence of inaction. For some directors passivity and silence may be the perceived price for maintaining one's board position and its attendant benefits. Other perceived benefits of lax monitoring may include financial and other benefits that flow to the corporations and indirectly to individual officers and directors as a result of a failure to comply with legal or regulatory requirements. In reality, even a minor benefit may be enough to induce noncompliance if the perceived costs of noncompliance are sufficiently low.

A functioning accountability system matters most for those who are motivated principally by calculated factors. For a person motivated by calculated factors, increasing the likelihood of enforcement can increase one's commitment to compliance.<sup>131</sup> A pessimistic view of human nature lies at the center of deterrent-based strategies.<sup>132</sup> Deterrence based strategies rely on the availability of some mechanism to hold responsible the person or corporation engaged in misconduct.

## 3. Multiple Motivating Factors

Recent scholarship on law compliance suggests that it oversimplifies matters to assume that a single motivating factor can be ascribed to any individual.<sup>133</sup> Instead, such scholarship suggests that it is most likely that each person is motivated by multiple factors to comply with their duties, and that various motivations come to the forefront at different points in time. As Winter and May observe, while calculated, normative, and social motivating factors are sometimes presented as competing bases of compliance, the three are not mutually exclusive.<sup>134</sup>

---

131. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (presenting the deterrence perspective on law compliance).

132. SALLY S. STIMPSON, CORPORATE CRIME, LAW AND SOCIAL CONTROL 94 (2002).

133. See *supra* text accompanying notes 110–23.

134. Winter & May, *supra* note 110, at 676.

Other commentators have concluded that the factors motivating compliance will vary for different people, and further note that an individual's motivations may shift over time. For example, John Braithwaite and Ian Ayres assert that corporate actors will be motivated to comply with laws and regulatory requirements by a range of factors.<sup>135</sup> In their view, some corporate actors may be driven to act by a sense of social responsibility or a commitment to ethical behavior, whereas others will be driven purely by economic factors.<sup>136</sup> Some will be induced to act by a combination of these and other factors.<sup>137</sup> In addition, the factors driving the behavior of individuals may change over time.<sup>138</sup> The norms governance hypothesis ignores this dynamic.

### C. *Toward an Ideal Enforcement Regime*

Literature on law compliance demonstrates that regulators benefit from having a range of tools to address individuals and corporations that are motivated by different factors for compliance.<sup>139</sup> The lesson of these studies is that a successful regulatory regime should have at its disposal mechanisms that allow virtuous actors the chance to be virtuous and to comply voluntarily with the law. Ideally, an effective legal system would marshal the forces of normative and social factors to induce compliance with the law in the absence of detection. Indeed, society could not function if most citizens did not voluntarily comply with the law most of the time. However, a successful regime must also include mechanisms to penalize violations of the law in order to entice nonresponsive actors to comply.<sup>140</sup>

135. See, e.g., IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992) (arguing under responsive regulation theory that a regulatory agency will not be able to detect and enforce every contravention of the law it administers and therefore must have mechanisms at its disposal that it can utilize to encourage regulated persons to comply with the law); JOHN BRAITHWAITE, *TO PUNISH OR PERSUADE: ENFORCEMENT OF COAL MINE SAFETY* (1985) (same); George Gilligan et al., *Civil Penalties and the Enforcement of Directors' Duties*, 22 U.N.S.W. L.J. 417, 426 (1999) (arguing responsive regulation theory encourages regulators to utilize the enforcement regimes at their disposal in such a way as to "stimulate maximum levels of regulatory compliance").

136. AYRES & BRAITHWAITE, *supra* note 135, at 24.

137. *Id.*

138. *Id.*

139. See, e.g., Parker & Nielsen, *supra* note 119, at 195 ("[R]esponsive regulation, responds to the plurality and complexity of the motivations and contextual factors that influence compliant and non-compliant behavior by saying that regulators should also use multiple enforcement strategies in contextually sensitive ways.").

140. AYRES & BRAITHWAITE, *supra* note 135, at 26. Responsive regulation theory has been applied in many contexts. See FIONA HAINES, *CORPORATE REGULATION: BEYOND "PUNISH OR PERSUADE"* (1997) (applying theory to an analysis of corporate response to deaths at work); Darryl Brown, *Street Crime, Corporate Crime and the*

In the absence of concrete consequences for the failure to adhere to a legal standard, the standard loses force as a guide for behavior for those motivated by normative, social, and calculated factors. As the recent corporate debacles suggest, aspirational standards have failed to guide directors of many prominent corporations to act as vigilant overseers of corporate operations.<sup>141</sup> The lax liability regime has not in fact induced the responsible conduct that its proponents asserted it would.<sup>142</sup> It thus appears that the prolonged failure by courts to enforce fiduciary standards has contributed to an erosion of conduct standards across the corporate landscape.

In Australia, courts have been called upon to evaluate the conduct of directors of corporations that failed or became embroiled in scandal. The Australian courts evaluate director conduct under an objective standard.<sup>143</sup> As a result, prominent directors of several public corporations in Australia have faced significant civil sanctions.<sup>144</sup> Yet, contrary to the fears of many U.S. commentators, the higher standard of conduct has neither led to a rash of director

---

*Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295 (2001) (applying theory to criminal liability); Todd Lochner & Bruce Cain, *Equity and Efficacy in the Enforcement of Campaign Finance Laws*, 77 TEX. L. REV. 1891 (1999) (applying theory to campaign finance reform); Lawrence W. Sherman, *Defiance, Deterrence, and Irrelevance: A Theory of the Criminal Sanction*, 30 J. RES. CRIME & DELINQ. 445, 452 (1993) (arguing that procedural justice, fairness, or legitimacy of experienced punishment is essential to the acknowledgment of shame, which conditions deterrence).

141. As with investigative reports into the Enron and WorldCom failures, several investigations into the causes of the 2008 financial crisis have concluded that the directors, and to some extent, senior managers of failed firms were unaware of the extent of risk the firms had incurred, and the firms' failures to fully disclose these risks. For accounts of firms involved in the financial crisis, see *In re Citigroup Inc. Sec. Litig.*, 753 F. Supp. 2d 206 (S.D.N.Y. 2010); Report of Anton R. Valukas, Examiner, *In re Lehman Bros. Holdings Inc.*, (Bankr. S.D.N.Y. 2010) (No. 08-13555), available at <http://online.wsj.com/public/resources/documents/lehmanvol2.pdf>; FCIC, *supra* note 80, at xii. For thorough accounts of the WorldCom and Enron failures, respectively, see RICHARD C. BREEDEN, *RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF: THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC.* (2003), available at <http://law.du.edu/images/uploads/restoring-trust.pdf>; SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., *REPORT OF INVESTIGATION* (2002), available at <http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

142. FCIC, *supra* note 80, at xxvii–xxviii (“[W]e found dramatic breakdowns of corporate governance, profound lapses in regulatory oversight, and near fatal flaws in our financial system.”). For partial disavowals by former advocates of market regulation, see, for example, *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 18 (2008) (statement of Alan Greenspan, Former Chairman, Fed. Reserve Bd.) (noting that the market, alone, cannot provide adequate incentives to protect shareholders); Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 26, 2008, at A1 (quoting former SEC Chairman Christopher Cox as noting “[t]he last six months have made it abundantly clear that voluntary regulation does not work”).

143. *Corporations Act 2001* (Cth) s 180(1) (Austl.).

144. For a thorough discussion of judicial review of director conduct in Australia, see *infra* Part IV.C.

resignations, nor resulted in any discernible negative impact on the Australian economy.<sup>145</sup>

Through public enforcement of corporate law, Australia has overcome many of the standard objections voiced in the United States to more vigorous enforcement of directors' duties. The concern with discouraging strike suits fades under a public enforcement regime. Similarly, judicial hesitation to impose draconian penalties is dampened because penalties can be calibrated based on the culpability of the defendants. With public enforcement, regulators can bring actions in the public interest even absent the prospect of a big payoff for lawyers. Finally, public enforcement offers mechanisms that can protect investors and the public from future harms that may be visited by unfit or inattentive directors, as regulators are able to obtain orders disqualifying directors from managing public companies upon proof of a breach of the duty of care.

#### IV. PUBLIC ENFORCEMENT OF DIRECTORS' DUTIES IN AUSTRALIA

The Australian approach to enforcing directors' duties differs significantly from U.S. practice. It has long been accepted in Australia that it is appropriate to provide a range of enforcement mechanisms for the duties of directors. Australian directors who breach their duties may be subject to public enforcement by ASIC in addition to private civil enforcement. The Australian statutory regime allows ASIC to seek a range of orders including pecuniary penalties and officer and directors bans. In recent years, ASIC has obtained significant orders against directors of several high-profile companies.

##### A. *The Development of Australia's Corporate Law Regime*

Australian corporate law is governed by the 2001 Australian Corporations Act (the Corporations Act).<sup>146</sup> ASIC, the national

---

145. See *infra* Part IV.C.2 (evaluating the impact of enforcement in Australia).

146. *Corporations Act 2001* (Austl.). Until recently, Australian corporate law was state-based as the Australian Constitution does not give the Commonwealth Parliament clear power to make law with respect to all companies. The lack of uniformity across the states and territories created difficulties, leading to several unsuccessful attempts to standardize the law beginning in the 1960s. By the early 1980s, arrangements were in place which resulted in the same corporate law being applied in all Australian states and territories. However, it was not until 2001, when each state agreed to refer their constitutional power to the Commonwealth Parliament, that a truly national legislative scheme was adopted. For a history of the development of Australia company law, see ROBERT AUSTIN & IAN RAMSAY, *FORD'S PRINCIPLES OF CORPORATIONS LAW* (14th ed. 2010); PHILLIP LIPTON, ABE HERZBERG & MICHELLE WELSH, *UNDERSTANDING COMPANY LAW* (15th ed. 2010).

corporate regulator, is an independent Commonwealth government body charged with regulating “Australian companies, financial markets, financial services organizations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit.”<sup>147</sup> ASIC has a variety of enforcement mechanisms at its disposal, including the civil penalty provisions that are the focus of this Article.

### B. *The Basic Structure of Australian Corporate Law*

Directors of Australian corporations are subject to fiduciary and statutory duties. The fiduciary duties include the duty of loyalty and care and the duty to avoid conflicts of interest. The statutory directors’ duties require all directors to “exercise their powers and discharge their duties with a reasonable degree of care and diligence,”<sup>148</sup> and to act in the best interests of the corporation and for proper purposes.<sup>149</sup> All directors, other officers, and employees are subject to additional statutory duties not to improperly use their position<sup>150</sup> and not to improperly use certain information.<sup>151</sup> The statutory duties apply to directors of both public and private companies.<sup>152</sup> They do not replace the fiduciary duties but operate in addition to them.<sup>153</sup>

The duty that most resembles the U.S. duty of oversight is the duty of care and diligence. Section 180(1) of the Corporations Act states:

---

147. *Our Role*, AUSTRALIAN SECURITIES AND INVESTMENT COMMISSION, <http://www.asic.gov.au/asic/asic.nsf/byheadline/Our+role?openDocument#who> (last visited Mar. 1, 2012). For a history of corporate regulators in Australia, see Bernard Mees & Ian Ramsay, *Corporate Regulators in Australia (1961–2000): From Companies Registrars to ASIC*, 22 AUSTRALIAN JOURNAL OF CORPORATE LAW 212 (2008).

148. *Corporations Act 2001* s 180(1) (Austl.).

149. *Id.* s 181(1).

150. *See id.* s 182(1) (“A director, secretary, other officer or employee of a corporation must not improperly use their position to: (a) gain an advantage for themselves or someone else; or (b) cause detriment to the corporation.”).

151. *See id.* s 183(1) (“A person who obtains information because they are, or have been, a director or other officer or employee of a corporation must not improperly use the information to: (a) gain an advantage for themselves or someone else; or (b) cause detriment to the corporation.”). For a discussion of the history of directors’ duties in Australia, see Jason Harris, Anil Hargovan & Janet Austin, *Shareholder Primacy Revisited: Does the Public Interest Have Any Role in Statutory Duties*, 26 COMPANY & SECURITIES LAW JOURNAL 355, 360–61 (2008).

152. *See Corporations Act 2001* s 9 (defining “director” without distinguishing between directors of private and public companies).

153. *See id.* s 185 (“Sections 180 to 184 . . . have effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person because of their office or employment in relation to a corporation.”). For a discussion of the relationship between statutory remedies under the Corporations Act and equitable remedies, see generally Joachim Dietrich & Thomas Middleton, *Statutory Remedies and Equitable Remedies*, 28 AUSTRALIAN BUSINESS REVIEW 136 (2006).

A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they: (a) were a director or officer of a corporation in the corporation's circumstances; and (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.<sup>154</sup>

This section imposes an objective "reasonable person" standard. The standard of care varies according to the type of company, the type of office held, and the responsibilities of the individual director. However, while the standard may vary, it is clear that the law imposes minimum standards of care and diligence on all directors.

The duty of care requires directors to "take reasonable steps to place themselves in a position to guide and monitor the management of a company."<sup>155</sup> Directors are under a continuing obligation to make inquiries and keep themselves informed about all aspects of the company's business operations and financial position.<sup>156</sup> Directors are allowed to make business judgments and take commercial risks, but they cannot safely proceed on the basis of ignorance and a failure to inquire. They cannot shut their eyes to corporate misconduct.<sup>157</sup>

The duty of care is subject to a business judgment rule contained in s 180(2) of the Corporations Act.<sup>158</sup> However, directors in Australia have rarely invoked the business judgment rule. On the few occasions when directors attempted to rely on the business judgment rule, they

154. *Corporations Act 2001* s 180(1).

155. *See Daniels v Anderson* (1995) 118 FLR 248, 306 (Austl.) (discussing the responsibilities of directors).

156. *See Austl. Sec. & Inv. Comm'n v Healey* [2011] FCA 717, ¶ 17 (Austl.) (listing the responsibilities a director has as including "keep[ing] informed about the activities of the corporation"); *Vines v Austl. Sec. & Inv. Comm'n* (2007) 233 FLR 1, 82 (Austl.) (emphasizing that the director should have taken steps to be sure he stayed informed of relevant matters); *Daniels* (1995) 118 FLR at 308 (citing *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924)); *Commonwealth Bank of Austl. v Friedrich* (1991) 5 ACSR 115 (Austl.) ("[A] director is expected to be capable of understanding his company's affairs to the extent of actually reaching a reasonably informed opinion of its financial capacity.").

157. *Daniels* (1995) 118 FLR at 309.

158. *See Corporations Act 2001* s 180(2). Under s 180(2):

A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they: (a) make the judgment in good faith for a proper purpose; (b) do not have a material personal interest in the subject matter of the judgment; (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and (d) rationally believe that the judgment is in the best interests of the corporation. The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

*Id.* Section 180(3) defines business judgment as "any decision to take or not take action in respect of a matter relevant to the business operations of the corporation." *Id.* s 180(3).

were unsuccessful.<sup>159</sup> A possible explanation for this is that any behavior by a director that constituted a breach of the duty of care in s 180(1) would likely negate the business judgment rule in s 180(2).<sup>160</sup>

Like the United States, Australian fiduciary duties run to the corporation and can be enforced by the corporation itself or by its shareholders via a derivative suit.<sup>161</sup> However, unlike the United States, the Australian statutory regime allows ASIC to take enforcement action against directors personally in response to alleged breaches of the statutory duties.<sup>162</sup> The statutory directors' duties are enforced under the civil penalty regime.<sup>163</sup> ASIC can commence these actions when it is in the public interest to do so.<sup>164</sup>

### 1. Sanctions for Breach of Duty

The civil penalty orders that can be sought include pecuniary penalties, disqualification, and compensation orders. The maximum pecuniary penalty that can be imposed following a declaration that a director has breached the statutory duties is AUD \$200,000 per breach.<sup>165</sup> Pecuniary penalty orders can be imposed where the contravention of duty "materially prejudices the interests of the corporation or scheme, or its members; or materially prejudices the corporation's ability to pay its creditors; or is serious."<sup>166</sup> Pecuniary

---

159. Michael Legg & Dean Jordan, *The Australian Business Judgment Rule after ASIC v Rich*, 62 KEEPING GOOD COMPANIES 388 (citing *Austl. Sec. & Inv. Comm'n v Adler* (2002) 168 FLR 253 as an example where directors unsuccessfully attempted to rely on the business judgment rule).

160. *Id.* at 389.

161. *Id.* s 236 (granting shareholders the right to bring proceedings on behalf of the company).

162. *Id.* ss 1317E, 1317J(1) (allowing ASIC to issue proceedings seeking civil penalty orders following a contravention of the statutory directors' duties). The statutory scheme also allows corporations to seek compensation orders following a contravention of a statutory duty. *See id.* s 1317J(2).

163. *See Corporations Act 2001* s 1317J (detailing who may apply for a declaration or order enforcing civil consequences when there is a contravention of civil penalty provisions). A breach of the statutory duties other than the duty of care may, under certain circumstances, constitute a criminal offense and criminal sanctions may be imposed. *See generally Corporations Act 2001* ss 181–184 (discussing civil obligations and criminal sanctions). A contravention of the duty of care in s 180(1) cannot constitute a criminal offense. A civil penalty application is the most severe enforcement action that can be initiated by the ASIC in response to an alleged breach of the statutory duty of care. *Id.*

164. *See Australian Securities and Investments Commission Act 2001* (Cth) pt 1, div 1(2) (Austl.) (setting out ASIC's public interest objectives).

165. *Corporations Act 2001* s 1317G. The Australian dollar is roughly equivalent to USD \$1.07, making AUD \$200,000 equal to approximately USD \$214,000. *Australian Dollar to US Dollar Rate*, XE, <http://www.xe.com/ucc/convert/?Amount=1&From=AUD&To=USD> (last visited Mar. 1, 2012).

166. *Corporations Act 2001* s 1317G(1).

penalties ranging from AUD \$5,000 to \$450,000 have been imposed since the inception of the regime in 1993.<sup>167</sup>

Before the court can order the payment of compensation, it must be satisfied that a breach of duty has occurred and that the corporation has suffered damage as a result of that breach.<sup>168</sup> The amount of the compensation order cannot exceed the loss caused by the breach.<sup>169</sup> Punitive damages are not authorized.<sup>170</sup> Typically the amount ordered is equivalent to the loss caused by the director's breach,<sup>171</sup> although in some cases a lesser amount has been ordered.<sup>172</sup> Compensation orders have ranged from AUD \$65,000<sup>173</sup> to AUD \$92 million.<sup>174</sup>

The court may also order that a person be disqualified from managing corporations for a period it thinks appropriate if it is satisfied that disqualification is justified. Under s 206C(2) of the Corporations Act, "[i]n determining whether the disqualification is justified, the Court may have regard to: (a) the person's conduct in relation to the management, business or property of any corporation; and (b) any other matters that the Court considers appropriate."<sup>175</sup>

167. See *Austl. Sec. & Inv. Comm'n v Adler* [2002] NSWSC 483 (Austl.) (imposing pecuniary penalties of \$5,000 and \$450,000 on former directors of HIH).

168. See *Corporations Act 2001* ss 1317H(1), 1317HA(1) (clarifying requirements for compensation orders).

169. See *id.* s 1317H (providing that compensation can be ordered for damage suffered as a result of a contravention of the directors' duty provisions). The section does not specifically authorize compensation that exceeds the amount of damage suffered. *Id.*

170. See *id.* (providing for compensatory damages only).

171. For example, in *Australian Securities & Investment Commission v Rich* (2003) 44 ACSR 682 (Austl.), Mr. Keeling, a former director of One.Tel Ltd., consented to a declaration of contravention being made that he contravened the duty of care. The loss caused by the contravention was AUD \$92 million. *Id.* A compensation order for that amount was imposed. *Id.*

172. For example, the quantum of the compensation order was less than the loss caused by the defendant's contravention in *Australian Securities & Investment Commission v Forem-Freeway Enterprises Pty. Ltd.* (1999) 30 ACSR 339 (Austl.). In this case, Justice Madgwick stated it would be difficult to accurately assess the amount of the loss that had resulted from the defendant's contravention. *Id.* As the defendant was bankrupt and there was little chance of any recovery, there was no need to precisely assess the amount of the loss. *Id.*

173. *Austl. Sec. & Inv. Comm'n v Petsas* (2005) 23 ACLC 269 (Austl.).

174. *Rich* (2003) 44 ACSR 682.

175. *Corporations Act 2001* (Cth) s 206C(2) (Austl.). Under s 206A(1), a person who has been disqualified from acting as a director pursuant to the civil penalty regime commits an offense if:

- (a) they make, or participate in making, decisions that affect the whole, or a substantial part, of the business of the corporation; or
- (b) they exercise the capacity to affect significantly the corporation's financial standing; or
- (c) they communicate instructions or wishes (other than advice given by the person in the proper performance of functions attaching to the person's professional capacity or their business relationship with the directors or the corporation) to the directors of the corporation:
  - (i) knowing that the directors are accustomed

There is no limit on the length of the disqualification order that can be imposed. Australian courts have imposed several permanent disqualification orders in recent years in cases where there were multiple contraventions of multiple provisions.<sup>176</sup>

## 2. Prohibition on Indemnification and Company-Provided Insurance

In contrast to common practice in the United States, Australian corporations are prohibited from exempting directors from liability for pecuniary penalty and compensation orders imposed under the civil penalty regime.<sup>177</sup> Nor is it possible to indemnify directors for legal costs incurred defending civil penalty proceedings, if the director is found to have breached his duty.<sup>178</sup> This prohibition extends to civil penalty proceedings that seek pecuniary penalty, compensation, and disqualification orders. Corporations are also prohibited from paying for insurance against director liability arising from conduct that involves a willful breach of duty.<sup>179</sup> While it is theoretically possible for directors to obtain their own insurance policies, such policies usually exclude coverage for liability arising from a willful breach.<sup>180</sup> Finally, due to the personal nature of the penalty, it is not possible to insure against the impact of a disqualification order.

## 3. The Rationale for the Civil Penalty Regime

It is generally accepted in Australia that there is a role for both public and private enforcement of directors' duties. From as early as the mid-twentieth century many Australian states recognized the need to provide public authorities the ability to enforce directors' duties. The first statutory duties that allowed for public enforcement in the English-speaking world were adopted in the state of Victoria in

---

to act in accordance with the person's instructions or wishes; or (ii) intending that the directors will act in accordance with those instructions or wishes.

*Id.* s 206C(2).

176. See Michelle Welsh, *Civil Penalty Orders: Assessing the Appropriate Length and Quantum of Disqualification and Pecuniary Penalty Orders*, 31 AUSTL. B. REV. 96, 107 (2008) (noting that as of December 31, 2007, four such permanent disqualification orders had been entered).

177. See *Corporations Act 2001* s 199A(2) (forbidding indemnification of liability for a pecuniary penalty under s 1317G or a compensation order under ss 1317H or 1317HA).

178. See *id.* s 199A(3) (stating the conditions under which a company must not indemnify a person against legal costs incurred in defending an action).

179. See *id.* s 199B (discussing insurance premiums for certain liabilities).

180. Michael Quinlan & Mark Lindfield, *Directors' and Officers' Insurance*, 22 COM. L.Q. 25 (2008) (Austl.), available at <http://www.aar.com.au/pubs/pdf/insur/pap4oct06.pdf>.

1958.<sup>181</sup> Similar provisions were quickly adopted in many other Australian states.<sup>182</sup>

The civil penalty regime was added to the national corporate law in 1993.<sup>183</sup> Before then, the statutory directors' duties were exclusively criminal provisions.<sup>184</sup> Advocates of the civil penalty regime argued that its introduction was necessary in order to overcome difficulties associated with the existing criminal sanctions. They maintained that the civil penalty regime would make it easier to obtain penalty orders, and thereby enhance the deterrent effect of the law.<sup>185</sup>

Civil penalties were viewed as easier to obtain than traditional criminal penalties because of the lighter standards of proof.<sup>186</sup> Civil penalty proceedings are treated as civil proceedings for the purposes

---

181. *Companies Act 1958* (Vic) s 107 (Austl.). The Victorian duties were introduced following an inquiry into a series of self-interested transactions involving the directors of Freighters Ltd., a publicly listed company. The inquiry found that while no criminal law had been breached, certain transactions revealed "a complete lack of appreciation of the standards demanded of and displayed by public company directors." P.D. PHILLIPS, PARLIAMENTARY PAPER NO. 2, REPORT OF THE INSPECTOR APPOINTED TO INVESTIGATE THE AFFAIRS OF FREIGHTERS LIMITED PURSUANT TO THE PROVISIONS OF THE COMPANIES (SPECIAL INVESTIGATIONS) ACT 1940 (1956) (Vic) 29 (Austl.); see also Harris, Hargovan & Austin, *supra* note 151, at 360-61 (discussing the role of public interest in statutory duties).

182. See, e.g., *Companies Act 1961* (NSW) s 124 (Austl.) (establishing duties and liabilities of officers in New South Wales). Until ASIC was established in 1991 as the Australian Securities Commission (ASC), statutory duties were enforced by the National Companies and Securities Commission and the Corporate Affairs offices of the states and territories. In 1998, the ASC was renamed ASIC and assumed added responsibilities for consumer protection in superannuation, insurance and, deposit taking.

183. Civil penalty provisions were introduced on the recommendation of the Senate Standing Committee on Legal and Constitutional Affairs (the "Cooney Committee"), which found that there had been a lack of public enforcement of the directors' duties. Its advocates argued that the lack of successful prosecutions leading to imprisonment led to community discontent and to a belief by some that the law had fallen into disrepute, as there was no credible accountability mechanism for breaches of the statutory duties. S. STANDING COMM. ON LEGAL & CONSTITUTIONAL AFFAIRS, PARLIAMENT OF AUSTL., COMPANY DIRECTORS' DUTIES: REPORT ON THE SOCIAL AND FIDUCIARY DUTIES AND OBLIGATIONS OF COMPANY DIRECTORS 192 (1989) (Austl.) [hereinafter COONEY REPORT].

184. See *Corporations Act 1989* (Cth) s 232(3) (Austl.) (stating the applicable penalty for a contravention of duties as \$20,000 or imprisonment for five years if "the contravention was committed with intent to deceive or defraud the company, members or creditors of the company or creditors of any other person or for any other fraudulent purpose").

185. See COONEY REPORT, *supra* note 183, at 187-89.

186. See Michael Gillooly & Nii Lante Wallace-Bruce, *Civil Penalties in Australian Legislation*, 13 U. TAS. L. REV. 269, 270 (1994) (Austl.).

of applying the rules of evidence and procedure.<sup>187</sup> The standard of proof is proof on the balance of probabilities.<sup>188</sup>

Another perceived advantage was that the civil penalty regime would limit the reach of criminal sanctions, which was seen as desirable by those who believed that criminal sanctions were not appropriate for regulatory offenses.<sup>189</sup> The existing criminal sanctions were retained for statutory duties other than the duty of care.<sup>190</sup> Thus, ASIC has at its disposal both criminal and civil penalties for breaches of the directors' duties, other than the duty of care.<sup>191</sup>

### C. Enforcing the Duty of Care in Australia

U.S. and Australian corporate law share the same theoretical objective—to ensure that corporate directors and officers work to

---

187. See *Corporations Act 2001* (Cth) s 1317L (Austl.) (establishing the civil evidence and procedure rules for declarations of contravention and civil penalty orders).

188. *Id.* s 1332. Given the nature of the penalties that can be imposed under these provisions the courts have stated that the burden of proof is to be applied in accordance with the manner described by Justice Dixon in *Briginshaw v Briginshaw* (1938) 60 CLR 336, 368 (Austl.).

189. See Mirko Bagaric, *The "Civil-isation" of the Criminal Law*, 25 CRIM. L.J. 184, 186–87, 192 (2001) (discussing proportionality between the purpose and the means selected to achieve it); John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1876 (1992) (proposing that criminal law should be reserved for conduct that lacks social utility whereas civil penalties should be used where the activity has positive social utility but imposes externalities on others); AUSTL. LAW REFORM COMM'N [ALRC], REPORT NO. 95, PRINCIPLED REGULATION: FEDERAL CIVIL AND ADMINISTRATIVE PENALTIES IN AUSTRALIA ¶ 3.37 (2003) (listing common arguments against criminalizing regulatory contraventions).

190. See *Corporations Act 2001* s 184 (detailing the circumstances under which a contravention of the directors' duties contained in ss 181–183 will constitute a crime).

191. COONEY REPORT, *supra* note 183, at 187. Michael Gething argues that in relation to the directors' duties contained in the Corporations Act there is a need for a range of sanctions to allow ASIC to effectively enforce the provisions. Michael Gething, *Do We Really Need Criminal and Civil Penalties for Contraventions of Directors' Duties?*, 24 AUSTL. BUS. L. REV. 375, 376 (1996); see also Vivien Goldwasser, *CLERP 6—Implications and Ramifications for the Regulation of Australian Financial Markets*, 17 COMPANY & SEC. L.J. 206, 212 (1999) (Austl.). Another advantage of the provision of a range of enforcement options that include civil penalties is that it can protect society from both under-enforcement and over-enforcement. Civil penalties protect against under-enforcement because they allow the regulator to take enforcement action in situations where the conduct is not severe enough to justify the commencement of a criminal prosecution. If civil penalties did not exist, these contraventions could be subjected only to a civil action for damages. Civil penalties protect against over-enforcement by "providing a noncriminal punitive sanction for conduct that otherwise would be pushed into the criminal paradigm because its severity makes it unreasonable to impose only a remedial sanction." Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1865 (1992); see also SIMPSON, *supra* note 132, at 73–78 (discussing the use of civil law to deter corporate crime).

protect the interests of the corporation and its investors. In the United States, directors' duties are enforced principally through private litigation. In Australia, private enforcement against outside directors plays an insignificant role,<sup>192</sup> but ASIC enjoys broad enforcement authority. These differences in enforcement structure matter little, however, unless the Australian system leads to different results in cases involving failures of director oversight. If Australian directors face no greater liability risk than U.S. directors, then there will be no significant difference in accountability between the two regimes.

A recent study by Professors Cheffins and Black assessed the risk of personal liability for directors of Australian corporations and concluded the risk was low. Professors Cheffins and Black examined the incidence of out-of-pocket payments by directors of public companies across a number of jurisdictions, including the United States and Australia.<sup>193</sup> They reported that there did not appear to be a single reported case where private litigation against directors resulted in an outside director of an Australian public company being ordered to pay out of pocket following a finding of a breach of duty of care.<sup>194</sup> However, they did identify several cases where civil penalty applications sought by ASIC resulted in out-of-pocket payments by

---

192. The lack of private enforcement of directors' duties in Australia may be due in part to cost rules which make it likely that plaintiffs who lose an application for leave to bring a derivative suit will have costs ordered against them. Even if plaintiffs succeed in the application for leave, they are not automatically entitled to an order that the corporation pay the costs of the substantive suit. See Cheffins & Black, *supra* note 11, at 1433–35 (discussing the obstacles to derivative litigation). The introduction of shareholder class actions and litigation funders in Australia may impact the number of private suits filed against directors in the future. See Graeme Gurney & Michael Legg, *Shareholder Activism: Consumerism, Class Actions and Litigation Funding*, 25 AMPLA Y.B. 255, 255–84 (2006) (Austl.); Shueh Hann Lim, *Do Litigation Funders Add Value to Corporate Governance in Australia?*, 29 COMPANY & SEC. L.J. 135 (2011) (Austl.). For a general discussion of the differences between the U.S. and Australian derivative actions, see Lynden Griggs, *The Statutory Derivative Action: Lessons That May Be Learnt from Its Past!*, 6 U.W. SYDNEY L. REV. 63 (2002); Lang Thai, *How Popular Are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand*, 30 AUSTL. BUS. L. REV. 118, 118–37 (2002); Kurt A. Goehre, *Is the Demand Requirement Obsolete? How the United Kingdom Modernized Its Shareholder Derivative Procedure and What the United States Can Learn from It*, 28 WIS. INT'L L.J. 140 (2010) (comparing the statutory derivative procedure in the United Kingdom with the United States and Australia).

193. Cheffins & Black, *supra* note 11, at 1385.

194. See *id.* at 1433–34. The authors refer to Joanna Bird, *The Duty of Care and the CLERP Reforms*, 17 COMPANY & SEC. L.J. 141 (1999) (Austl.), which cites four cases in which judgment was entered against a director for a breach of the duty of care combined with other breaches. *Id.* at 150. None of these cases involved an outside director of a public company. *Id.*; see also Hill, *Regulatory Responses*, *supra* note 11, at 401 (“Traditionally the level of legal action against directors and officers in Australia tended to be low.”).

directors.<sup>195</sup> After assessing directors' liability exposure in all of the countries in their study, Cheffins and Black concluded that "the largest source of risk [of personal liability] is efforts by government agencies to make an example of particular directors."<sup>196</sup> The statutory duties in Australia allow this risk to be realized.

ASIC has brought several additional high-profile actions against outside directors of Australian corporations since the date of the Cheffins and Black study.<sup>197</sup> These more recent cases suggest that liability risks for outside directors are greater than previously perceived.<sup>198</sup> A review of ASIC's recent enforcement record shows that a breach of statutory duties exposes directors to a nontrivial risk of personal liability. In addition, as noted below, outside directors risk having disqualification orders imposed against them. Cheffins and Black did not address this risk in their study.<sup>199</sup>

### 1. ASIC's Enforcement Record

Between January 1, 2000, and July 31, 2011, ASIC commenced civil penalty applications alleging a contravention of the statutory duty of care on twenty occasions.<sup>200</sup> Most of these applications were issued against multiple defendants, including a number of inside and outside directors. Thirteen of these applications were issued against directors of public corporations and seven were issued against directors of private corporations. Although most applications alleged that additional provisions of the Corporations Act had been breached,

---

195. See Cheffins & Black, *supra* note 11, at 1451 ("In Australia, all of the instances of out-of-pocket liability resulted from ASIC enforcement proceedings.").

196. *Id.* at 1385.

197. See *infra* notes 206–35 and accompanying text (discussing recent ASIC actions against outside directors).

198. See Hill, *Regulatory Responses*, *supra* note 11, at 402 ("[O]ne development in Australia that has strengthened the enforcement of directors' duties is the increasingly strategic use by the Australian Securities and Investments Commission (ASIC) of the civil penalty regime as a regulatory mechanism.").

199. Cheffins & Black, *supra* note 11, at 1392 ("[W]e treat disqualification [orders] as beyond the paper's scope because a financial penalty is not an intrinsic aspect of the sanction.").

200. See *Media Releases and Advisories*, AUSTL. SEC. & INV. COMMISSION, <http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Media%20and%20information%20releases%20Home%20Page> (last visited Mar. 1, 2012). The author examined the corresponding civil penalty judgments. To identify the civil penalty judgments the author searched AustLII, CCH Online, and LexisNexis electronic databases.

The number of civil penalty applications may appear to be small but in the context of the size of Australia's market when compared with the U.S. market, the number is significant. For a detailed discussion of ASIC's enforcement patterns, see generally HELEN BIRD ET AL., *ASIC ENFORCEMENT PATTERNS* (2003); Helen Bird et al., *Strategic Regulation and ASIC Enforcement Patterns: Results of an Empirical Study*, 5 J. CORP. L. STUD. 191 (2005).

there were four cases where the only alleged contravention was a contravention of the duty of care.

For the sake of comparison it is worth noting that Australia is significantly smaller than the United States in terms of the size of its population and its economy. Its population is roughly one-tenth that of the United States<sup>201</sup> as is the size of its economy as measured by GDP.<sup>202</sup> The United States has roughly three times as many publicly traded corporations.<sup>203</sup> This sizable differential should be taken into account when considering the number and type of enforcement actions initiated by ASIC.

a. The James Hardie Group

Several recent cases demonstrate the potential of ASIC's enforcement actions to hold directors accountable for failures in oversight. The civil penalty application that received the most publicity in recent years is the *James Hardie* application issued by ASIC in 2007.<sup>204</sup> The James Hardie Group is a billion dollar global enterprise that produces fiber-cement construction products, such as exterior siding and roofing materials, used throughout the world.<sup>205</sup> The company had produced and distributed asbestos products during much of the twentieth century. Cancers and respiratory illnesses were linked to exposure to asbestos, and by 2001 there had been numerous claims for compensation made against entities of the James Hardie Group. While the group was no longer involved in the sale of asbestos products, it was anticipated that it would face significant future compensation claims.<sup>206</sup>

In 2001, Hardie's board of directors considered a proposal to restructure the company under a new holding company to be

---

201. Australia has a population of approximately 22 million, compared with a U.S. population of roughly 311 million. See *Australian Demographic Statistics, June 2001*, AUSTRALIAN BUREAU OF STATISTICS (Dec. 12, 2011), <http://www.abs.gov.au/ausstats/abs@nsw/94713ad445ff1425ca2568200192af2/1647509ef7e25faaca2568a901154b63?opendocument> (reporting Australia's population as of June 2011).

202. Australia's GDP for 2009–2010 was AUD \$1.3 trillion, compared with a U.S. GDP of \$14 trillion. *Key Economic Indicators 2011*, AUSTRALIAN BUREAU OF STATISTICS, <http://www.abs.gov.au/AUSSTATS/abs@nsw/mf/1345.0?opendocument?opendocument> (last visited Mar. 1, 2012).

203. Approximately 2,000 public companies are listed on the Australian Securities Exchange (ASX), compared with roughly 7,000 listed companies on the two major U.S. stock exchanges. See *Historical Market Statistics*, AUSTRALIAN SECURITIES EXCHANGE, [http://www.asx.com.au/research/historical\\_equity\\_data.htm#](http://www.asx.com.au/research/historical_equity_data.htm#) (last visited Mar. 1, 2012).

204. See *Austl. Sec. & Inv. Comm'n v Macdonald (No. 11)* (2009) 230 FLR 1 (Austl.).

205. *About James Hardie*, JAMESHARDIE.COM, <http://jameshardie.com.au/main/about.html> (last visited Mar. 1, 2012).

206. See *Morley v Austl. Sec. & Inv. Comm'n* (2010) 274 ALR 205, ¶ 13 (Austl.) (discussing the decision to create a trust).

incorporated in the Netherlands. Under the proposed arrangement, any future decisions of Australian courts regarding the company's asbestos liability would not be enforceable.<sup>207</sup> In order for the restructure to proceed, the James Hardie Group established a Medical Research and Compensation Foundation (the Foundation) to pay future asbestos related claims.<sup>208</sup> There was great public interest in ensuring that the Foundation would have sufficient funds to meet all future claims. ASIC's civil penalty application arose as a result of public statements made by the corporation about the sufficiency of the funds in the Foundation.

ASIC issued civil penalty proceedings against two corporate entities, three inside directors, and seven outside directors. ASIC alleged that various public statements made by the James Hardie Group of companies in relation to the funding of the Foundation were false and misleading, or misleading and deceptive, and as a result the corporations had breached various provisions of the Corporations Act.<sup>209</sup> In addition, ASIC alleged that the inside and outside directors had breached the duty of care contained in s 180 in the preparation and approval of those statements.<sup>210</sup> One of those statements was a draft Australian Securities Exchange (ASX) announcement stating that the Foundation would have sufficient funds to meet all legitimate asbestos claims, and that the Foundation was fully funded and would provide certainty for people with legitimate asbestos claims. Two of the outside directors attended the board meeting via teleconference, and it was alleged that they approved the announcements without seeing them or the supporting documentation.<sup>211</sup>

At first instance, the trial court found that the outside directors were in breach of their statutory duty of care and diligence in s 180(1) because they approved the draft announcement when, due to the information that was before them, the directors could not have been satisfied that the company had a proper basis for making the assertions contained in the announcement. The court found that:

All of the [outside] directors . . . knew or should have known that if [the James Hardie Group] made the statements as to the sufficiency of funding of the Foundation in the Draft ASX Announcement there was the danger that [it] would face legal action for publishing false or misleading or misleading or deceptive statements, its reputation would suffer and there would be a market reaction to its listed securities

---

207. *Id.* ¶¶ 12–13.

208. *Id.* ¶ 13.

209. *Macdonald* (2009) 230 FLR 1, ¶¶ 5–51.

210. *Id.*

211. *Id.*

The fact that it was approved with its overstatement of the situation as to the level of funding of the Foundation . . . meant that they failed in their duty to [the James Hardie Group] to protect it from the harm it potentially faced upon publication of the Draft ASX Announcement.<sup>212</sup>

Each of the outside directors was disqualified from managing corporations for five years and ordered to pay pecuniary penalties of AUD \$30,000.<sup>213</sup> The disqualification orders imposed on the inside directors ranged from seven to fifteen years and the pecuniary penalty orders ranged from AUD \$75,000 to AUD \$350,000.<sup>214</sup>

The outside directors successfully appealed this decision.<sup>215</sup> The court of appeal was not satisfied that the board of directors had in fact voted and approved the announcement that was made. However, the court of appeal noted that it would have been satisfied that the directors had breached the duty of care and diligence if it had not overturned the factual finding.<sup>216</sup> ASIC has appealed this decision to the High Court.<sup>217</sup>

#### b. Other ASIC Cases

Other cases in which the court imposed penalties on outside directors of public companies include *One.Tel*, *HIH*, and *Centro Properties*. In *One.Tel*, the court imposed civil penalties against John Greaves, an outside director and chairman of the board.<sup>218</sup> Greaves was chairman of the company's finance and audit committee. In 2004, ASIC obtained a declaration that Greaves had breached the duty of care by failing to take reasonable steps to monitor the financial position of the group and failing to make timely recommendations to the board that it cease trading or appoint an administrator.<sup>219</sup> Greaves was disqualified from acting as a director for four years and was ordered to pay AUD \$20 million in compensation plus ASIC's costs.<sup>220</sup> ASIC's civil penalty proceedings against two other directors

---

212. *Id.* ¶¶ 259, 343.

213. *Austl. Sec. & Inv. Comm'n v Macdonald (No. 12)* (2009) NSWSC 714, ¶ 390 (Austl.).

214. *Id.* ¶¶ 487–90.

215. *Morley v Austl. Sec. & Inv. Comm'n* (2010) 274 ALR 205 (Austl.).

216. *Id.* ¶ 796.

217. The High Court is the last court of appeal in Australia. *Role of the High Court*, HIGH CT. AUSTR., <http://www.hcourt.gov.au/about/role> (last visited Mar. 1, 2012).

218. One.Tel Ltd., was a listed telecommunications company that collapsed in 2001 with losses of approximately AUD \$92 million. See *ASIC Loses Epic OneTel Case*, ABC, <http://www.abc.net.au/news/2009-11-18/asic-loses-epic-onetel-case/1147614> (last updated Nov. 18, 2009) (announcing ASIC's loss to One.Tel in the 2009 legal battle against two of the One.Tel directors over the 2001 collapse of the company).

219. See *Austl. Sec. & Inv. Comm'n v Rich* (2004) 50 ACSR 500, ¶ 4 (Austl.) (discussing the alleged contraventions of the Corporations Law).

220. *Id.* ¶ 92.

of One.Tel Ltd. were dismissed because ASIC failed to prove its pleaded case.<sup>221</sup>

In *HIH*, ASIC issued civil penalty proceedings against a number of HIH directors including Rodney Adler, an outside director. Prior to its collapse in 2001, the HIH Group was the second largest general insurer in Australia.<sup>222</sup> ASIC's claim related to the directors' approval of an undocumented payment of AUD \$10 million to a corporation controlled by Adler in the period of time leading up to the corporation's collapse.<sup>223</sup> Following a finding that he had breached the duty of care, other statutory directors' duties, and other provisions of the Corporations Act, Adler was disqualified from managing corporations for twenty years and ordered to pay a total of AUD \$450,000 in pecuniary penalties and almost AUD \$8 million in compensation.<sup>224</sup>

A more recent case, *Centro Properties*, also ended with liability findings against inside and outside directors of a publicly traded company. Centro Properties is the second largest retail property operator in Australia, with revenues of AUD \$1.3 billion.<sup>225</sup> On June 27, 2011, one inside and six outside directors of various entities within the Centro Properties Group and Centro Retail Group were found to have breached the statutory duty of care for approving the consolidated financial statements of the public company and trusts within the group for the 2007 fiscal year.<sup>226</sup> The financial statements did not comply with the relevant accounting standards and regulations because they incorrectly classified short-term current liabilities and long term debt.<sup>227</sup> The court found that the information omitted from financial statements was significant for the purpose of assessing the risks faced by the Centro Group. Centro nearly collapsed in 2007 when it announced that it could not refinance AUD \$3.9 billion of debt.<sup>228</sup> The court found that the directors either were aware of the omitted information, or that reasonably competent directors in their positions should have been aware.<sup>229</sup>

---

221. *Austl. Sec. & Inv. Comm'n v Rich* (2009) 236 FLR 1, ¶ 25.1 (Austl.).

222. *Austl. Sec. & Inv. Comm'n v Adler* (2002) 168 FLR 253, 267 (Austl.).

223. *Id.* at 260.

224. *Adler* (2002) 168 FLR 253.

225. *Centro Properties Group*, INVESTSMART, <http://www.investsmart.com.au/shares/asx/CENTRO-PROPERTIES-GROUP-CNP.asp> (last visited Mar. 1, 2012) (recording Centro's revenues from ordinary activities at approximately AUD \$1.33 billion); *Centro Shares Continue Plummet*, SYDNEY MORNING HERALD (Dec. 18, 2007), <http://www.smh.com.au/business/centro-shares-continue-plummet-20071218-1hqq.html>.

226. *Austl. Sec. & Inv. Comm'n v Healey* [2011] FCA 717, ¶¶ 1–5 (Austl.).

227. The amount that was the subject of the claim exceeded AUD \$3.2 billion. *Id.* ¶ 9.

228. See *Austl. Sec. & Inv. Comm'n v Healey* (2011) 196 FCR 430, ¶¶ 66–76 (Austl.) (discussing the consequence of the omissions).

229. *Id.* ¶ 11.

On August 31, 2011 the court disqualified one of the inside directors from managing corporations for two years, and imposed a pecuniary penalty of AUD \$30,000 on the other inside director.<sup>230</sup> The outside directors argued that they should be relieved from liability altogether and that no declarations of contravention should be made. However, the court disagreed, stating that this was not a case:

[W]here a mere warning “not to do it again,” without more, [was] appropriate. . . . A judicial reprimand in the form of merely finding a contravention (without appropriate declarations) [was] not a substitute for punishment, and [was] not appropriate here.<sup>231</sup>

Although the court issued declarations of contravention against the outside directors, it declined to impose the disqualification orders ASIC sought.<sup>232</sup> According to the court, the declarations of contravention were “sufficient to ‘send the message’ to the community that the court strongly disapproves of the conduct giving rise to the contraventions,”<sup>233</sup> and the disqualification orders were unnecessary and excessive.<sup>234</sup> The *Centro* case is one of few civil penalty applications where a declaration of contravention was made and no penalty orders imposed. In most cases at least one of the available penalties was imposed following a declaration of contravention.

## 2. Assessing the Impact of ASIC Enforcement

Overall, ASIC has achieved a high degree of success with the civil penalty applications it has issued. As of July 31, 2011, fifteen of the twenty civil penalty applications alleging a breach of the duty of care issued between January 1, 2000 and July 31, 2011 have been finalized.<sup>235</sup> ASIC obtained a declaration that the duty of care had been contravened by at least one of the defendant directors in twelve of those fifteen cases.<sup>236</sup> Many of these civil penalty applications were

230. *Id.* ¶¶ 109, 134.

231. *Id.* ¶ 187.

232. *Id.* ¶ 188 (“The punishment element (which a disqualification order encompasses), has already been inflicted by the failure to relieve from liability and the making of the declarations in light of the reputational damage already inflicted upon these particular directors.”).

233. *Id.* ¶ 191 (expressing disapproval but also expressing sympathy regarding “the circumstances of the non-executive directors, the circumstances leading to the contraventions, and subsequent events”).

234. *Id.* ¶¶ 187–91.

235. See generally *Media Releases and Advisories*, *supra* note 200 (providing information on the civil penalty applications).

236. See Michelle Welsh, *Civil Penalties and Responsive Regulation: The Gap Between Theory and Practice*, 33 MELB. U. L. REV. 908, 932 (2009) (discussing ASIC’s success with civil penalty applications). The *Hardie* case and the *Fortescue* case are counted as not finalized because they are currently on appeal before the Australian High Court. See Press Release, Austl. Sec. & Inv. Comm’n, 11-214MR Decision in Fortescue Metals Group Appeal (Sept. 29, 2011), available at

issued against high-profile directors.<sup>237</sup> When these high-profile proceedings are successful they not only ensure that the offending director is held to account for his or her wrongdoing, but the publicity generated sends a strong deterrent message to other directors in the community.<sup>238</sup>

In particular, the cases involving James Hardie, Centro, and HIH attracted significant publicity. The judgments sent a strong deterrent message to directors that the cost of not complying with the duty of care can be significant, especially if lengthy disqualification orders are imposed. Arguably a disqualification order of any length will end the career of outside directors of public companies. Of equal importance is the fact that these cases send a strong message to the business community about the standard of behavior that is expected of outside directors of public companies. This message is important for the vast number of directors motivated by normative and social factors. What is moral and socially desirable is shaped by both the attitudes of the regulatory authorities—in this case ASIC—and the courts in relation to contraventions of that law. A vigorous enforcement of the law influences such persons' perception of the importance of the law, and therefore their commitment to compliance.

Despite its level of success, in recent years ASIC's ability to obtain civil penalty orders was impacted by several court decisions that placed greater procedural burdens on the regulator. The objective of the civil penalty regime was to provide ASIC with a penalty that was easier to obtain than criminal sanctions. However,

---

<http://www.asic.gov.au/asic/asic.nsf/byheadline/11-214MR+Decision+in+Fortescue+Metals+Group+appeal?openDocument> (regarding the *Fortescue* case); Press Release, Austl. Sec. & Inv. Comm'n, 11-98MR ASIC Granted Special Leave to Appeal James Hardie Decision (May 13, 2011), available at <http://www.asic.gov.au/asic/asic.nsf/byheadline/11-98+MR+ASIC+granted+special+leave+to+appeal+James+Hardie+decision?openDocument> (regarding the *Hardie* case).

237. These cases include the applications issued against the directors of the HIH group of companies, One.Tel Ltd., AWB, the James Hardie Group, and Centro Properties. See *supra* Part IV.C.1.a-b.

238. For examples of "Lawyers Advisories," issued to warn their clients about the impact of the cases, see Priscilla Bryans, ASIC v Healey, FREEHILLS (June 28, 2011), <http://www.freehills.com/7288.aspx> (providing a summary of the practical implications of the *Healey* case); Angela Pearsall & Elspeth Arnold, *The James Hardie Appeals: Implications for Directors and Senior Management*, BLAKE DAWSON (Mar. 8, 2011), [http://www.blakedawson.com/Templates/Publications/x\\_article\\_content\\_page.aspx?id=61343](http://www.blakedawson.com/Templates/Publications/x_article_content_page.aspx?id=61343) (providing a summary of the impact of the *Hardie* case); Adam Strauss, *James Hardie - A Higher Bar for General Counsel?*, FREEHILLS (June 29, 2009), <http://www.freehills.com/5163.aspx> (same); *What Does the Centro Case Mean for Directors?*, CLAYTON UTZ (June 29, 2011), [http://www.claytonutz.com/publications/news/201106/29/what\\_does\\_the\\_centro\\_case\\_mean\\_for\\_directors.page](http://www.claytonutz.com/publications/news/201106/29/what_does_the_centro_case_mean_for_directors.page) (same); *The Centro Eight - ASIC Turns up the Heat on Company Directors and Executives*, MCCULLOUGH ROBERTSON (June 30, 2011), [http://www.mccullough.com.au/icms\\_docs/100198\\_The\\_Centro\\_Eight\\_-\\_ASIC\\_turns\\_up\\_the\\_heat\\_on\\_company\\_directors\\_and\\_executives.pdf](http://www.mccullough.com.au/icms_docs/100198_The_Centro_Eight_-_ASIC_turns_up_the_heat_on_company_directors_and_executives.pdf) (same).

various protections introduced by the courts in civil penalty proceedings have made it difficult for ASIC to succeed in several recent civil penalty applications.<sup>239</sup> There has been at least one case in which ASIC suffered a high-profile defeat in recent years.<sup>240</sup>

Nonetheless, civil penalties remain important regulatory mechanisms. The penalty regime allows ASIC to take enforcement action in situations where it would otherwise be unable to act.<sup>241</sup> The duty of care contained in s 180 of the Corporations Act does not attract criminal liability, so without the civil penalty regime, court-based enforcement action instigated by the regulator would not be possible. According to ASIC, civil penalty applications feature strongly in what it regards as the key results it achieves each year.<sup>242</sup>

While ASIC's use of the civil penalty regime likely has had an impact on compliance levels, we acknowledge that there is no reliable method of testing this hypothesis empirically. One cannot prove that public enforcement has provided an effective deterrent, set minimum standards of corporate managerial behavior, or encouraged directors and officers motivated by calculated, normative, or social factors to comply more readily with their duty of care. There is simply no accurate way to measure compliance levels with the duty of care. The use of surveys to measure compliance has previously been seen to be

---

239. See Tom Middleton, *The Difficulties of Applying Civil Evidence and Procedure Rules in ASIC's Civil Penalty Proceedings Under the Corporations Act 2001 Cth*, 21 COMPANY & SEC. L.J. 507 (2003) (Austl.) (advocating for the introduction of a uniform civil code for all Corporations Act civil proceedings, including civil penalty proceedings); Peta Spender, *Negotiating the Third Way: Developing Effective Process in Civil Penalty Litigation*, 26 COMPANY & SEC. L.J. 249 (2008) (Austl.); Michelle Welsh, *The Regulatory Dilemma: The Choice Between Overlapping Criminal Sanctions and Civil Penalties for Contraventions of the Directors' Duty Provisions*, 27 COMPANY & SEC. L.J. 370 (2009) (Austl.).

240. In *One.Tel*, ASIC obtained declarations of contravention and civil penalty orders against Keeling and Greaves in 2003 and 2004, respectively, but suffered a high-profile defeat when in 2009 the court declared that it had failed to make out its case against the other directors, Rich and Silberman. *Austl. Sec. & Inv. Comm'n v Rich* (2009) 236 FLR 1 (Austl.).

241. Welsh, *supra* note 236, at 932.

242. An examination of the ASIC annual reports from 2001–2002 to 2009–2010 reveals that civil penalty proceedings are prominent in the matters identified as 'key' or 'significant' for each year. The annual reports can all be accessed on the ASIC website, AUSTL. SEC. & INV. COMMISSION, <http://www.asic.gov.au/asic/asic.nsf/byheadline/Annual+reports?openDocument> (last visited Mar. 1, 2012). AUSTL. SEC. & INV. COMM'N [ASIC], ANNUAL REPORT 2002–03: FIGHTING FRAUD AND MISCONDUCT 23, 27 (2003); ASIC, ANNUAL REPORT 2003–04: BUILDING CONFIDENCE IN FINANCIAL MARKETS 14–15 (2004); ASIC, ANNUAL REPORT 2004–05: PATROLLING A BROAD TERRITORY 16 (2005); ASIC, ANNUAL REPORT 2005–06: WORKING FOR AUSTRALIA – CONSUMERS, INVESTORS, BUSINESS AND MARKETS 18 (2006); ASIC, ANNUAL REPORT 06–07: REGULATING IN A TIME OF GROWTH – MARKETS, BUSINESS, INVESTORS AND CONSUMERS 16 (2007); ASIC, ANNUAL REPORT 07–08: A YEAR OF CHANGE 14–15 (2008); ASIC, ANNUAL REPORT 08–09: A YEAR OF CONSOLIDATION 4 (2009) ASIC, ANNUAL REPORT 09–10: A YEAR OF ACHIEVEMENT 18 (2010).

unreliable.<sup>243</sup> Similarly, measuring the number of enforcement actions alleging a contravention of the duty of care over a certain period of time would not give a true indication of compliance levels. A rise or fall in the number of enforcement actions initiated by ASIC may not indicate a rise or fall in compliance with the duty of care. Changes in enforcement statistics may be caused by many factors, including changes in the regulator's enforcement priorities, personnel, resources, and surveillance capabilities.<sup>244</sup>

However, one can draw on the results of an empirical study previously undertaken by one of the authors. This study measured the impact of ASIC's enforcement of a different statutory provision.<sup>245</sup> The research was undertaken in the context of the Australian continuous disclosure provisions, which require listed corporations to disclose price sensitive information to the ASX as soon as the corporation becomes aware of that information.<sup>246</sup> The author collected empirical data by counting the number of price sensitive disclosures and mapping those disclosures against the introduction of different enforcement regimes and changes in enforcement practices by ASIC.<sup>247</sup>

This study showed that a marked increase in the number of announcements occurred immediately following a period when ASIC

---

243. For a discussion of the difficulties associated with reliance on self-assessment including the possibility of misrepresentation, see Henk Elffers et al., *Explaining Regulatory Non-compliance: A Survey Study of Rule Transgression for Two Dutch Instrumental Laws, Applying the Randomized Response Method*, 19 J. QUANTITATIVE CRIMINOLOGY 409, 411 (2003).

244. Previous studies have highlighted the difficulties associated with measuring compliance levels more generally. See Mary Kreiner Ramirez, *Just in Crime: Guiding Economic Crime Reform After the Sarbanes-Oxley Act of 2002*, 34 LOY. U. CHI. L.J. 359, 414 (2003) (noting that the true indicator of the success of a deterrence-based strategy is the number of individuals who comply with the law, despite temptations to do otherwise). Ramirez also notes, however, that people do not ordinarily announce such decisions; therefore, it is usually not possible to count their incidence. *Id.*; see also Elffers et al., *supra* note 243, at 410 (reporting that the lack of statistics on compliance was one of the causes of the scarcity of empirical research in this area).

245. Michelle Welsh, *New Sanctions and Increased Enforcement Activity in Corporate Law: Impact and Implications*, 41 COMMON L. WORLD REV. (forthcoming 2012) (on file with authors).

246. The project examined the incidence of disclosure of price sensitive information to the ASX to determine whether or not the introduction of new enforcement regimes and the use of those regimes by ASIC corresponded with an increase in the level of compliance by listed corporations with the continuous disclosure requirements. The project comprised a quantitative study of the levels of corporate disclosure from 1993 to 2007 and an analysis of a series of interviews with company secretaries of six corporations listed on the ASX and one partner of a legal firm who, at the date of the interview, was an outside director of a number of listed corporations.

247. The project included a quantitative study of the levels of disclosure from 1993 to 2007. Welsh, *supra* note 245.

increased its enforcement activity.<sup>248</sup> This finding suggests that enforcement action by ASIC is an important factor in encouraging corporate compliance. ASIC enforcement proceedings may act as a deterrent to persons motivated by calculated factors who are inclined toward noncompliance. A perceived increase in the risk that a contravention may result in enforcement activity may also strengthen a commitment to compliance by persons motivated by social and normative factors. The perceived legitimacy and importance of the continuous disclosure requirements may have increased when ASIC began to enforce them actively.

The results of this research support our hypothesis that an effective accountability mechanism plays an important role in encouraging corporate compliance. Enforcement activity can increase the deterrent effect of the law. In addition, an effective accountability mechanism evidenced by enforcement activity encourages corporate actors who are motivated by normative and social factors to implement measures to ensure that their corporations are compliant.

#### V. ENVISIONING PUBLIC ENFORCEMENT OF DIRECTORS' DUTIES IN THE UNITED STATES

In the United States, the federal securities law regime provides for overlapping and concurrent public and private remedies for securities law violations. In addition, federal law coexists with state securities laws, which also provide for both public and private enforcement. Under state corporate laws, where most substantive standards for director conduct arise, there are no provisions for public enforcement of fiduciary duties. Given the broad public interest in effective corporate governance, the absence of mechanisms for formal public oversight of director conduct is striking.

---

248. *Id.* As part of the study, the author conducted several interviews with company secretaries and/or assistant company secretaries from six listed corporations, and with a partner in a law firm who was a nonexecutive director on the boards of a number of listed corporations. The interviewees identified many factors that were important from a compliance perspective. One of those factors was enforcement activity by the regulator. *Id.* Not only was enforcement viewed as important in relation to corporate actors motivated by calculated factors toward noncompliance, enforcement action by ASIC impacts compliance-focused corporate actors. Most interviewees agreed that enforcement action focused their attention on an issue and usually led to a review of the corporation's internal processes and procedures to ensure that the company was compliant. *Id.* The interviewees discussed the issue of personal liability of directors. While some interviewees expressed reservations about the appropriateness of imposing personal liability, almost all conceded that directors were more likely to pay attention to issues of compliance when there was a possibility of personal liability. For example, one interviewee stated that, "nothing is more effective than directors being in the 'gun,' civilly, and particularly, criminally."

It is important to acknowledge that U.S. regulators can pursue cases involving financial misstatements and fraud through the securities enforcement regime. However, such enforcement actions rarely impact a firm's outside directors.<sup>249</sup> For example, independent investigations of the Enron, WorldCom, and Lehman failures revealed serious lapses in director oversight, yet regulators did not charge any of the directors of these corporations with fraud.<sup>250</sup> Although outside directors of these corporations faced private shareholder suits, only Enron and WorldCom directors made personal payments to settle such claims.<sup>251</sup> Furthermore, the personal payments included in the Enron and WorldCom settlements were anomalies that have not been replicated since.<sup>252</sup> Loyalty-based claims also rarely lead to personal payments by outside directors.<sup>253</sup> Thus, even in cases involving financial misstatements, self-dealing, and fraud, outside directors in Australia are more likely to face enforcement actions and personal penalties than similarly situated directors in the United States.

Although Australia's regulatory regime seems to offer some advantages over the U.S. system, the U.S. corporate governance system does not easily lend itself to adopting the Australian approach. Deeply ingrained concepts of federalism in the United States make imagining public enforcement of fiduciary duties appear somewhat fanciful. The United States divides authority over corporate regulation between federal and state authorities, with state governments taking the lead in defining and enforcing fiduciary duties.<sup>254</sup> This traditional division of labor presents challenges to reforming U.S. corporate law along the Australian model. Despite these conceptual obstacles, careful analysis of U.S. enforcement practices suggests that such reforms would be less radical than they may appear at first blush.

---

249. Black, Cheffins & Klausner, *supra* note 3, at 1062 (finding only one instance where an SEC enforcement action led to an out-of-pocket payment by an outside director).

250. *See id.* at 1126–27 (describing the independent investigations revealing omissions and material misstatements reflecting oversight failure at Enron and WorldCom).

251. *Id.* at 1057.

252. *Id.* at 1063–64 (“From 1980 onwards—as far back as we looked—we found a total of thirteen cases in which outside directors made out-of-pocket payments. . . . Ten of these cases involved oversight failure, two involved self-dealing or duty of loyalty claims, and one involved a claim that a transaction involving directors’ own compensation was *ultra vires*.”).

253. *See id.* at 1063–64, 1112 (noting that directors make personal payments in only a tiny percentage of cases and that directors’ risk for out-of-pocket liability in director oversight claims is very low).

254. *See Jones, supra* note 5, at 110.

### A. Some Advantages of Australia's Enforcement Regime

One advantage of the Australian system is that it allows proceedings alleging a breach of the duty of care to be issued against directors when it is in the public interest to do so. Mechanisms for director accountability do not rely solely on incentives for private litigators working on a contingent basis. In the United States, courts and commentators worry that such incentives often lead lawyers to pursue speculative cases in pursuit of large damage awards, or pass up meritorious cases if the prospective damages are too small to justify the risk of litigation.<sup>255</sup> By contrast, in Australia, ASIC can take up a case in the public interest even when the size of the case would not warrant a contingent fee lawsuit.

Another advantage of the Australian system is that public enforcement provides the prospect of personal accountability for directors through the imposition of disqualification orders and pecuniary penalties that cannot be indemnified or insured at company expense. This regulatory flexibility means the regulator can provide for penalties that will deter those motivated chiefly by calculated factors, while also providing more modest penalties for less culpable actors to reinforce norms for those motivated by normative and social factors.

#### 1. Pecuniary Penalties

In the United States, the penalties for a breach of fiduciary duty can be harsh and, according to some, disproportionate to a director's degree of culpability.<sup>256</sup> Legal sanctions for breach of duty are not tied to the seriousness of a director's misconduct. Instead the penalty is determined by the losses that a company suffers as a result of the breach.<sup>257</sup> Thus, "[f]or a multibillion dollar company, a single mistake could mean millions of dollars of damages to be borne by the directors."<sup>258</sup> As one of us has previously argued, two problems can arise from depending on draconian penalty schemes to discipline directors. First, if the requisite penalty is harsh, courts may be

---

255. See Stephen Choi, *The Evidence in Securities Class Actions*, 57 VAND. L. REV. 1465, 1489 (2004) (describing factors attorneys consider when deciding whether to pursue litigation, including the risk that damages awards will not be high enough to cover attorney's costs); Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 574 (2000) (explaining that asymmetric risks affect lawyers' decisions in settlement and bringing claims).

256. Jones, *supra* note 5, at 148.

257. *Id.*

258. *Id.*

reluctant to impose it, and second, harsh penalty schemes may undermine the internalization of proper moral values.<sup>259</sup>

One advantage we see in the Australian enforcement regime is that pecuniary penalties can be calibrated to reflect the seriousness of the harm and the degree of culpability of the director. Pecuniary penalties that are capped at AUD \$200,000 are less severe than the damages awards or settlements of the size likely to attract contingent fee litigators.<sup>260</sup> If the United States adopted a similar system, whereby pecuniary penalties are calibrated to reflect an individual director's culpability, such flexibility could help overcome some of the objections that the tort measure of damages raises in the current enforcement regime.

## 2. Disqualification Orders

ASIC is also authorized to seek disqualification orders, which can serve multiple objectives. The orders protect the public from future harm that may be caused by inattentive or incompetent directors. They also serve as an individual deterrent, and as a form of punishment.<sup>261</sup> Most importantly, the disqualification order ensures a measure of personal accountability for directors that is not available under the U.S. system. Unlike monetary settlements and damages

---

259. See *id.* at 148–52 (summarizing nullification problems and reviewing studies showing that harsh penalties can interfere with internalization of proper moral values).

260. Compensation orders are also available under the Australian regime to compensate victims of wrongdoing. The quantum of a compensation order is limited to the loss suffered as a result of the contravention and punitive damages are not available. See *supra* notes 169–70 and accompanying text.

261. Australian courts have recognized that the main aim of the disqualification order is to provide protection for the wider public. For example, in *Australian Securities & Investment Commission v Adler* [2002] NSWSC 483, ¶ 56, the court noted that the public needs protection against the misuse of the corporate structure by directors who are unfit to hold office. In *Australian Securities & Investment Commission v Forem-Freeway Enterprises Pty. Ltd.* (1999) 30 ACSR 339, the court recognized that the aim of the disqualification order is to protect the public, and as a result, the capacity of the defendant to cause harm to the public must be given consideration by the court when it is deciding whether or not to impose a disqualification order. Australian courts also recognize that the imposition of a disqualification order involves aspects of personal and general deterrence, and that it can have a punitive effect. See *Austl. Sec. & Inv. Comm'n v Beekink* (2007) 61 ACSR 305, 314–15 (“What is required in their case is a penalty sufficient to satisfy the punitive objectives of the applicable law, to be seen to be a personal deterrent and to be apparent as a deterrent to the general public against a repetition of like conduct.”); *Austl. Sec. & Inv. Comm'n v Maxwell* (2006) 59 ACSR. 373, ¶ 150 (listing principles and factors in finding disqualification orders); *Austl. Sec. & Inv. Comm'n v Vines* (2006) 58 ACSR 298, 311–2, 333, 346 (describing the punitive penalties to the directors and that they should be no greater than necessary to achieve the deterrent purpose); *Austl. Sec. & Inv. Comm'n v White* (2006) 58 ACSR 261, 265–67; *Austl. Sec. & Inv. Comm'n v Plymin* (2003) 21 ACLC 1237, 1241.

awards, a disqualification order cannot be indemnified or insured away.

One of us conducted interviews with a former senior enforcement officer from ASIC. The officer stated that ASIC sees disqualification orders as the most important of the three orders that are available.<sup>262</sup> Disqualification orders are important and useful remedies because they provide a mechanism whereby people who should not manage corporations are removed from such positions.<sup>263</sup>

Pecuniary penalties and disqualification orders help promote accountability for corporate officials in Australia. Because the penalties are comparatively mild and can be tailored to be proportionate to the harm caused and the degree of culpability of each individual director, courts may be more likely to impose such penalties when the circumstance warrant. Disqualification orders act as personal and general deterrents. They allow for the removal of incompetent directors, and most importantly, directors cannot contract out of the personal impact of such orders.

### B. Implementing Public Enforcement

U.S. policymakers should consider Australia's public enforcement model. In particular, the disqualification order, or bar on future service as a director, is a remedy that should be added to the arsenal of state and federal regulators, so that they may more effectively enforce directors' oversight duties. Despite the many salutary aspects of the Australian enforcement regime, any effort to adopt a comparable system in the United States would face a number of challenges. America's peculiar brand of corporate federalism creates ideological and conceptual barriers that must be overcome before the United States could embrace public enforcement of fiduciary duties.

#### 1. Federalism Constraints

Corporate federalism concepts present the most significant obstacle to adoption of public enforcement of fiduciary duties in the United States. There are at least two ways that federalism notions

---

262. Interview with Senior Enforcement Officer, Austl. Sec. & Inv. Comm'n, in Melb., Austl. (Dec. 8, 2006). The senior enforcement officer requested that she not be named and that no direct quotations be attributed to her. See also Welsh, *supra* note 236, at 929 (expressing that prior to beginning a civil penalty application, ASIC considers alternative available remedies such as disqualification orders as a regulatory response).

263. See generally Welsh, *supra* note 176 (explaining that the courts' view that disqualification orders protect the public from actions of incapable directors impacts the length of disqualification).

could impede implementation of a public enforcement regime. First, unlike ASIC, the SEC lacks formal authority to enforce corporate law rules. Although the SEC's enforcement powers mirror ASIC's to a significant extent, the United States has no federal corporate statute. Instead, corporate law is the province of the states and each state has its own statute enforced by its judiciary.<sup>264</sup> Further, states do not provide mechanisms for public officials to enforce directors' duties. Instead, the state law system relies exclusively on shareholder litigation to police director conduct.<sup>265</sup>

Given the existing corporate governance structure, providing for public enforcement of fiduciary duties would require one of two possible reforms. The first would be to empower the SEC explicitly to enforce directors' fiduciary duties. The second would be for states to empower its public officials to oversee director conduct. Standard federalism conventions would likely complicate efforts to adopt either reform. Yet careful examination of the powers and practices of state and federal regulators reveals that the types of reforms envisioned here represent a logical extension of state and federal regulators' existing enforcement powers.

## 2. SEC Enforcement

One possible mechanism for creating public enforcement of directors' oversight duties would be to grant the SEC explicit authority to enforce the director obligations that were created under federal statutes such as Sarbanes-Oxley and Dodd-Frank. As the law stands, the SEC already has the power to penalize securities law violations that also constitute fiduciary breaches. As many commentators have noted, cases of corporate fraud often involve fiduciary breaches, as when directors fail to prevent misleading public statements or fraudulent financial reports.<sup>266</sup>

Since 1990, the SEC has enjoyed explicit power to bar those who violate the securities laws' anti-fraud provisions from future service as an officer or director of any public company.<sup>267</sup> In 2002, the

---

264. See Lucian Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1829–31 (2006) (discussing limitations on state courts' ability to police corporate misconduct).

265. See *id.* at 1831 (noting that states' failure to provide for public enforcement of corporate law may lead to under-enforcement of corporate norms).

266. See Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 1 (1993) ("In the twentieth century state corporate law norms for the large publicly held corporation have been progressively supplanted by federal standards . . ."); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860–63 (2003) (observing that U.S. corporate governance is now largely the province of federal securities law).

267. See Jayne W. Barnard, *Rule 10b-5 and the "Unfitness" Question*, 47 ARIZ. L. REV. 9, 13–14 (2005) [hereinafter Barnard, *Unfitness Question*] (describing the SEC's

Sarbanes-Oxley Act eased the SEC's burden in seeking such bars. First, Sarbanes-Oxley lowered the standard for imposing a bar from "substantial unfitness" to serve as an officer or director to mere "unfitness."<sup>268</sup> Second, Sarbanes-Oxley allows the SEC to impose bars in administrative proceedings in addition to federal court proceedings.<sup>269</sup>

Despite this expanded authority, the SEC has remained reluctant to impose bars as a remedy for director oversight failures. Instead, the SEC seeks bars against outside directors only in the most egregious cases, where directors flagrantly disregarded multiple red flags indicating fraud.<sup>270</sup> Recent SEC cases pursuing bars against outside directors have focused on members of the audit committee, particularly committee chairs who assumed some investigative responsibilities. For example, in two recent enforcement actions against outside directors, the directors had ignored multiple employee warnings, ignored auditor and law firm resignations, or allowed executives suspected of misconduct to retain their positions of authority and thus continue their fraud.<sup>271</sup>

---

authority to impose bar orders under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990); Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit to Serve"?*, 70 N.C. L. REV. 1489, 1522 (1992) (noting that the potential impact of the Remedies Act's debarment powers); Jon Carlson, Note, *Securities Fraud, Officer and Director Bars, and the Unfitness Inquiry After Sarbanes-Oxley*, 14 FORDHAM J. CORP. & FIN. L. 679, 685 (2009) (noting that when Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act it sought to "maximize the remedial effects of its enforcement actions" and to "achieve the appropriate level of deterrence in each case").

268. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, (codified at 15 U.S.C. §§ 77h-1(f), 78u-3(f) (2006)).

269. *Id.*; Barnard, *Unfitness Question*, *supra* note 267, at 19–20.

270. See Floyd Norris, *For Boards, SEC Keeps the Bar Low*, N.Y. TIMES, Mar. 4, 2011, at B1 ("[T]he commission has chosen not to proceed in cases in which there was anything less than severe recklessness. If directors relied on experts like law firms or auditing firms, they have received the benefit of the doubt. No outside directors of financial firms were named as defendants in cases the S.E.C. filed that stemmed from the credit crisis."); John F. Olson, *SEC Targets Directors Who Ignore Red Flags*, in CORPORATE LAW AND PRACTICE COURSE HANDBOOK SERIES 328 (2011) ("[T]he Commission rarely sues directors solely in their capacity as directors. In fact, in the last three years, during which we brought more than 1800 enforcement actions involving more than 3,000 defendants and respondents, the Commission has sued less than a dozen outside directors." (quoting former Enforcement Director Linda Chatman Thomsen)); Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Military Body Armor Supplier and Former Outside Directors with Accounting Fraud (Feb. 28, 2011) ("We will not second-guess the good-faith efforts of directors. But in stark contrast [the defendants] repeatedly turned a blind eye to warning signs of fraud and other misconduct by company officers." (quoting Director of Enforcement, Robert Khuzami)).

271. See Complaint, Sec. & Exch. Comm'n v. Gupta, No. 11-7566 (S.D.N.Y. Oct. 26, 2011), 2011 WL 5105859 (presenting claims against former outside directors of InfoUSA); Complaint for Injunctive and Other Relief, Sec. & Exch. Comm'n v. Krantz, No. 11-60432 (S.D. Fla. Feb. 28, 2011), 2011 WL 680181 (presenting claims against former outside directors of DHB Industries).

If the SEC pursued such bars more readily it might neutralize some of the common objections to enforcing directors' duties. The bar is more meaningful as a reputational sanction than monetary payments, because the signal from being named in a lawsuit or paying a settlement is ambiguous.<sup>272</sup> Further, a bar prevents indolent directors of companies brought down by fraud from serving in similar capacities at other companies.<sup>273</sup>

Such bars could be appropriate in cases such as WorldCom and Enron, where public reports reveal that the directors were asleep at the switch and thus failed to prevent their corporations' massive frauds.<sup>274</sup> Yet former directors of these failed companies continue to serve as directors of other public companies.<sup>275</sup> This suggests that the force of reputational sanctions that purportedly discipline directors is muted. Similarly, public reports on the financial crisis suggest that Citigroup's directors were in the dark about the extent of its subprime exposure, preventing them from managing growing risks and ensuring the accuracy of Citigroup's financial reports.<sup>276</sup> Likewise, Lehman's directors were seemingly unaware of the Repo

---

272. Samuel W. Buell, *Potentially Perverse Effects of Corporate Civil Liability*, in PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 92 (Anthony S. Barkow & Rachel E. Barkow eds., 2011) ("Not only does an SEC settlement not match the criminal action's tendency to ascribe the label of wrongdoer to a firm, it ascribes nothing."); see also DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT 651 (2003) (noting the SEC's common practice of settling cases by allowing defendants to avoid admitting liability). Recently, the SEC's longstanding practice of allowing defendants to settle cases without admitting liability has attracted sharp judicial criticism and the attention of Congress. See Sec. & Exch. Comm'n v. Citigroup Global Mkts. Inc., No. 11-7387, 2011 WL 5903733, at \*8 (S.D.N.Y. Nov. 28, 2011) (rejecting proposed SEC settlement as "neither fair, nor reasonable, nor adequate, nor in the public interest . . . because it does not provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified under any of these standards"); Sec. & Exch. Comm'n v. Bank of Am. Corp., 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009) (holding that the proposed settlement is not fair or reasonable even applying the most deferential standards); Peter Schroeder, *Lawmakers to Press SEC to Change Rules on Settlements for Wrongdoing*, THE HILL (Jan. 2, 2012, 6:00 AM), <http://thehill.com/blogs/on-the-money/banking-financial-institutions/201915-lawmakers-to-press-sec-to-change-rules-on-settlements-for-wrongdoing> (reporting the scheduling of hearings to review the SEC's settlement practices).

273. Regina F. Burch, *Unfit to Serve Post-Enron*, 42 VAL. U. L. REV. 1081, 1084 (2008).

274. See generally BREEDEN, *supra* note 141 (reporting on directors' lapses leading up to WorldCom's failure); POWERS, *supra* note 141 (reporting on Enron directors' lapses leading up to the firm's demise).

275. See Steven M. Davidoff, *Despite Worries, Serving at the Top Carries Little Risk*, N.Y. TIMES (June 7, 2011), <http://dealbook.nytimes.com/2011/06/07/despite-worries-serving-at-the-top-carries-little-risk> (noting directors of firms that failed during the 2008 financial crisis continue to serve as directors of other public companies, including leading financial institutions).

276. FCIC, *supra* note 80, at 260-65; see also Dash & Creswell, *supra* note 77, at A1 (describing Citigroup executives' ignorance of the scope of the firm's subprime exposure).

105 transactions that the company used to shed billions of dollars of assets and debts from its balance sheet at the end of each quarter.<sup>277</sup> Yet despite the financial calamities facilitated in part by their ignorance, directors of these firms have not been held personally accountable for their failures.<sup>278</sup>

Federal governance reforms included in Sarbanes-Oxley and Dodd-Frank place new obligations on independent directors.<sup>279</sup> For such provisions to have meaning there must be a way to hold directors accountable when they fail to meet these heightened conduct standards. Unfortunately, neither Sarbanes-Oxley nor Dodd-Frank created mechanisms for enforcing these new obligations. Because states have refrained from enforcing oversight duties, it may be appropriate to expand the SEC's authority in this realm. The SEC already has authority to scrutinize directors' oversight performance.<sup>280</sup> To the extent that Sarbanes-Oxley, Dodd-Frank, and other federal reforms create additional obligations for directors, it makes sense to allow a federal agency to monitor directors' performance and maintain a federal standard of conduct for Congress's conception of a director's role.

Although current problems plaguing the SEC undermine faith in its ability to protect investor interests, expanding its jurisdiction to cover directors' duties could result in a more efficient use of scarce resources. The SEC could use this power as an ancillary tool in ongoing investigations, achieving better investor protection with minimal additional costs. The risk exists that the SEC would be tempted to use its expanded powers to pursue a political agenda and

---

277. See Valukas, *supra* note 141, at 732–35 (describing the misleading effect of Lehman's accounting for its "Repo 105" transactions).

278. See Davidoff, *supra* note 275 (noting that in a twenty-six year period, only nine directors had been held personally liable for securities fraud); Norris, *supra* note 270, at B1 (noting that corporate directors who were supposed to be watching over management are rarely held accountable). Several outside directors of Citigroup and Lehman remain subject to ongoing securities litigation in connection with inaccuracies in their companies' financial statements during the run-up to the crisis. See *In re Lehman Bros. Sec. & ERISA Litig.*, 799 F. Supp. 2d 258, 264 (S.D.N.Y. 2011) (claiming that directors knew of false and misleading statements relating to Lehman's Repo 105 transactions); *In re Citigroup Inc. Sec. Litig.*, 753 F. Supp. 2d 206, 212 (S.D.N.Y. 2010) (asserting claims against directors for overstating the company's assets).

279. Just as it responded to the corporate scandals of 2001 and 2002 by specifying in Sarbanes-Oxley certain tasks directors must perform, Congress adopted the Dodd-Frank Act in response to the 2008 Financial Crisis. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Like Sarbanes-Oxley, Dodd-Frank includes significant governance reforms designed to enhance director oversight of compensation and risk. Although Sarbanes-Oxley and Dodd-Frank created new responsibilities for directors, the statutes do not include mechanisms to hold directors accountable for their performance. Instead, Congress left the task of monitoring director conduct firmly in state hands.

280. See *supra* text accompanying notes 267–69.

make an example out of high-profile corporate leaders.<sup>281</sup> Although such a risk is present, creating a regulatory “middle ground” between no civil charges and criminal referrals could better protect prominent directors from politically motivated prosecutions.<sup>282</sup>

### 3. State Enforcement

According to the traditional division of authority in corporate regulation, federal law governs corporate disclosure obligations, and states set substantive conduct standards for officers and directors. Although overbroad and imprecise, this conceptual divide creates barriers for expanding SEC authority to regulate director conduct. Thus this section explores the possibility of relying on states to provide a better system for holding directors accountable for corporate oversight. There are two possible avenues for enhancing states’ authority to police director misconduct. First, an executive agency such as the attorney general might be granted authority to investigate and bring cases for oversight failures. Second, state judges could impose alternative remedies to traditional damage awards in cases involving a breach of the duty of oversight.

#### a. Administrative Action

Allowing state authorities to enforce oversight duties and impose officer and director bars could be an alternative to enhanced SEC enforcement of director oversight. For example, a state’s attorney general could investigate director oversight failures and seek penalties or bars in appropriate circumstances. Because corporate law is often perceived of as private law, such powers may seem unusual. However, the exercise of such authority would be a mere extension of existing state power to enforce fiduciary duties.

As the law currently stands, state regulators can enforce the duties of directors of charitable organizations, including nonprofit corporations.<sup>283</sup> In most states, the attorney general exercises this

---

281. Martha Stewart comes readily to mind. *See generally* MARTHA STEWART’S LEGAL TROUBLES (Joan McLeod Heminway ed., 2004) (describing and analyzing the U.S. government’s actions against domestic maven Martha Stewart for insider trading, obstruction of justice, and lying to investigators).

282. *See* Buell, *supra* note 272, at 95 (arguing for enhancing the severity of sanctions for corporate fraud imposed through civil proceedings to make civil actions more attractive to public regulators as an alternative to criminal charges); *cf.* Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 368 (2008) (“[C]ivil law and criminal law in the corporate law arena must be harmonized to restore the traditional policy preferences of allowing free access to the civil courts while harnessing prosecutorial power.”).

283. Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 938 (2004).

authority as *parens patriae*.<sup>284</sup> Extending authority to cover directors of for-profit corporations could thus be seen as a natural extension of the attorney general's existing powers.

Although the notion is contested, the public purpose of the business corporations has long been acknowledged.<sup>285</sup> Most commentators accept that corporations and their officials bear some responsibility to promote the public interest.<sup>286</sup> Furthermore, the social impact of major corporate failures, plant shutdowns, and widespread layoffs has pushed legislatures and courts to acknowledge the public purpose of corporations. Thirty states have adopted so-called "other constituency" statutes acknowledging directors' authority to consider the interests of employees, communities, and other stakeholders when making business decisions.<sup>287</sup> Allowing state attorneys general to enforce the fiduciary duties of directors of business corporations would be consistent with this public conception of the corporation.

Objections to this proposal could emerge along at least two lines. On one hand, state attorneys general have not been particularly aggressive in enforcing duties of directors of charitable institutions.<sup>288</sup> Although

---

284. *Id.*; see also *DUKEMINIER ET AL.*, *supra* note 18, at 785–86 (noting that this supervision may not be enough to ensure that a trustee of a charitable organization does not breach a fiduciary duty).

285. For a classic account discussing directors' fiduciary obligations to a corporation, see generally E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 *HARV. L. REV.* 1145 (1932). See also *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581 (N.J. 1953) (holding that corporations have the authority to reasonably contribute to charity).

286. *COX & HAZEN*, *supra* note 7, at 88–89; see *PRINCIPLES OF CORPORATE GOVERNANCE, ANALYSIS AND RECOMMENDATIONS* § 2.01(b) (Revisions to the Proposed Final Draft 1992) ("Even if corporate profit and shareholder gain are not thereby enhanced, the corporation in the conduct of its business (1) Is obliged to the same extent as a natural person to act within the boundaries set by law; (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.").

287. *JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY* 116–17 (5th ed. 2003). Delaware has not enacted an "other constituency" statute; however, its supreme court has acknowledged directors' discretion to consider the interests of stakeholders when responding to hostile takeover attempts. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("[The defensive measure] entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange."). In a later decision the court qualified this statement by making clear that for the interests of other constituencies to be validly considered they must be "rationally related benefits accruing to the stockholders." *Revlon Inc. v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).

288. See Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 *U. HAW. L. REV.* 593, 622–24 (1999) (describing the

attorneys general have intervened in instances of large-scale abuse, they generally lack both the resources and the motivation to vigorously enforce the duties of nonprofit corporation directors.<sup>289</sup> Such concerns may be muted with respect to business corporations, where citizens may be hungering for public enforcement action and thus more likely to provide political and budgetary support for enforcement of directors' duties.

A contrasting objection to expanding attorneys general's enforcement powers might stem from a lack of trust in the attorney general's political motivations.<sup>290</sup> In recent years, commentators have expressed concern with the "zealousness" of recent New York Attorneys General Eliot Spitzer and Andrew Cuomo, both of whom pursued Wall Street firms on fraud charges and then used the AG's office as a stepping stone to the governor's office. Of course, if an attorney general's enforcement practices are popular enough that voters reward his enforcement efforts by electing him to higher office, it seems somewhat odd to criticize their efforts in that regard.

#### b. Judicial Remedies

If the attorney general's office is deemed ill-equipped to take on the additional burden of enforcing directors' duties, state judges could assume the mantle. For example, with little change to current practice, judges could impose director bars as a remedy in traditional shareholder litigation. Even when a court concludes there is insufficient evidence of bad faith to impose monetary liability for breach of duty, a court could issue an injunction against future director service upon a finding of inadequate oversight.<sup>291</sup> After all, § 102(b)(7) of the Delaware General Corporation Law proscribes only monetary damages for due care breaches, allowing for actions for injunctive relief based upon the gross negligence standard.<sup>292</sup>

---

challenges faced by attorney generals when enforcing the duties of charitable directors).

289. See Brody, *supra* note 283, at 939 ("[F]ew state attorneys general have the funding and inclination to engage in aggressive charity enforcement."); Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128 (2007) (explaining that lack of resources and low staffing levels contribute to criticisms of permissive oversight).

290. See Brody, *supra* note 283, at 946 (quipping that AG is known to stand for "aspiring governor").

291. The SEC's legislative authority to impose bars was granted in recognition of the courts' use of injunctive powers to bar individuals from future violations of the securities law. See Carlson, *supra* note 267, at 682–84 (discussing the development of the SEC injunction and the five-factor test employed to determine likelihood of recurrence).

292. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). Delaware courts regularly consider actions for injunctive relief based on directors' alleged breach of fiduciary duty in connection with proposed acquisitions.

If an action for a judicial order banning future service were sanctioned by the states, lawyers would continue to bring cases alleging breach of the duty of care and would be entitled to attorneys' fees in appropriate cases. For corporate jurisprudence to play a meaningful role in shaping corporate norms, as many commentators claim it does, there must be cases to adjudicate.<sup>293</sup> However, the current doctrine provides little incentives for lawyers to file claims alleging a breach of oversight duties.<sup>294</sup>

### C. Federalism's Conundrum

Expanding judicial remedies for oversight breaches might be the reform most faithful to existing federalism boundaries. However, states may be reluctant to pursue this remedy for fear of alienating managers and losing the corporate franchise. The nature of interstate competition for corporate charters thus makes it unlikely that states would embrace such a change.<sup>295</sup> Whether one views the competition for corporate charters as creating a race to the top or a race to the bottom, most commentators agree that such competition inevitably leads to management-friendly policies.<sup>296</sup> Because corporate managers have the power to select the state of incorporation, states can be expected to resist any reforms that threaten the comfort level of directors, absent the prospect of more onerous federal legislation along similar lines.<sup>297</sup>

---

293. Miller, *supra* note 94, at 329. Professor Miller suggests another alternative to adjudicating oversight claims. He proposes that in certain circumstances judges conduct judicial inquiries into allegations of due care breaches upon the motion of an intervenor. *Id.* at 336. The purpose of the judicial inquiry would be to determine whether a breach occurred, not to determine liability. *Id.* at 338. Professor Miller argues that such inquiries would preserve a judicial role in establishing conduct standards for directors, which the courts' current doctrines have essentially eliminated. *Id.* at 336–41.

294. *Id.* at 329 (stating that obstacles to success in derivative litigation mean few lawyers will bring due care cases).

295. See generally William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (envisioning the competition for corporate charters as a "race to the bottom"); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (discussing the interstate competition for corporate charters as "a race to the top").

296. See RALPH NADER ET AL., TAMING THE GIANT CORPORATION 63–65 (1976) (explaining that state chartering is a "revenue game between states" which has increased the American corporation's power); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–15 (Christopher C. DeMuth & Jonathan R. Macey eds., 1993) (discussing the effect of corporate charter competition and identifying the common position that firm-demanded laws result); Winter, *supra* note 295, at 255 (explaining that as state corporate law has developed, management now faces fewer restrictions).

297. See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 629 (2004) (urging sustained federal engagement on corporate governance issues as a check against Delaware's tendency toward laxity).

Thus, while states might be the most appropriate locus for the reforms advocated here, they are also the level of government least likely to adopt them. Ironically, then, the best way to prod states to consider the reforms discussed here would be to advocate for their adoption at the federal level, even though expanding federal regulation requires further trampling of closely held federalism ideals.

## VI. CONCLUSION

This Article has proposed implementation of a public enforcement system for the fiduciary duties of directors of U.S. corporations. It reasons that a credible accountability mechanism is a necessary element of a regulatory regime that aims to promote optimal compliance levels. In the United States, private fiduciary duty litigation represents the principal mechanism for director accountability. However, due to doctrinal and procedural hurdles, such litigation fails to provide for real accountability.

In Australia, ASIC has the power to enforce directors' statutory duties, including the duty of care. The public enforcement system exists alongside the private shareholder derivative lawsuit. Australia's public enforcement system offers several advantages over the American approach. First, Australian law allows the regulator to undertake enforcement action when it is in the public interest to do so. Second, Australian law provides the regulator with a range of possible remedies when enforcing statutory duties, including disqualification orders and pecuniary penalties. Disqualification orders allow for the removal of incompetent directors, and pecuniary penalties allow for the imposition of penalties that are calibrated to the level of director culpability. Finally, the system of public enforcement overcomes many of the objections to private shareholder litigation in the United States, including fear of strike suits and disproportionate damage awards.

For these reasons, the public enforcement model deserves careful consideration in the United States. The imposition of civil penalties for fiduciary violations could serve as an important disciplinary function that is currently absent from the U.S. corporate law regime. Adopting such a model in the United States would not be easy. Obstacles to implementation include questions of federalism, the traditional conceptual divide between corporate and securities law in the United States, and the absence in the United States of a system for public enforcement of directors duties. Despite these conceptual barriers, it is time for U.S. policymakers to consider implementing a public enforcement system for directors' fiduciary duties.

\*\*\*