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Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance

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Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance

Abstract
On July 21, 1992, six outside directors on the board of Westar Mining Ltd. resigned abruptly from the company's board of directors. Westar was a troubled mining company operating in British Columbia. In 1991, the company had lost $62.2 million, mainly as the result of a poorly performing export coal mine. While resigning from the board, the directors assured the public that there had been no wrongdoing by the company. Rather, the reason for their departure was related to concern over personal liability for wages and other benefits that might be owed to more than 1900 of the company's employees under provincial employment standards legislation should the company become insolvent. Despite the fact that their departure might not absolve them from liability for other duties and would greatly complicate the company's bid for survival, the size of the personal liabilities they faced - more than $20 million - left the directors little choice.

Predictably, the announcement of the resignations created considerable consternation in the financial community, the magnitude of which was enhanced when, just one week after the Westar resignations, the entire board of PWA Corp. resigned en masse from the boards of each of its subsidiaries, including Canadian Airlines Ltd. As in the case of Westar, the directors attributed their decision to the fear that they "would be forced to pay employee wages, taxes or some other obligation out of their own pockets should the struggling airline run out of money".

These highly publicized defections have been invoked by critics as exemplifying the rather myopic and unthinking addiction that Canadian governments have developed to the elixir of directors' liability. By one legal practitioner's account, in Ontario alone more than 100 different federal and provincial statutes prescribe some type of directors' liability. Some critics have gone further and have viewed the board resignations as a powerful passion play that demonstrates in vivid terms the callous and hostile treatment that Canadian shareholders and business managers can expect to receive at the hands of populist legislatures.

Disciplines
Law

Comments
MUST BOARDS GO OVERBOARD? AN ECONOMIC ANALYSIS OF THE EFFECTS OF BURGEONING STATUTORY LIABILITY ON THE ROLE OF DIRECTORS IN CORPORATE GOVERNANCE

Ronald J. Daniels*

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I. INTRODUCTION

On July 21, 1992, six outside directors on the board of Westar Mining Ltd. resigned abruptly from the company's board of directors.1 Westar was a troubled mining company operating in

* Associate Professor of Law, University of Toronto. This is the revised version of a paper presented by the author at a Conference on International and Comparative Commercial Insolvency Law held at the University of Toronto on June 24-26, 1993, and will also be published in book form in J.S. Ziegel, ed., Current Developments in International and Comparative Corporate Insolvency Law (Oxford Univ. Press, 1994), chapter 23.

British Columbia. In 1991, the company had lost $62.2 million, mainly as the result of a poorly performing export coal mine. While resigning from the board, the directors assured the public that there had been no wrongdoing by the company. Rather, the reason for their departure was related to concern over personal liability for wages and other benefits that might be owed to more than 1900 of the company’s employees under provincial employment standards legislation should the company become insolvent. Despite the fact that their departure might not absolve them from liability for other duties and would greatly complicate the company’s bid for survival, the size of the personal liabilities they faced — more than $20 million — left the directors little choice.

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These highly publicized defections have been invoked by critics as exemplifying the rather myopic and unthinking addiction that Canadian governments have developed to the elixir of directors’ liability. By one legal practitioner’s account, in Ontario alone more than 100 different federal and provincial statutes prescribe some type of directors’ liability. Some critics have gone further and have viewed the board resignations as a powerful passion play that demonstrates in vivid terms the callous and hostile treatment that Canadian shareholders and business managers can expect to receive at the hands of populist legislatures.

3 Ibid.
6 "The message of the great Westar revolt" (the Westar resignations give the lie to the notion of the businessman as inanimate object), Globe and Mail, Friday July 24, 1992, p. A14.
Yet, despite the intense and often shrill terms of the public debate over the proliferation of these statutory provisions, their existence poses some very vexing challenges for mainstream theories of corporate law. By and large, corporate law theory has wrestled with the issue of the appropriate nature and scope of discretionary duties owed by directors to shareholder versus non-shareholder interests. This issue was first canvassed by Berle and Dodd in a landmark debate in the Harvard Law Review in 1932. While the Stakeholder Debate has attracted frequent academic attention since then, for all intents and purposes the sheer weight of judicial and legislative precedent has settled the issue in favour of those arguing for duties owed by directors to shareholders exclusively. And although there was some legislative and judicial backsliding from this position during the "Takeover Wars" of the 1980s, most commentators doubt that these developments were anything more than minor skirmishes that leave the shareholder welfare conception of the corporation largely undisturbed.

The case for narrow discretionary duties to shareholders is based on an amalgam of efficiency and political legitimacy arguments. In respect of the former, the claim is that under a regime which permits, indeed requires, directors to vindicate the full panoply of stakeholder interests, directors would effectively be rendered accountable to no one. Essentially, under a stakeholder regime, directors would always be able to invoke some stakeholder interest to justify even the most venal forms of self-indulgence, and one of the core features of corporate law (permitting specialization economies to be realized through the

7 The economic case for broad discretionary duties owed by directors and managers to stakeholders is canvassed in J. Macey, "An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties" (1991), 21 Stetson L.R. 23. For a more recent treatment of this issue, see J. MacIntosh (1993), 43 U. T. L.J. 425.
8 E.M. Dodd, "For Whom Are Corporate Managers Trustees?" (1932), 45 Harv. L.Rev. 1145; A. Berle, "For Whom Corporate Managers Are Trustees: A Note" (1932), 45 Harv. L.Rev. 1365.
9 See the discussion in R. Daniels, "Stakeholders and Takeovers: Can Contractarianism be Compassionate" (1993), 43 U.T.L.J. 315.
10 For example, see: Committee on Corporate Laws, "Other Constituency Statutes: Potential for Confusion" (1990), 45 Business Lawyer 2253.
11 The point has been most convincingly made by Berle in his response to Dodd: "[Y]ou can not abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their stockholders until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibility to someone else": Berle, supra, footnote 8, at p. 1367.
controlled delegation of power from shareholders to directors) would be undermined, which, in turn, would inflict costs on the broader economy. The latter concern, political legitimacy, has been tied to the pernicious distributional and ethical effects of allowing directorial elites to utilize corporate resources to vindicate their vision of the social good. It is preferable that democratically elected and accountable legislatures make these quintessentially public choices.

At first blush, the burgeoning growth of statutory duties and liabilities of directors would hardly seem to warrant condemnation, given the background of accountability and political legitimacy concerns which lie at the heart of the Stakeholder Debate. Because they impose explicit duties, these statutory provisions do not create a prospect of unconstrained directorial frolics. In varying degrees of specificity, directors are told the narrow goals that they are to pursue and sometimes even the means for doing so. And since these duties are enacted by legislatures, presumably in response to externalities created by the corporation they do not implicate issues of political legitimacy.

Nevertheless, the spectre of directors of Canada's leading corporations resigning en masse from the boards of troubled companies is a serious concern. While there is controversy about the level of actual oversight and control exercised by directors over managers in the normal course of a corporation's activities, most empirical studies of boards confirm that directors do become more activist when a corporation is in severe financial distress. This activism is extremely valuable as it is responsive to the heightened incentive for opportunistic risk-taking by shareholders and managers, contrary to the interests of fixed claimants, as the corporation enters the "vicinity of insolvency". Unless directors can be counted on to scrutinize the corporations' behaviour in distress situations, creditors will have to rely on other, presumably more costly, techniques to protect their interests, which will increase the costs to shareholders of conducting economic activity.

13 However, contra, see: R. Mundheim, "A Comment on the Social Responsibilities of Life Insurance Companies as Investors" (1975), 61 Va. L. Rev. 1247, at pp. 1256-8.
14 See: Mace, infra, footnote 68, and Lorsch, infra, footnote 68.
The potential for liability chill imposing costs on the corporation exists even when the board resists the temptation to defect in a distress situation; to avoid liability, directors may well be induced to operate the company in an excessively risk averse fashion which, again, retards the wealth-creating capacity of the corporation. Hence, the mere fact that the legislature has given explicit instructions to directors does not necessarily mean that agency problems between directors and various corporate constituencies have been resolved. In the end, directors' liability provisions may be undesirable from a welfare perspective because of their unintended (and socially undesirable) effects on directorial behaviour.

In this article, I sketch out a framework for determining the appropriate scope of statutory directors' liability. Following Kraakman, the starting point for this analysis is to understand why the state would deviate from reliance on enterprise liability as the exclusive means of internalizing the consequences of corporate conduct. If, through the imposition of optimal fines, the state is capable of internalizing the costs of injury back onto the corporation, then what role is there for directors' liability? Here, the rationale for supplementary liability is based on perverse incentives introduced by limited liability, infirmities in existing sanction schemes and endemic internal agency costs. I consider each of these in turn and identify those cases where enterprise liability is least likely to induce corporations to act in a socially optimum fashion. Having identified those cases where enterprise liability is likely to fail, I then examine the case for imposing supplementary liability on directors. Rather than looking to other corporate actors (shareholders, managers, creditors, employees and professional advisers), what factors inform the widespread reliance on oversight by directors? In the context of this discussion, I draw some general conclusions respecting the appropriate ambit of directors' liability.

II. THE DEFECTS OF ENTERPRISE LIABILITY

1. Externalities and Optimal Penalties

One of the standard rationales for state intervention is the internalization of external effects.\footnote{The rationales for public intervention are discussed in J. Stiglitz, *Economics of the Public Sector*, 2nd ed. (New York, Norton and Co., 1988), pp. 75-6. For a critical discussion of the role of externalities as a rationale for public intervention, see: C. Dahlman, “The Problem of Externality” (1979), J. L. and Economics 141.} To achieve allocative efficiency goals, the state is required to either tax or subsidize certain activities in order to ensure that the private benefits and costs of those activities are commensurate with the social benefits and costs that are occasioned. In the case of negative externalities connected to corporate conduct, internalization is achieved through the imposition of optimal penalties that are based on the social costs of the activity divided by the probability of detection.\footnote{Optimal penalties are discussed in R. Posner, *Economic Analysis of Law*, 3rd ed. (Boston, Mass., Little Brown and Co., 1986), pp. 205-13. See also: J. Arlen, “Optimum Criminal Sanctions for Corporations”, Working Paper WS 1992-93-10 in Law and Economics Workshop Series of the Law and Economics Programme at the Faculty of Law, University of Toronto; G. Becker, “Make Punishment Fit the Corporate Crime”, *Business Week* (March 13, 1989), p. 22, c. 2; and W. Landes, “Optimal Sanctions for Antitrust Violations” (1983), 50 U. Chi. L. Rev. 652.} Under neoclassical models of the firm, the threat of optimal fines should cause rational shareholders to instruct their agents to invest in avoidance activity to the point where the marginal costs of additional investment in avoidance activities equal the marginal benefits thereof. And because accountability is not a problem in the neoclassical model, agents will dutifully implement the instructions of their shareholder principals. In this respect, corporate personality is of little consequence.

2. Constraints on the Creation and Enforcement of Optimal Penalties

Nevertheless, when infirmities in private and public decision-making are taken into account, the efficacy of exclusive reliance on enterprise liability as a mechanism for achieving allocative efficiency becomes much less clear. The first difficulty for the model is the existence of practical constraints on creating and enforcing optimal penalties through increases in the level of fines to compensate for low rates of apprehension and conviction.
While the model envisages that fines can be raised without constraint, concerns about due process and fairness have prompted courts and juries to limit the level of penalties that the state is able to impose on wrongdoers. Apart from these moral concerns, the size of fines is also constrained by marginal deterrence and solvency problems. Where fines are set at extremely high levels, wrongdoers will have perverse incentives to increase the magnitude of their wrongdoing since they will already face high levels of punishment. Inevitably then, to achieve optimal penalties, the state is left with little choice but to increase the amount of resources expended on monitoring and enforcement in an effort to increase the probability of detection. However, in the current fiscal environment, it is often difficult for administrative agencies charged with enforcement of various regulations to secure the resources necessary to beef up their enforcement effort and, as a consequence, penalties will be below their optimal level.

The existence of moral, administrative and ethical constraints related to the imposition of optimal penalties has led a number of commentators to consider the feasibility of supplementary liability. Simply put, governments are considered incapable of creating efficient fines against corporations. But it may be deceptive to assess the efficiency of optimal penalties by focusing solely on the level of fines imposed by the state. The prosecution and conviction of a firm for wrongdoing may transmit valuable information to shareholders that will cause them to reassess the underlying value of the firm. Cornell and Shapiro, for instance, argue that reputational capital is an important component of organizational capital. If a breach of an obligation (to stakeholders or to society) is construed by stakeholders as evidence of

19 Posner, supra, footnote 17.
20 Kraakman, supra, footnote 15.
21 Interactive stakeholder monitoring is discussed in R. Daniels and G. Triantis, “The Role of Debt in American Corporate Governance”, draft dated April 28, 1993, on file with the author.
22 B. Cornell and A. Shapiro, “Corporate Stakeholders and Corporate Finance” [Spring, 1987] Financial Management 5, at p. 8. Cornell and Shapiro cite IBM’s willingness to manufacture parts and do repairs for its discontinued PC Jr. computer line, despite the losses that it created for the company. IBM’s willingness to do so was not motivated by altruism, but by concern over the signalling effect that breach of this commitment would have had on other present and future implicit obligations that the company had made or might wish to make in the future.
managerial willingness to breach obligations generally, this will impact the value of the firm. Indeed, in a recent empirical study, Jonathan Karpoff and John Lott found that announcements of criminal wrongdoing impose on firms substantial reputational penalties that greatly exceed the value of the fines levied on them by the state. 23

3. The Option Value of Limited Liability

The second major difficulty for the model is the existence of limited liability. Typically, in the financially solvent corporation, limited liability does not distort social incentives for responsible shareholder conduct. Assuming that optimal fines could be devised and enforced, shareholders would avoid engaging in sanctioned conduct up to the point where the marginal costs of avoidance equal the marginal benefits. Risk neutral shareholders will wish to avoid these fines because payment drains the corporation of profits that could otherwise be used to pay dividends to shareholders or, alternatively, to fund positive net present value projects that would increase the value of the shareholders’ claims. Nevertheless, as is implied by the standard agency analysis of the levered corporation, shareholders in financially distressed companies will be inclined to engage in risky behaviour in order to increase the option value of their equity investment. 24 In some circumstances, shareholders will be able to do this by avoiding their social responsibilities. Shareholders may, for instance, adopt projects that entail an increased likelihood of excessive gain but at

23 J. Karpoff and J. Lott, “The Reputational Penalty Firms Bear from Committing Criminal Fraud” (1993), 36 J. Law and Economics 757. Using data on 132 cases of alleged and actual corporate fraud from 1978 to 1987, the researchers found that initial press reports of allegations or investigations of corporate fraud against private parties were associated with average decreases of 1.34%, or $60.8 million, in the value of the common stock of affected companies. For frauds against government agencies, the loss in value is 5.05%, or $40.0 million. Since court-imposed costs represented just 6.5% of the total loss (penalties and criminal fines accounted for 1.4%), the loss in share value cannot be attributed to costs of expected state sanctions. These costs must reflect losses in the value of firm reputation.

the cost of social injury. If the project succeeds, the corporation will be in a position to pay the fine to the state. If it is unsuccessful and the company fails, the state, like other fixed claimants, will be forced to bear the loss.25

The impact of limited liability on shareholder incentives for opportunistic risk-taking depends on a number of different factors. First, as will be discussed below, owing to endemic agency problems, managers may not be willing to implement a course of wrongdoing that would further shareholder interests. Second, in respect of wrongdoing penalized by optimal fines, limited liability matters only when the company veers close to insolvency. Finally, while shareholders' financial wealth may be shielded from responsibility for wrongdoing, their reputational assets (esteem, stature in the community) may not be. Obviously, the more visible the connection between shareholders and the corporation, the more intense the sanction from the community.26 These concerns are likely to be most acute when the company is closely held. While not a perfect answer to shareholder opportunism, community sanctions will increase the costs to shareholders of corporate wrongdoing.

4. Agency Problems

The third and most important difficulty for the model of exclusive enterprise liability is endemic agency problems. These problems cut in a number of directions and greatly confound predictions of how a corporation will respond to optimal penalties.27 Although the received model of corporate law regards shareholders as the principals of the corporation, the fact remains that a variety of factors undermine the allegiance of directors and managers to shareholder interests.28 As Berle and Means

25 Obviously, if, as many commentators have suggested, the ability to control the corporation follows shifts in residual claimant status, then these problems will be ameliorated (J. Macey, “Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes”, [1989] Duke L.J. 173). Nevertheless, valuation uncertainties, as well as technical legal barriers, make rapid control shifts in the context of financially distressed companies problematic.

26 Community standing as a mechanism for promoting efficient forms of behaviour is discussed in R. Daniels, “The Law Firm as an Efficient Community” (1992), 37 McGill L.J. 801.


28 The pioneering work in the economic analysis of corporate law is by Henry Manne,
observed, these problems are most severe in the context of widely held companies. Due to innate co-ordination problems, shareholders will systematically under-invest in monitoring and disciplining their agents. Shareholders will be "rationally apathetic", realizing that the benefits of their investment will accrue to all but the costs will be borne by each alone. Consequently, rather than investing in monitoring and control, shareholders will prefer to free ride on the efforts of others. And, of course, if this is rational for one, it is equally rational for all and sub-optimal monitoring will take place.

Further compounding these difficulties are a variety of legal barriers. As Eisenberg has shown, the legal model of the corporation impairs shareholders’ capacity to control and influence the corporate agenda. Although shareholders are entitled to elect directors annually at general meetings, to requisition special meetings and to enforce directors’ specific legal duties, each of these mechanisms is costly to invoke and is subject to inherent limitations. And while some commentators express faith in a variety of structural (independent directors), political (institutional investor activism), and market mechanisms (product, capital and takeover markets) to surmount these problems, their efficacy, in so far as aligning shareholder and managerial interests is concerned, is dubious: some residual agency costs remain.


The term is credited to R. Clark. See discussion in R. Clark, Corporate Law (Boston, Mass., Little Brown and Co., 1986), chapter 3.


Eisenberg, ibid.


In respect of independent directors, see: V. Brudney, "The Independent Director — Heavenly City or Potemkin Village" (1982), 95 Harv. L. Rev. 597; and K. Scott, "Corporation Law and the American Law Institute Corporate Governance Project" (1983), 35
In this vein, it is necessary to acknowledge that directors and managers will not be perfect agents for dispersed shareholders. In the parlance of contemporary agency theory, managers will engage in opportunistic behaviour that is aimed at the diversion of shareholder wealth. In some cases, self-indulgent behaviour takes the form of shirking — the propensity to avoid undertaking expected levels of effort in the management of the company. In other cases, the difficulty is more serious and involves the misappropriation of corporate assets. However, the final and perhaps most widespread problem is risk aversion: the failure of managers to select certain positive net present value projects for the corporation because they increase firm specific risks of failure. While shareholders can reduce the impact of these risks by holding diversified portfolios, infirmities in human capital markets limit the ability of managers to achieve effective diversification.

The combined effect of these various agency problems on managers’ fidelity to shareholder interests confounds the analysis of corporate incentives to engage in conduct that is sanctioned by optimal fines. To begin with, as argued above, when corporations are financially solvent, risk neutral shareholders are unlikely to have strong *ex ante* incentives to engage in wrongful acts. The expected value of the optimal fine should deter any incentive to assume the risk of liability. The case, however, for senior managers is more complex. Risk averse or even risk neutral managers do not attempt to divert some of the gains they generate for the corporation to themselves. In other words, the wrongdoers are entitled to keep only that portion of the gain that is contemplated by the terms of their compensation arrangements with the firm.

I do not explicitly deal with the case of divisional managers and employees. To the extent that their division is performing well, the analysis tracks the argument developed in relation to senior managers in the solvent corporation. However, if their divisions are performing poorly, the analysis is closer to the analysis of managerial behaviour in the insolvent company.
senior managers are unlikely to assume the risk of engaging in proscribed conduct. Such conduct presents the manager with limited upside potential and substantial downside risks. In the manager’s best case scenario, her wrongdoing goes undetected by the state and by senior corporate managers and directors. In this case, her activities will be profitable to the corporation and, under most performance-based compensation systems, the manager can be entitled to keep some modest percentage of the ill-gotten gain; the lion’s share will go to the corporation’s shareholders.  

However, managers face non-trivial risks of discipline in the event that the wrongful activity is detected by either the state or the shareholders. In the case of detection by the state, the corporation will be publicly prosecuted and penalized. Although the optimal penalty is likely to far exceed the personal assets of the manager wrongdoer (and thus be beyond her ability to pay), the manager still faces significant costs from detection. To distance itself from her conduct, the corporation will be inclined to dismiss the manager, to publicly condemn her and even, perhaps, to sue her for damages. In tandem, these actions are certain to inflict a devastating toll on the manager’s investment in human capital.

In the case of detection by the shareholders alone, the manager can also expect to face discipline by the corporation despite the fact that, ex post, her conduct has proven profitable to shareholders. While shareholders will be hesitant to publicly penalize the manager (for fear of informing the state of the wrongdoing, which will subject the corporation to prosecution and to fines), they will be disposed to quietly but firmly sanction her conduct. Shareholders will worry that a failure to penalize wrongful conduct will encourage other managers to decide unilaterally to gamble the firm’s assets on wrongdoing, which may be detected by the state and punished by large fines. In summation then, for senior managers in a solvent company, wrongdoing would appear to hold little attraction.

The analysis of managerial conduct shifts if the corporation is financially distressed. As discussed above, shareholder incentives for risk-taking will be greatest in this setting. The question is

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40 M. Jensen and K. Murphy, in “Performance Pay and Top Management Incentives” (1990), 98 J. Pol. Econ. 225, find that most executive compensation arrangements permit managers to keep only a trifling percentage of the gains they produce for corporations (CEO wealth changes $3.25 for every $1,000 change in shareholder wealth).

41 See Arlen, supra, footnote 17.
whether shareholder desires translate into managerial action. As shown by LoPucki and Whitford and by Gilson, most managers will not retain their jobs through the bankruptcy and reorganization process. Thus, while managers are usually risk averse, their preferences may shift as the company nears insolvency because they fear that they have little to lose, and it is at this point that they will be willing to engage in prohibited conduct. Because shareholder action is not a necessary condition for corporate action, willingness to engage in wrongdoing is primarily a function of managerial self-interest and so, with or without shareholder agency costs, shareholders' and managers’ interests will coincide. On the other hand, in light of their imminent re-entry into the job market, managers may reason that the best strategy to adopt in a distress situation is one of honesty and integrity. Rather than using wrongdoing as a way of gambling the company back to success, the managers may decide to avoid scrupulously any hint of wrongdoing out of a concern for inflicting irrevocable damage on their reputational capital in the managerial job market.

5. Assessment of the Case for Enterprise Liability

The foregoing discussion indicates that enterprise liability in a regime characterized by optimal fines should, in the vast majority of cases, ensure corporate adherence to explicit social obligations.

42 L. LoPucki and W. Whitford, “Corporate Governance in the Bankruptcy, Reorganization of Large, Publicly Held Companies” (1993), 141 U. Penn. L. Rev. 669 (90% of CEOs of firms in the sample were replaced in the period beginning 18 months prior to the filing of a plan and ending 6 months afterward); S.C. Gilson, “Bankruptcy, Boards, Banks and Block Holders” (1990), 27 J. Fin. Econ. 355 at pp. 369-71 (half of the companies in the sample of companies in Chapter 11 or private reorganization removed the CEO or directors during restructuring process).

43 Managers' refusal to follow shareholder desires by wrongdoing should not be regarded as a pure agency problem. In a near insolvency situation, residual claimant status is ambiguous and, functionally, though not at law, managers could be regarded as agents of creditors as much as of shareholders. Alternatively, managerial resistance to shareholder desires for risk-taking may be seen as consonant with the terms of the ex ante contract negotiated between shareholders and managers. As A. Shleifer and L. Summers have argued in another context (“Breach of Trust in Hostile Takeovers”, chapter 2 in A. Auerbach, ed., Corporate Takeovers: Causes and Consequences (Chicago, Ill., U. Chi. Press, 1988)), the reputational integrity of managers is a bond that shareholders can post to other stakeholders that reduces the costs of monitoring and contracting. According to the authors, managerial reputational bonds are so valuable in facilitating cost effective contracting that "shareholders . . . (will) seek out or train individuals who are capable of commitment to stakeholders, elevate them to management, and entrench them" (at p. 40, emphasis added).
None the less, the analysis also indicates that there are a range of situations in which enterprise liability may not be sufficient to secure socially optimal outcomes. However, given the complex interplay of factors involved, these situations defy neat categorization and facile regulatory solutions. The task for policy-makers is to determine when, why and to what degree enterprise liability is likely to fail and then determine, as among a number of different alternatives, if a Pareto improvement is possible and the most efficient way of realizing it. In this respect, supplementary ex post liability for particular corporate actors is but one of many choices. Defects in the calculation of optimal fines may be best redressed by more vigorous enforcement (raising the probability of detection) or by redesign of the social and legal institutions that constrain the imposition of the optimal fine. Alternatively, minimum capital and insurance levels for corporations may be an attractive option.44

In any event, across the entire range of policy options available to correct for defects in enterprise liability, it is important for policy-makers to avoid falling prey to the Nirvana fallacy. Just because a defect in the existing structure of liability has been identified does not mean that the state, even through the most well-intentioned and nuanced use of public instruments, will be able to generate welfare gains for society by changing the structure. Infirmities in public decision-making, combined with unanticipated and perverse behavioural responses by those subject to regulation, may thwart ostensible social gains.45 This is particularly important to bear in mind when contemplating supplementary personal liability. Whereas enterprise liability allows shareholders the latitude to devise regimes for controlling liability exposure that are configured to the specific needs of their firm, supplemental liability is a much blunter instrument that may inhibit implementation of optimal arrangements.

III. DIRECTORS AS SOCIAL MONITORS OF CORPORATE CONDUCT

1. The Case for Supplementing Enterprise Liability with Directorial Liability

If it is assumed that a case exists for resorting to some type of supplementary liability in an effort to bring corporate and social interests into alignment, the question then becomes which actors associated with the corporation are the most appropriate targets of liability. A related question is whether this liability should be imposed absolutely or strictly, and whether it should be subject to explicit transfer. Recently, this issue has attracted considerable attention in the context of supplementary shareholder liability. However, for the purpose of this article, I wish to concentrate solely on directorial liability, which has been generally ignored in the academic literature.

On the surface, a strong case can be made for directorial liability imposed through statutory enactment. At the core of this claim is the notion that the board is the legal and functional command centre of the corporation. Under most Canadian corporate statutes, the board is vested with the responsibility of managing (and, in some cases, supervising) the business and affairs of the corporation. Although this legal requirement seems to imply that directors must be actively involved in the day-to-day management of the corporation, judicial interpretation has recognized a much more circumscribed role. While directors are under a duty to be informed about the activities of the corporation, they are not bound to participate in or to approve every decision made by the corporation. Rather, their role is one of general oversight, direction and control.

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49 For an extreme and, no doubt, outdated articulation of this view, see: Brazilian Rubber Plantations and Estates, Ltd. (Re), [1911] 1 Ch. 425 (C.A.); and City Equitable Fire Insurance Co. Ltd. (Re), [1925] 1 Ch. 407 (C.A.).

50 Generally, the board is required to set strategic objectives for the corporation and then to
The central role of the board in the legal model is echoed by various economic theories that purport to explain why economic activity is organized in firms rather than by market contracts.\(^{51}\) Some theorists place faith in firm hierarchy, namely the ability of those at the apex of the corporation, presumably the board, to direct firm resources by command rather than negotiation and contract.\(^{52}\) Other theorists emphasize the complex monitoring and control mechanisms that are supervised by the board.\(^{53}\) Regardless of the precise rationale, institutional oversight by the board is a key functional feature that explains the survival of the firm.

In view of the central monitoring and control function that the board performs in relation to its shareholder obligations, it is not at all surprising that the state would view it as the natural (\textit{i.e.}, least cost) avoider of corporate social harm. The logic is seductively simple. To perform its monitoring function effectively on behalf of shareholders, boards of directors rely on a number of different organizational mechanisms, including channels of communication that provide for the transmittal of real-time information to the board; specialized institutions (\textit{i.e.}, specialized subcommittees of the board) that provide expertise in the review and analysis of collected information; and, finally, levers that enable the board to shift corporate performance in response to the information received. Thus, with these mechanisms for collecting, analyzing and reacting to information already in place, the costs to the board of attending to other explicit obligations in its decision-making should be marginal, particularly in view of the tighter boundaries on directorial discretion entailed by enumerated social obligations.

Take, for example, the requirement that boards of directors be explicitly responsible for the corporation’s failure to meet sundry

\begin{itemize}
\item review the corporation’s performance regularly with a view to determining whether these objectives are being realized; to ensure the corporation’s compliance with its legal and social responsibilities; to negotiate and then review the effectiveness of executive compensation arrangements; to plan for executive succession; to vet conflict of interest transactions to ensure fairness to the corporation; and, finally, to resolve crisis situations (\textit{e.g.}, financial distress).
\end{itemize}


\(^{52}\) Coase, \textit{ibid}.

environmental liabilities. Even in the absence of explicit directors' liability, a well functioning board would already be monitoring the various parts of the corporation’s production process that entail environmental risk.\textsuperscript{54} In part, this monitoring may be undertaken in response to explicit enterprise liabilities. In part, however, the board may be monitoring these activities with a view to ensuring low cost, efficient production. Once the board (or management on the board’s behalf) has established mechanisms for centralized collection and transmission of general performance data, it can be argued that the marginal costs of modifying these mechanisms so as to include additional data and/or interpret these data against different performance benchmarks will be low or trivial. In other words, by imposing supplementary liability on directors, the state is able to exploit intra-firm economies of scope.

It is important to note, however, that the case for supplementary directors’ liability need not turn exclusively on the claim that the board, as among different corporate actors, is the least cost avoider of proscribed conduct. Even if they are not, directors may be the best group within the corporation to identify the true least-cost avoiders and then, if permissible, to arrange for the transfer of liability to them. Although the line separating control and transfer of risks is murky, the idea is that through explicit insurance and indemnification contracts, through the retention of outside experts in monitoring and control, and through the creation of explicit monitoring groups within the corporation and the formal transfer of authority to them, boards are able to shift the risks that are initially imposed on them and, therefore, the responsibility for compliance with legal and social obligations. Of course, the successful transfer of these risks depends on a number of factors, the most important being the state’s willingness to legally recognize the legitimacy of these risk transfers.

The board’s superior risk-shifting ability is a function of its access to firm proprietary information and its low co-ordination costs in negotiating transfers of risk. The board is typically comprised of a relatively small group of individuals who share similar values, views and goals. As well, the board enjoys an established organizational structure with a high claim on

\textsuperscript{54} The role of the board in the context of environmental responsibilities is discussed by Diane Saxe, \textit{Environmental Offences: Corporate Responsibility and Executive Liabilities} (Aurora, Canada Law Book Inc., 1990).
corporate resources to fund its activities. For all of these reasons, the board, particularly in comparison to far flung shareholders who are more remote from internal corporation decision-making, is best able to identify risk and then transfer it to other actors. Indeed, if anything, the concern may be that the board, especially in relation to risk transfers to employees, will be able to negotiate terms that reflect disproportionate bargaining power and not optimal allocations of risk.

The final argument buttressing the case for directors' liability relates to the role of outside directors. Where the interests of shareholders and managers converge in the direction of proscribed conduct, the inclusion of outside directors on the board of directors narrows the scope for wrongful conduct. In contrast to inside managers, the economic stake (both financial and human capital) that most outside directors have in firms upon whose board they serve is quite limited. Most directors having outside appointments on the boards of public companies are individuals who do not depend for their livelihood on the income received for board service. Most, in fact, are senior management personnel from other companies.

As a result of this limited economic stake, outside directors are much less likely than management to be swayed by shareholder desires for wrongful conduct in end-period situations. Quite the opposite — outside directors will worry that conduct that debases their reputational investment will induce spillover effects that will reduce their effectiveness, thus the value of their economic investment, in their primary activities. The CEO of another public company sitting as an outside director is unlikely to relish the thought of being implicated in conduct that contravenes explicit legal obligations. The same would be true for professional advisers

55 Few outside directors hold large stock positions in the companies on whose boards they sit. Moreover, the standard compensation arrangements for outside director service are not keyed to corporate performance. Instead, directors are compensated on the basis of a relatively low annual fee augmented by bonuses tied to attendance at board and subcommittee meetings. Korn/Ferry Board of Directors, Fifth Annual Survey in Canada, 1991 (73% of surveyed companies compensate directors with a combination of an annual retainer plus per meeting fees. In 1990, the average total combined fees paid to Canadian directors (including committee service) equalled $17,160). See also: Canadian Directorship Practices: Compensation of Boards of Directors, Report 72-91 (Ottawa, Conference Board of Canada, 1991).

56 Indeed, according to the Korn/Ferry Survey, the preferred candidates (by 95% of surveyed CEOs) for outside directors are “active CEOs and COOs”, and the second most desired category is “retired CEOs” (76%).
who serve as outside directors, even when their firms have professional relationships with the company. Thus, as between the interests of the corporation on whose board they serve and their own interests in safeguarding the value of their investment in reputational capital, outside directors will almost always favour the latter, thereby increasing the efficacy of directors’ liability.

2. **Cracks in the Edifice: Limiting the Case for Directors’ Liability**

On the basis of the foregoing discussion, the case for supplementary directors’ liability would appear to be relatively unassailable. Once the state determines that enterprise liability is incapable of aligning societal and corporate (i.e., shareholder) interests, the imposition of liability on directors naturally follows. And while the formation of a supplementary liability regime requires the state to define precisely the duties and penalties imposed on directors, these issues are largely secondary design issues that do not impact on the basic soundness of targeting directors.

Yet, to this point, the discussion has assumed that directorial oversight and control of the corporation’s social responsibilities by directors can be invoked at relatively low social cost. However, careful examination of the case in favour of directors’ liability demonstrates reliance on several hidden assumptions that understate the true social costs accompanying directors’ liability. As in most other areas of public policy, the internalization of the costs of corporate wrongdoing is not an absolute goal.\(^{57}\) If, when viewed from a societal perspective, it can be shown that the costs (i.e., to wealth creation) of directors’ liability outweigh the benefits, then legislative caution in involving directors in the pursuit of public goals is merited. For instance, were directors to react to directors’ liability by recoiling from socially optimal levels of risk-taking, then this behavioural response should be considered in the social calculus governing the use of directors’ liability.

In the following discussion, I identify and assess the importance

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\(^{57}\) For instance, while some critics (extreme naturalists) have called for a societal prohibition on all activities that entail any risk of harm to the environment, most commentators, even those affiliated with the environmentalist movement, recognize that such outcomes are neither feasible nor desirable. At some point, the spotted owl takes a back seat to life-saving drug production.
of qualifications on the use of directors' liability. Specifically, I focus on the role of director risk aversion; limited availability of risk-shifting strategies; managerial board domination; and sub-goal pursuit. In conjunction, these factors imply a far more qualified case for directors' liability than is traditionally acknowledged by its enthusiasts. In no particular order, I discuss each below.

(i) Director Risk Aversion

Outside directors are prized for the integrity, judgment and experience they bring to the management of the corporation. These attributes are undoubtedly a reflection of the considerable success that directors are required to demonstrate before becoming eligible for an appointment. And, as was mentioned earlier, the value of these accomplishments constitutes a crucial plank in the case for directorial liability. Essentially, the outside director posts his or her reputational investment as bond that is subject to forfeiture in the event that the corporation's performance violates community norms of behaviour, and these violations are traced to some sort of failure by directors. In the simplest case, forfeiture is triggered by legal sanction. But, as Charny has argued, non-legal sanctions may also impose penalties on wrong-doers that are no less stinging than legal ones. 58

For the outside director, posting this bond is not something that is done lightly. Unlike other sorts of investments that are subject to market diversification, the outside director's reputation is not. If the board is seen to have contributed to the corporation's failure to comply with certain explicit or implicit social obligations, all of the directors' reputational capital will be debased. The public criticism that outside directors have received following a host of recent corporate failures is evidence of the intensity of this sanction. 59 The fear of sanction is undoubtedly magnified by virtue of the nature of boardroom decision-making. Outside directors

58 D. Charny, "Nonlegal Sanctions in Commercial Relations" (1990), 104 Harv. L.Rev. 373.
59 A vivid illustration of this risk is provided by the recent shareholders meeting of Royal Trustco Ltd., the ailing trust company in the Hees/Edper Group. During a 4-hour, 10-minute special shareholders meeting called to approve the sale of substantially all of the trust company assets to Royal Bank, the directors and management were excoriated by irate shareholders. "Shareholders speak out: 'You have brought this company to its knees' ", Globe and Mail, Saturday, June 19, p. B1.
may not have been mainly, or even marginally, responsible for certain decisions, but unless the board is subject to legal prosecution, there will be little opportunity for innocent directors to exculpate themselves. Directors must expect the public to tar the board of a misperforming company with a broad brush.

In this environment, a board that cannot effectively control or transfer risks of social liability is likely to become extremely risk averse in its decision-making. Instead of evaluating and then adopting projects under a positive net present value rule, directors are more likely to consider extraneous factors that reflect extreme sensitivity to the prospects of legal and social sanction. The predictable consequence of directorial risk aversion will be to bias project choice towards less risky projects, even though these projects have lower positive (or in the extreme, negative) net present values in relation to other available projects. In this respect, directors' liability may seriously jeopardize allocative efficiency goals.

(ii) Limited Availability of Risk-Shifting Strategies

Director risk aversion would not be so severe if effective risk-shifting strategies were readily available to the board. The most obvious way to protect oneself from the risk of director liability is through insurance. Indeed, elected politicians have frequently invoked the prospect of risk-shifting through insurance contracts as a way of defusing business concern over the proliferation of directors' liabilities. The belief is widespread that if only directors were willing to pay the price, private insurance markets would be able to provide directors with effective protection from non-trivial financial losses related to corporate wrongdoing.60

Unfortunately, the gulf between perception and reality respecting the availability of directors' insurance coverage is large. In an analysis of the directors' and officers' (D&O) insurance market in Canada, Daniels and Hutton find that, as a specialty or fringe line of insurance, D&O coverage is subject to abrupt and quite dramatic fluctuations in supply.61 These supply fluctuations

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60 In arguing for the adoption of revisions aimed at expanding the liability of directors under the provincial Employment Standards Act, the Ontario NDP Government frequently expressed the view that insurance would be available to protect directors. See brief discussion in R. Nixon and L. Tennant, "Obligations of Officers and Directors under the Ontario Employment Standards Act" (draft paper on file with author).

61 Ronald J. Daniels and Susan M. Hutton, "The Capricious Cushion: The Implications of
can be measured in a number of ways: price and deductible increases, coverage exclusions and compression of coverage periods. The most distressing problems are related to growth in excluded categories of insurance and in coverage restrictions. The use of these restrictions means that at some points in the insurance-cycle coverage for certain D&O liability risks will not be available at any price. For example, in 1987, the last year for which data were available, 91% of the insurance policies written in Canada excluded liability for pollution and environmental damage and 17% of the policies contained exclusions for actions by various regulatory agencies. Furthermore, most insurance policies were written on a claims-made basis and allow for only relatively short discovery periods after termination.

The net effect of these various restrictions is to make risk-shifting via insurance an extremely speculative strategy for most directors. Even if directors can secure appropriate levels of insurance, the combined effect of the claims-made basis of policies, relatively short insurance terms, and compressed discovery periods still leaves directors vulnerable to civil actions arising out of conduct undertaken during the term of the policy but which were not commenced until after expiry of the policy.

If insurance offers directors only limited and capricious opportunities for risk-shifting, what other strategies exist? Under most, though not all, statutory liability provisions, directors are able to escape liability for corporate wrongdoing if they can satisfy a due diligence defence. Under the due diligence test, courts will permit directors to shift risks to officers, consultants, and other outside experts so long as their reliance on these individuals is reasonable. In this respect, retention of and reliance on specialized experts offers the board some additional scope for risk-shifting.

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62 To account for the differential impact of these factors on insurance availability, the Wyatt Company constructs a premium index that attempts to capture the combined effect of these trends on total coverage. Taking 1974 as a base year of 100, the Wyatt Premium Index stood at 71.2 in the United States and 58.6 in Canada in 1982. By 1984, the index had fallen further to 54.3 in the U.S. and 52.4 in Canada. In 1987, however, the U.S. index stood at 682.4 and the Canadian index at 361.1. Essentially, during the three-year period between 1984 and 1987, D&O insurance became 13 times more expensive for American companies and 7 times more expensive for Canadian ones.

Nevertheless, risk-shifting to inside or outside experts pursuant to a due diligence defence is subject to inherent limitations. Before permitting directors to rely on delegations to experts (either outside or inside the corporation), directors are still required to show that they exercised due care and diligence in the selection and monitoring of these individuals or firms. The continuous monitoring obligation tends to subvert the capacity of directors to effect crisp delegations of authority. Not only are directors required to react to problems that arise under an internal monitoring system, but, as well, they are also expected to conduct periodic review to ensure that the system installed by experts is working effectively and, if not, to take immediate and appropriate action.\textsuperscript{64} Obviously, the spectre of \textit{ex post} judicial review of conduct taken after diligent delegation creates considerable uncertainty for directors in knowing whether they have, in fact, shifted liability risks.

No doubt, at least part of the difficulty for directors in implementing effective risk-shifting strategies through delegation is related to judicial concerns about opportunistic delegation. As was mentioned earlier, directors might attempt to exploit their command and control powers within the corporation by thrusting their statutory obligations on lower level employees for compliance with social responsibilities. While, in theory, it is always open to employees to quit companies whose boards are making unfair demands of them, non-diversifiable investments in firm-specific assets may create undesirable lock-in effects, which impair employee exit and, as a result, erode the strength of threat strategies aimed at limiting the assumption of risks or at extracting fair compensation for risks that are assumed.

However, judicial uncertainty may extend beyond these concerns of board coercion and reflect a desire to effect social loss-spreading. As Trebilcock and Priest have both argued in the tort

\textsuperscript{64} In the recent \textit{Bata} case, for instance, the court considered the following factors in determining whether the directors of a company which had unlawfully discharged waste into the environment were liable for the breach: (i) were the directors aware of industry standards in controlling comparable environmental risks; (ii) did the directors establish a pollution control system; (iii) did the directors monitor regularly management's compliance with the system, and, in particular, did they ensure that they would be informed by officers of any non-compliance in a timely manner; (iv) in the event that the system failed, did the directors immediately and personally react? See \textit{R. v. Bata Industries Ltd.} (1992), 9 O.R. (3d) 329 at pp. 362-3, 70 C.C.C. (3d) 394, 7 C.E.L.R. (N.S.) 245 (Prov. Div.).
context, courts, while paying lip service to the spirit of traditional doctrinal negligence standards, have in actuality interpreted these standards in a way that permits them to distribute losses broadly across society. In the case of directors' liability, courts may well reason that by imposing losses directly on directors, loss-spreading goals will be realized because of insurance coverage. Put simply, statutory defences of reasonable care and diligence constitute only a weak fetter on judicial social engineering. Indeed, cases regarding directors' liabilities for the collection and remittance of sundry governmental payments reveal in arresting terms the difficulties that directors confront in identifying durable and effective safe harbours.

The difficulty, of course, is that without recourse


66 The notorious Fraser case is a telling example of these problems (Fraser (Trustee of) v. M. N. R. (1987), 87 D.T.C. 250, 64 C.B.R. (N.S.) 58 (T.C.C.)). Fraser was one of three directors on the board of a small company that failed to remit certain taxes owed to Revenue Canada and which later became bankrupt. Fraser was a 15% shareholder of the company and was responsible for manufacturing operations. There were two other principals of the company who were also directors, managers and shareholders. These individuals had control over all financial aspects of the company's activities. One of them was trained as a chartered accountant. Although Fraser had signing authority with respect to the company's bank account, he used it only once. In 1981, the company ran into financial and tax remittance difficulties, which became apparent to Fraser in March, 1982. At that time and several months later, Fraser made inquiries of the other two principals respecting the nature of these problems. He was assured that although there were arrears with Revenue Canada, they would be covered by profits from contracts with which Fraser was acquainted. Despite Fraser's inquiries of the other principals, the court refused to allow him to escape personal liability for the tax shortfall through reliance on a due diligence defence because he "did absolutely nothing to prevent the failure". The court stated that:

Although (Fraser's) expertise lay in the field of manufacturing operations, I cannot believe that he did not possess the skill and ability necessary to formulate policies required to ensure that (the company) was at least discharging its obligations under (the Act). This is not a case in which a director is forced to rely on other directors or officers or subordinate employees because those others possess skills which he does not. Mr. Fraser did not make an unsuccessful attempt to prevent default. He simply did not try.

At least one commentator has argued that Fraser could have prevented the corporation's failure to remit taxes by requesting an immediate board meeting, examining financial information with respect to source deduction, establishing a corporate policy and procedure that would ensure compliance with the Act, obtaining an undertaking from the treasurer that such policies and procedures would be complied with in the future, and, finally, undertaking review himself of the corporation's financial information to ensure that the treasurer was complying with established policies and procedures. However, it is clear that such a course of action sterilizes any significant delegation of authority to inside or outside specialists, thereby complicating the search for an
to effective insurance policies, judicially imposed liability on directors does not end up being spread across society, but falls squarely on the shoulders of directors. Faced with limited risk-shifting opportunities, the board will rationally constrain socially desirable risk-taking in an effort to limit directors' liability. Alternatively, as in the cases surveyed at the outset of this article, directors will resign from boards at the first sign of crisis.

(iii) Managerial Domination of the Board

Compounding the difficulties that risk-averse directors face in shifting liability risks are the traditional problems relating to inside domination of corporate boards. As numerous commentators have pointed out, corporate boards are dominated by inside management in the case of widely held companies or, in the case of closely held companies, by controlling shareholders. 67 This domination derives from the tight control wielded by insiders over the nature and quality of information that reaches the board and over the opportunities for boards to discuss the implications of this information for corporate performance. This control does not reflect improper motives on the part of insiders. Rather, it is a natural outgrowth of the time constraints that limit outside directors' involvement in board activities and, more importantly, of the appropriate deference that outsiders should show to insiders who are performing their duties responsibly and effectively. Given this control, outside directors will face daunting obstacles in challenging management's handling of the corporation's social obligations.

However, this problem of deferential directors is usually attenuated in companies that are suffering crises relating to lacklustre economic performance, conflict or fraud. Empirical studies of the board of directors show that the more severe the crisis confronting the company, the more likely it is that insiders will lose their stranglehold over the board. 68 Irrespective of the strength of the relationship that outside directors have to the company, most

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67 See, generally, Brudney, supra, footnote 35.
outside directors will be sufficiently attentive to their shareholder and societal obligations in distress situations that they will resist inside domination. Yet, given the deferential stance usually adopted by outside directors, delays will inevitably plague outside directors in asserting effective control over the corporation. 69 Possibly, these problems can be ameliorated by institutional investors placing early pressure on the board in distressed companies. 70

(iv) Sub-goal Pursuit

The final problem confronting both inside and outside directors in meeting social obligations is sub-goal pursuit, namely the prospect that lower level employees whose co-operation is essential for the implementation of an effective corporate compliance regime will fail to take proper care in performing activities that entail risks of directors' liability. 71 In essence, sub-goal pursuit is just another species of agency problem. The fact that employee goals and interests are not convergent with the board's means that employees will systematically deviate from the instructions given by management and the board. Lower level employees may be less risk-averse than the board or management because they may feel confident that murky internal lines of accountability will insulate them from responsibility for corporate wrongdoing. 72 The problems created by sub-goal pursuit are exacerbated when the board is dependent upon lower level employees for the collection, analysis and dissemination of crucial performance information. By withholding or, even more aggressively, distorting front-line information, employees may be able to bias board decision-making in directions that would be deemed perverse were accurate information available. 73 Thus, the

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69 In rapidly deteriorating situations, these lags may mean that outside directors never have the chance to exert meaningful scrutiny and control. Essentially, the company goes bankrupt before the directors muster the wherewithal to act.

70 Essentially, institutional pressure, providing it is brought early enough, gives outside directors the leverage to alter the traditional boardroom dynamic of deference.


73 However, recent improvements in information collection and retrieval, as well as
inclusion of sub-goal pursuit into the analysis of supplementary liability raises legitimate concern over whether a board, even one that is committed to full realization of the corporation’s legal and social obligations, will be able to ensure responsible corporate conduct. Obviously, the severity of these problems is greatest in those companies with complex and multi-tiered internal organizational structures.

3. Assessment of the Case for Supplementary Directors’ Liability

The case for supplementing enterprise liability with specific directors’ liability is more complex than hitherto has been acknowledged. While considerations of the board’s access to information and its control over the corporate machinery push in the direction of liability, consideration of director risk aversion, limited insurance availability, sanction indeterminacy emanating from judicial loss-spreading, inside domination and sub-goal pursuit push in the opposite direction. In the end, the imposition of explicit liability on the board may create more social costs than benefits. In some cases, liability chill will deter talented individuals from accepting a nomination for board service. Alternatively, individuals may agree to serve on boards, but then insist as a precondition of service that management sedulously avoid any activities entailing the prospect, however remote, of directors’ liability. In either case, the costs, to the corporation and to society, of foregone wealth production are clear and unequivocal.

IV. Conclusion

The previous discussion underscores the daunting complexities for policy-makers in determining, first, when enterprise liability should be deviated from and then who, as among the shareholders, creditors, directors, managers and employees, should be the target of this liability. In this article, I have simply focused on the board of directors — a group which, in Canada at least, is being increasingly fingered for liability by legislatures. While it is

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compression of corporate hierarchies through paring of middle-management positions, may partially counter these problems. See discussion in P. Drucker, Post-Capitalist Society (Butterworth-Heinemann, 1993).
tempting to conclude that the analysis required to justify the imposition or removal of directors' liability is so complex and fact specific that forming general observations is parlous, it seems that there are at least a few general guidelines that follow from this analysis, and which assist in devising optimal corporate liability regimes.

The first and most obvious conclusion is that policy-makers must proceed cautiously before deviating from enterprise liability as the primary, if not exclusive, mechanism for aligning social and corporate interests. As the earlier discussion suggests, even in the face of endemic societal limitations on the imposition of optimal fines, there are clear grounds for assuming that enterprise liability is an effective control regime. There will, of course, be situations in which enterprise liability is likely to fail, but the crucial question is whether the social costs of these failures are so severe that abandonment of the flexibility inherent in the enterprise liability regime is merited. Unlike the blunt instrument of ex post fines against specific corporate actors which is available to the state, a wide array of internal sanctions and rewards can be used by corporations to ensure socially responsible corporate behaviour, including promotion, compensation, criticism, and dismissal. Policy-makers ought to be attentive to the likelihood that creation of supplementary legal liability regimes may diminish the attractiveness to shareholders of establishing and operating better calibrated and nuanced systems on their own.

However, once policy-makers have decided to opt for directors' liability, they should be careful to ensure the availability of clear, crystallized safe harbours for diligent directors. While explicit standards will undoubtedly retard investment by directors in innovative risk control strategies, director risk aversion combined with infirmities in the D&O insurance market make crystallized, rather than fuzzy, standards desirable. Crystallized standards limit the ability of courts to pervert statutory standards in an effort to achieve loss-spreading objectives. Clear standards will also enable directors, even in the context of inside dominated boards, to make discrete, limited inquiries of management that are aimed at ensuring fidelity to social and legal obligations, but without impairing the overall dynamic of the board in the well-performing company. In this respect, the few statutes that impose absolute liability on directors (e.g., responsibility for employee wages and benefits) should be an early target for legislative revocation.
Another point relates to the inherent limits in any corporate liability regime, however constructed, on its capacity to vindicate simultaneously all of society's objectives. Generally, corporate liability should be viewed as a deterrence mechanism: by internalizing all of the costs of wrongful conduct within the corporation, corporations will be encouraged to engage in socially responsible levels of activity. However, the reliance on absolute directors' liability provisions in some contexts suggests that other goals (most likely compensation-related) are implicated. If compensation for certain groups, e.g. workers displaced by structural change, is a valuable objective, schemes which more efficiently realize this objective should be devised. One is particularly struck by the paralyzing terms of the debate which has surrounded the issue of whether directors or creditors are the most appropriate risk-bearers for back-wages and other benefits owed to employees in bankruptcy. In focusing on the narrow issue of how best to meet these claims, policy-makers have largely ignored the disconcerting reality that even if a claim for back-wages and benefits were fully met, many employees would still be left to bear considerable non-diversifiable losses from foregone future earnings. From a societal standpoint, these very concentrated losses are deserving of much greater policy attention than the relatively trivial losses involved in unpaid back-wages.

A final point relates to the rather simplistic and cynical perspective that some public officials have brought to the enterprise of constructing and implementing optimal corporate liability regimes. Implicit in the way in which directors' liability statutes

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76 The issue of unpaid employee wages has loomed large in the process of revising Canada's bankruptcy legislation. Numerous drafts of proposed legislation were defeated on the employee wage issue, specifically whether employees should receive a super-priority over secured claimants of the firm (and to what extent) or whether employee claims should be dealt with via a state-administered unpaid wages fund furnished by a payroll tax. For a review of this debate, see: D.B. Gleig, "Unpaid Wages in Bankruptcy" (1987), 21 U.B.C.L.Rev. 61.
77 The average loss to employees whose companies entered bankruptcy was found to be $900 in 1980 (Canada, Report of the Committee on Wage Protection in Matters of Bankruptcy and Insolvency to the Minister of Consumer and Corporate Affairs (October 1981), p. 30). This number pales in comparison to the considerable welfare losses that employees can suffer from premature termination. See discussion and data in Daniels, *supra*, footnote 26.
are promulgated and enforced is the assumption that directors and other corporate insiders are cavalier about corporate failure. After all, the vast preponderance of modern directors' liability sanctions are triggered only when the company is bankrupt and the corporate estate is insufficient to cover all of the explicit social obligations. Yet, it is important to recognize the extremely powerful incentives that virtually all corporate actors have to avoid failure. For shareholders, creditors, managers and employees, corporate failure is an outcome which entails devastating financial hardship and, in the case of directors, profound personal embarrassment. The cases where a corporation deliberately opts for failure in order to avoid explicit or implicit obligations are few and far between, and policy-makers should avoid viewing these pathological cases as a paradigm for regulation. Moreover, policy-makers should bear in mind that failure is both an inevitable and desirable product of risk-taking in particular, and capitalism in general — recall Schumpeter's apt description of capitalism as a process of creative destruction. In this vein, rather than holding those individuals associated with failure up to societal condemnation, a more restrained, sympathetic stance is in order. Rolling back the unbridled expansion of statutory directors’ liability provisions would constitute a first important step in this direction.

I should emphasize that this claim is not borne out of any innate antipathy to the role of the modern welfare state — just the opposite. My concern is that if left unchecked, burgeoning dependence on directors’ liability will undermine the capacity of the public corporation to generate the wealth surplus necessary to fund the most cherished goals of the welfare state. To accommodate itself to the globalization of the modern economy, Canadian industry has experienced one of the most profound and wrenching periods of structural adjustment ever. The escalating pace of layoffs and plant closures powerfully illustrates the magnitude of this transition. If, upon close inspection, there is evidence that directors’ liability provisions are hobbling either the daring or the creativity of the traditional corporate governance apparatus in responding to globalization pressures, then this is an issue which commands careful and immediate legislative attention.