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Law, Norms, and the Breakdown of the Board

Renee M. Jones

Boston College Law School, renee.jones.2@bc.edu

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Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance

Renee M. Jones

Assistant Professor, Boston College Law School

Eugene P. Beard Faculty Fellow in Ethics, Edmond J. Safra Foundation Center for Ethics, Harvard University



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Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance

*Renee M. Jones**

ABSTRACT: This Article considers the dominant claim in corporate law literature that extra-legal mechanisms such as markets and social norms provide adequate safeguards against corporate mismanagement and opportunism. After noting recognized deficiencies in the arguments from market discipline, the Article draws on psychological insights to show that certain behavioral phenomena prevent social norms from appropriately constraining corporate conduct.

It then argues that because neither markets nor social norms can sufficiently discipline corporate officials, a credible accountability mechanism is necessary to prevent director conduct standards from deteriorating. Unfortunately, an inveterate tradition of judicial deference in corporate law has undermined the role of fiduciary duty litigation as a mechanism for accountability.

To promote greater accountability in corporate governance, the Article recommends reforms to the director liability regime. It argues that litigation and settlement practices should require negligent directors to make personal payments toward settlements and damage awards, and that such payments should be calibrated based on a director's ability to pay. This proposal addresses two main weaknesses in the current director liability regime: (1) judicial nullification and (2) legitimacy concerns regarding the scope of directors' liability risks.

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A reduction in penalties for fiduciary breaches should increase the likelihood that judges find liability in appropriate instances. Calibrating penalties should also improve general perceptions of the legitimacy of corporate law rules, and thus support the internalization of proper moral values by directors so that they are better motivated to fulfill their fiduciary obligations to corporations and their shareholders.

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I. INTRODUCTION

A puzzling aspect of corporate law is the absence of an effective enforcement mechanism for the duties of loyalty and care that form its traditional foundation. A combination of substantive doctrines and procedural requirements embodied in corporate law has made it nearly impossible for shareholders to prevail when challenging the decisions and practices of corporate management. One wonders how a set of virtually unenforceable rules can be expected to influence the actions of corporate officers and directors. More broadly, our corporate governance structure raises the question of whether a system of legal rules unbuttressed by a credible threat of sanction can actually deter the conduct it seeks to control.

Many prominent scholars argue that formal legal intervention in corporate internal affairs is rarely necessary or desirable because market forces and social norms adequately constrain managerial conduct. Social norms are informal rules and standards enforced through peer-administered sanctions, such as disapproval, ostracism, or reputational injury, or through internal emotions such as guilt or shame. Some scholars argue that such internalized values, coupled with the threat of social sanctions, appropriately constrain the conduct of corporate officials.

This Article addresses the question of whether the disciplinary power of social norms can replace the threat of legal liability as an effective accountability mechanism. After analyzing the complex relationship among law, social norms, and conduct in the context of corporate governance, it concludes that social norms alone cannot adequately constrain managerial conduct. Although social norms have the potential to motivate good conduct, they are equally capable of motivating and perpetuating bad conduct.¹ Psychological and social theory suggests that in order for norms to positively influence social behavior they must be supported by an external accountability mechanism. Without a reliable accountability mechanism, social norms that guide managerial conduct are likely to erode and tolerate increasing levels of unethical conduct.

This Article further argues that the existing liability regime for fiduciary duties fails as an accountability mechanism. A tradition of judicial deference has created a *de facto* “no liability” rule which means that directors are rarely called upon to justify their actions. The “no liability” regime results from a more complex and fundamental problem. The penalties that directors face for a breach of duty seem disproportionate in relation to the degree of wrongdoing. This draconian liability threat creates two perverse effects. First, it is a leading cause of nullification of liability rules by courts

1. Norms supporting racial and gender discrimination are salient examples of such undesirable norms. For additional examples, see JON ELSTER, *THE CEMENT OF SOCIETY* 139–47 (1989).

and legislatures. Second, the prospect of disproportionate penalties hinders the internalization of appropriate moral values by corporate leaders.

Drawing on insights from psychological literature, this Article recommends reforms to the director liability scheme that will address these problems. It argues that legal sanctions for fiduciary breaches should be modified to better reflect society's assessment of directors' degree of culpability for harms to the corporation. Drawing on the model provided by the recent WorldCom settlement, it suggests that damage awards for nonculpable breaches of the fiduciary duty of care be reduced and calibrated in a manner that reflects a negligent director's ability to pay. To be effective as a mechanism for accountability, such reform must require each negligent director personally pay a portion of the monetary penalty. If legal penalties were so calibrated, judges would be more likely to find liability in appropriate circumstances and would thus better fulfill their role as arbiters of director and executive behavior.

This Article proceeds in four parts. Part II describes the basic corporate law framework and catalogs weaknesses in existing enforcement mechanisms that have created a de facto "no liability" rule for corporate directors. Part III describes the standard defenses of the "no liability" rule, focusing mainly on law and social norms analysis. Part IV critiques the law and norms approach, especially as applied to corporate governance. It draws on insights from social psychology to demonstrate that the social norms of directors are prone to erosion in the absence of an external accountability mechanism. In light of the failure of markets and social norms to constrain corporate conduct, Part V recommends changes to the corporate liability scheme. It recommends a reduction in penalties for a negligent breach of the duty of care, accompanied by a requirement that directors contribute personally to the payment of penalties assessed for such negligent conduct.

II. THE "NO LIABILITY" RULE IN CORPORATE LAW

This Part describes the current corporate law regime in which directors of corporations rarely (almost never) personally pay damages or penalties for the breach of fiduciary duty or other violations of corporate or securities laws. Corporate statutes and jurisprudence wax eloquently regarding the solemn duties of directors to exercise due care and work faithfully for the exclusive benefit of the corporation. The legal doctrine provides for significant penalties for directors who fail to fulfill their duties. In reality, however, courts almost never assess damages against directors, and most costs and settlements of shareholder litigation are paid by corporations or insurance rather than the defendant directors. In this Article, I describe this reality as a "no liability" rule—an informal rule that results from the combined effect of the substantive doctrine, procedural mechanisms, and contractual protections described below.

A. THE THEORETICAL LEGAL FRAMEWORK

State corporate law establishes the legal obligations of corporate directors and officers to their corporations and their shareholders (in the form of fiduciary duties) and provides a remedy for the breach of such duties.² The federal securities laws also play a significant role in the governance of large public corporations.³ However, the prescription of directors' obligations to the corporation itself has traditionally been the province of state law.

The power to direct a corporation's affairs rests in the board of directors. Delaware's general corporation law is typical in providing that "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"⁴ In most large corporations, directors delegate this broad decision-making power to executive officers who exercise the bulk of corporate power, subject to oversight by the directors.⁵

A director's obligations to the corporation and its shareholders are rooted in the concept of fiduciary duty. Directors are bound by fiduciary duties of loyalty and care.⁶ In simplest terms, the duty of care requires that directors act diligently in managing the corporation's affairs, while the duty of loyalty requires that directors place the interests of the corporation above their own. State common law jurisprudence has fleshed out the substance of these duties, which tend to be stated in general rather than specific terms.

2. This discussion focuses on Delaware law, the predominant source of corporate law in the country. Except as noted, the same general principles apply under the Model Business Corporation Act (the "MBCA") and significant non-MBCA jurisdictions such as New York and California. Twenty-nine states have adopted the MBCA. Four jurisdictions have statutes based on an earlier version of the Act. A number of other states have adopted selected provisions of the Act. *See* MODEL BUS. CORP. ACT xix (2005).

3. *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 860-63 (2003) (arguing that securities fraud suits have become the "most visible means of regulating corporate governance"). Although the risk of liability under securities law is higher, such risks extend principally to executives and outside advisers such as accountants, lawyers, or investment banks who face liability as secondary actors. Actual monetary payments by nonexecutive directors remain as much a rarity under the securities law regime as under corporate law. *See infra* notes 44-47 and accompanying text.

4. DEL. CODE ANN. tit. 8, § 141(a) (2001); *see also* MODEL BUS. CORP. ACT § 8.01 (2005).

5. Although directors retain exclusive formal authority to initiate or authorize certain transactions such as mergers, consolidations, and charter amendments, as a practical matter almost all such actions are initiated by management and submitted to the board for formal approval.

6. A duty of good faith is sometimes recited among the basic fiduciary duties. However, the contours of "good faith" as an independent obligation remain poorly defined. *See infra* notes 21-23 and accompanying text.

1. Duty of Care

As commonly articulated, the standard of care for corporate directors is that of a reasonably prudent person in like circumstances, although in Delaware the standard of care is gross negligence.⁷ However, the level of judicial scrutiny of board conduct differs significantly from that applied in the tort context.⁸ The lynchpin of this specialized standard of review is the business judgment rule, which shields most board decisions from judicial scrutiny. Under the business judgment rule, courts limit their inquiry into the adequacy of the process by which a board reached its decision, rather than the wisdom or appropriateness of the decision itself. Rationality, not reasonableness, is the standard by which courts assess director conduct.

Although courts have been circumspect in reviewing board conduct, case law establishes some minimum requirements for directors to fulfill their duty of care. The duty of care requires directors to pay at least some attention to the affairs of the corporation. Thus, directors can be liable for a corporation's losses if found to have been "asleep at the wheel" or "missing in action."⁹ The duty of attention is supplemented by a "procedural" duty of care which requires directors to act responsibly in making affirmative corporate decisions. *Smith v. Van Gorkom*¹⁰ articulated this standard, holding that directors must demonstrate that they deliberated in an informed manner before reaching the challenged decision. The directors' failure to inform themselves adequately deprives them of business judgment rule protection and requires them to show that their decision meets a more demanding "fairness" standard.¹¹

In addition to the duties of attention and reasonable deliberation, courts have asserted that directors have a duty to monitor their corporation's compliance with law.¹² Under *Caremark*, directors must make efforts to ensure that adequate internal controls exist to detect fraud or illegal activities by the corporation's management and employees.¹³ However, under *Caremark*, if the board has implemented such a policy, the

7. See MODEL BUS. CORP. ACT § 8.30(a)(2); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

8. See FRANKLIN A. GEVURTZ, CORPORATION LAW 288–96 (2000) (discussing the variance between standards of liability for directors and other professionals such as doctors or lawyers).

9. See, e.g., *Francis v. United Jersey Bank*, 432 A.2d 814, 822 (N.J. 1981); *Hoye v. Meek*, 795 F.2d 893, 894–96 (10th Cir. 1986) (applying Oklahoma law).

10. *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985).

11. *Id.* at 893; *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993).

12. Monitoring duties are also imposed by the Foreign Corrupt Practices Act, Securities Exchange Act of 1934 § 13(b)(2)(b), 15 U.S.C. § 78m(b)(2)(B) (2000), which requires corporations to maintain internal controls adequate to provide reasonable assurance of the integrity of the corporation's financial reporting system.

13. *In re Caremark Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

business judgment rule forestalls judicial scrutiny into the adequacy or reasonableness of the compliance program.¹⁴

2. Duty of Loyalty

When a director or senior officer transacts business with a corporation, the risk of abuse is clear. As both a decision-maker and a potential beneficiary, the official faces the temptation to enrich himself at the expense of the corporation. To protect the corporation and its shareholders against such overreaching, the duty of loyalty requires directors to put the corporation's interests above their own at all times.¹⁵ Although corporate law once imposed a complete prohibition on self-dealing transactions, over time this prohibition yielded to a more deferential standard by which approval or ratification by an "independent" decisionmaker shields conflict transactions from judicial scrutiny.¹⁶ This permissive standard has been codified into most state corporate statutes.¹⁷

Section 144 of Delaware's corporate code is typical. It states that a transaction between a director and the corporation is not void solely because of the conflict, if the transaction was approved by disinterested directors, ratified by shareholders, or if the transaction is fair to the corporation.¹⁸ A conflict transaction that is approved in the manner prescribed by section 144 will typically be accorded business judgment rule protection.¹⁹

3. Other Duties

Although loyalty and care form the bedrock of fiduciary duty, certain sub-categories subsumed within these duties are often accorded independent treatment. Courts have held that directors owe shareholders a duty of full disclosure whenever the board requests that shareholders

14. *Id.* at 967–68. Because *Caremark* does not require an *effective* compliance program, many commentators view this as a weak standard. See J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 345 (2004) (“[T]he standard employed by *Caremark* meant that directors would almost never be liable for a failure to monitor”); Lawrence E. Mitchell, *The Sarbanes–Oxley Act and the Reinvention of Corporate Governance*, 48 VILL. L. REV. 1189, 1203 (2003) (asserting that *Caremark* approved of an “incredibly weak system of corporate monitoring”).

15. *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

16. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 39–40 (1966).

17. DEL. CODE ANN. tit. 8, § 144 (2001); MODEL BUS. CORP. ACT § 8.62 (2005); CAL. CORP. CODE § 310(a)(1) (1990); N.Y. BUS. CORP. LAW § 713(a)(1)–(2) (1983).

18. DEL. CODE ANN. tit. 8, § 144.

19. See *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987); *Oberly v. Kirby*, 592 A.2d 445, 467 (Del. 1991). The effect of section 144 compliance has not been clearly delineated by the courts. Although most cases accord such decisions business judgment rule protection, others suggest that compliance with section 144 merely shifts the burden of proof regarding the transaction's fairness from the defendants to the plaintiffs. See *Cooke v. Oolie*, No. Civ. A. 11134, 1997 WL 367034, at *9 (Del. Ch. 1997).

approve a transaction. Under this “duty of candor,” directors must disclose all material facts relevant to any decision the shareholders are asked to make.²⁰

Courts have also hinted at the existence of a free-standing duty of good faith that applies to all director action (or inaction) related to their duties to the corporation.²¹ The significance of the good faith obligation rests with director exoneration provisions that allow corporations to eliminate director liability for certain actions, but forbid exoneration for “acts or omissions not in good faith.”²² The contours of this duty of good faith are ill-defined; nonetheless, some scholars predict that good faith could play a significant role in future jurisprudence, representing an independent source of director liability.²³

B. THE FAILURE OF ENFORCEMENT MECHANISMS

In theory, the shareholder derivative lawsuit serves as the principal enforcement mechanism for fiduciary duties.²⁴ The derivative action allows shareholders to sue, in the corporation’s name, officers and directors for breach of duty. The purpose of this form of action is to ensure an avenue for the vindication of the corporation’s rights when those who otherwise control the corporation’s decision to sue are implicated in the wrongdoing.²⁵

A director’s breach of her fiduciary duty theoretically exposes her to liability for any damages to the corporation resulting from the breach. Thus, a negligent decision that causes \$100 million of losses to the corporation

20. *Arnold v. Soc’y for Sav. Bancorp Inc.*, 650 A.2d 1270, 1276–77 (Del. 1994); *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992). In addition, directors violate their duty of disclosure whenever they “knowingly disseminate false information” that leads to shareholder injury regardless of whether shareholder action is requested. *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998); *see also* GEVURTZ, *supra* note 8, at 219.

21. *See In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 278, 289 (Del. Ch. 2003) (ruling that allegations regarding board inaction in the hiring and subsequent termination of a company’s president raised questions as to the good faith of directors).

22. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001); *see infra* notes 37–39 and accompanying text.

23. Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 6 (2005); Elizabeth A. Nowicki, *The Unimportance of Being Earnest: Reflections on Director Liability and Good Faith* 17 (Aug. 1, 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=921668>); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456, 494 (2004) (examining the doctrine of good faith and recent evolution of the duty of good faith). The recent Delaware Supreme Court decision affirming the chancery court’s ruling in favor of the directors of Walt Disney Company has squashed latent expectations that a duty of “good faith” might serve as a viable basis for director liability. *See generally In re Walt Disney Co. Derivative Litig.*, No. 411, 2005, 2006 WL 1562466 (Del. June 8, 2006); *infra* notes 137–41 and accompanying text.

24. *See* ROBERT CHARLES CLARK, *CORPORATE LAW* 639–40 (1986). A direct class action is permitted when directors’ negligence is claimed to have harmed shareholders directly rather than the corporation. *Id.* at 640.

25. GEVURTZ, *supra* note 8, at 387.

would expose all directors who approved or acquiesced in such decision to joint and several liability for the full \$100 million in damages. However, a number of protective doctrines effectively insulate directors from any real threat of monetary liability.

First, as mentioned previously, the business judgment rule shields most director decisions from review by limiting judicial inquiry into the adequacy of the process by which the board reached its decision, rather than the wisdom or appropriateness of the decision itself.²⁶ As a general matter, it is probably best for courts to refrain from interfering in pure business decisions. Failed product lines such as the Ford Edsel or New Coke are examples of disastrous business decisions that nonetheless should not expose either directors or executives to personal liability. However, the business judgment rule is often applied beyond sensible limits to shield from scrutiny decisions so flawed that the implication of director bias is difficult to ignore.²⁷

More troubling, however, is the rule's application in instances where the existence of an underlying conflict is beyond dispute. Courts have shielded potentially corrupt or opportunistic actions from critical judicial supervision by encouraging directors to envelope conflict decisions in a veil of protection through the approval of independent directors. The use of independent directors to validate actions tainted by conflicts of interest is the central feature of procedural mechanisms that create nearly insurmountable hurdles for shareholders who seek to challenge board actions through derivative litigation.²⁸

The demand requirement and the special litigation committee device both emphasize the legitimizing effect of independent director action to facilitate early dismissal of derivative actions before courts consider the merits of shareholder claims.²⁹ Under the demand requirement, a shareholder cannot sue in the corporation's name unless she first makes a demand on the board or demonstrates that such demand would be futile.³⁰

26. *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (asserting that there is no substantive duty of care and that "such a concept is foreign to the business judgment rule").

27. *See, e.g.*, *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991) (approving settlement of suit regarding a corporation's decision to build a museum to house its CEO's art collection because the business judgment rule would protect the board's decision); *Shlensky v. Wrigley*, 237 N.E.2d 776, 781 (Ill. App. Ct. 1968) (applying the business judgment rule to a corporation's refusal to install lights at its stadium or schedule night games, even though every other major league team had done so); *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 812 (N.Y. Sup. Ct. 1976) (dismissing a complaint challenging a tax-disadvantaged, in-kind stock dividend despite allegations that the dividend benefited the corporation's executives under its incentive compensation scheme). In each of these cases plaintiff's allegations of bias or ulterior motive were disregarded and the business judgment rule invoked to forestall scrutiny of the justifications for the decision.

28. *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 653-54 (2004).

29. *See id.* at 661.

30. DEL. CH. CT. R. 23.1.

To establish demand futility, plaintiffs must allege particularized facts that create a reasonable doubt that a majority of the board was disinterested and independent or that the challenged decision was a valid exercise of business judgment.³¹ As currently applied, the demand requirement has erected a formidable bar for plaintiffs seeking to survive a motion to dismiss. Generally speaking, plaintiffs are required virtually to prove the merits of their claims without the benefit of discovery.³²

In the rare instances when courts excuse demand, defendants have an additional chance to wrest control of the litigation. The board can appoint a special committee of “independent” directors to investigate the charges.³³ Even when all of a corporation’s directors are implicated in the alleged wrong, they can appoint two or three new directors to the board and assign to them the task of evaluating whether a suit against their board colleagues should be dismissed.³⁴ Such a committee, after completing its investigation, typically moves to dismiss the action over the plaintiff’s objections.³⁵ With few exceptions, courts have been receptive to such requests.³⁶

31. *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984). Although *Aronson* posited this two-part test in the conjunctive, later decisions make clear that a reasonable doubt as to either condition is sufficient to excuse demand. *See Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991).

32. Without discovery, shareholders must rely on publicly available information or unauthorized disclosures by corporate whistleblowers to compile sufficient facts to support their allegations. In response to criticism of its demanding pleading standards, Delaware judges have urged plaintiffs to use the “tools at hand,” including requests for corporate records authorized by statute, to muster the information necessary to survive demand. *Brehm v. Eisner*, 746 A.2d 244, 266 (Del. 2000) (citing DEL. CODE ANN. tit. 8, § 220 (1974)). Litigating a request for inspection of records under section 220 is a cumbersome and time-consuming process when compared to the liberal standards provided for discovery under the Rules of Civil Procedure. *Compare* FED. R. CIV. P. 26, *with Saito v. McKesson HBOC, Inc.*, No. Civ. A. 18553, 2002 WL 31458233 (Del. 2002) (reviewing decision regarding plaintiff’s request for documents under section 220).

33. The question of who qualifies as an independent director is contentious. In Delaware, courts have taken a deferential approach, exhibiting a willingness to overlook many potential conflicts and adopting a “domination and control” standard for disqualifying directors. *See, e.g., Aronson*, 473 A.2d at 815–16; *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 355 (Del. Ch. 1998).

34. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981); CLARK, *supra* note 24, at 645.

35. *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATIONS AND FINANCE* 209–11 (9th ed. 2004). The special litigation committee’s authority to procure the dismissal of derivative litigation has been recognized in most jurisdictions, although courts afford varying degrees of deference to the committee’s recommendation. In New York, courts apply the business judgment rule to the determinations of a special litigation committee. *See Auerbach v. Bennett*, 393 N.E.2d 994, 996 (N.Y. 1979) (stating that the court may inquire only into the disinterested independence of the directors on the committee and the methodologies and procedures followed by the committee). Iowa courts afford no deference to a special litigation committee appointed by defendant directors. *See Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) (holding that directors who are parties to derivative action may not appoint a special litigation committee but the corporation may apply to the court for appointment of “special panel” to investigate and report on the suit). Delaware takes a middle

A trio of contractual devices—exculpation, indemnification, and insurance—provides a final layer of protection that together insulate directors almost completely from monetary exposure in the event of a shareholder suit.³⁷ Delaware's exculpation statute permits corporations to adopt charter provisions that eliminate almost all monetary liability for breach of duty of care.³⁸ Most large Delaware corporations have adopted such a provision.³⁹

ground between complete deference to and complete rejection of special committee findings, allowing courts to inquire into both procedural and substantive aspects of the committee's determination and giving courts wide discretion over the final decision. *Zapata Corp.*, 430 A.2d at 788–89. *Zapata* established a two-part test for review of motions to dismiss based on a special litigation committee's findings. First, the court should inquire into the committee's independence and good faith and the basis for its conclusions. If satisfied as to this inquiry, the court *may* in its discretion proceed to a second step and apply its own business judgment, taking into consideration issues of law, public policy, and the corporation's best interests to determine whether to grant the motion. *Id.* As applied, however, *Zapata* resembles the *Auerbach* standard. See *Kaplan v. Wyatt*, 484 A.2d 501, 519 (Del. Ch. 1984), *aff'd*, 499 A.2d 1185 (Del. 1985) (applying the *Zapata* test).

36. See, e.g., *Kaplan*, 484 A.2d at 519. There have been a few cases where courts have denied a committee's motion to dismiss. See, e.g., *Biondi v. Scrusby*, 820 A.2d 1148, 1166 (Del. Ch. 2003) (concluding it was unlikely that committee which had already made public statements indicating that it had prejudged the case could prove its independence); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 948 (Del. Ch. 2003) (denying motion to terminate action because of substantial social ties between the defendants and the committee members); *Lewis v. Fuqua*, 502 A.2d 962, 965 (Del. Ch. 1985) (noting that the committee consisted of only one member who had significant political and financial dealings with the defendant CEO).

37. Bernard Black et al., *Outside Director Liability* (unpublished manuscript, available at <http://papers.ssrn.com/abstract=382422>) [hereinafter Black et al. I]; Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 412–14 (2005); E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 401 (1987).

38. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). This provision permits corporations to include in their charter:

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 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. See generally Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295 (1998), for a discussion of the circumstances surrounding the adoption of section 102(b)(7) and similar liability limiting provisions in other states.

39. Surveys report that almost all Delaware corporations have adopted exculpatory charter provisions. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000) (out of a sample of one hundred small- and mid-capitalization companies, only one did not have such a provision); Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160–61 (1990) (in a sample of 180 Delaware firms, over ninety percent had a liability limiting provision).

In addition, typical indemnification arrangements require corporations to cover litigation costs associated with an officer's or director's official duties.⁴⁰ Most indemnification provisions require the corporation to fund litigation costs in advance, subject to a promise to reimburse the corporation in the event of an adverse ruling.⁴¹ This commitment to indemnify directors is usually backed by director and officer liability insurance paid for by the corporation.⁴² The director and officer liability coverage funds litigation costs and pays most settlements of shareholder suits, even settlements of claims for which indemnification is prohibited by statute.⁴³

C. THE "NO LIABILITY" RULE AND THE ABSENCE OF ACCOUNTABILITY

The cumulative effect of these protective devices is a de facto "no liability" rule for corporate directors. Independent directors face an infinitesimal risk of paying personally for damages to the corporation caused by their breach of fiduciary duty. They face no real risk of liability for their acts or omissions as directors.

This "no liability" reality has been widely recognized by corporate scholars.⁴⁴ As Professor Lynn Stout has put it, a director is "more likely to be attacked by killer bees than she is to have to ever pay damages for the breach of the duty of care."⁴⁵ Professor Stout's killer bee analogy is equally applicable for duty of loyalty breaches. A recent study by Professors Bernard Black, Brian Cheffins, and Michael Klausner confirmed what most scholars have concluded from casual observation.⁴⁶ That is, "no outside director of a public company has paid out-of-pocket for either damages or legal expenses under securities law, ever, nor under corporate law since Van Gorkom in 1985."⁴⁷

40. DEL. CODE ANN. tit. 8, § 145; Black et al. I, *supra* note 37; Veasey et al., *supra* note 37, at 404–08 (summarizing Delaware's indemnification provisions). An adverse ruling against a director precludes corporate indemnification. KLEIN & COFFEE, *supra* note 35, at 206.

41. Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1083 (2006) [hereinafter Black et al. II].

42. *Id.* at 1085.

43. Veasey et al., *supra* note 37, at 417–20. Section 145(b) prohibits indemnification of settlements in derivative actions, however insurance is typically available to cover such non-indemnifiable liabilities. *Id.*

44. See Black et al. I, *supra* note 37, at 5–7; Fairfax, *supra* note 37, at 414 (observing a regime of "nearly complete exoneration" for breaches of the fiduciary duty of care).

45. Lynn A. Stout, *On the Proper Motives for Corporate Directors (or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 7 (2003).

46. Black et al. I, *supra* note 37, at 2 ("[O]utside directors face a tiny risk of actual liability for good faith (non-self-interested) conduct, no matter how careless or reckless they are. They almost never pay anything to anyone, whether for damages, fines, or legal expenses.")

47. *Id.* This statement precedes the WorldCom and Enron settlements discussed later in this Article. See *infra* text accompanying notes 287–92. In an updated study, Professor Black and his colleagues uncovered ten more instances of out-of-pocket payments by directors (in addition to Van Gorkom, Enron, and WorldCom) in the period between 1980 and 2005. See

A central tenet of political and social theory is that legitimate power must be accompanied by a system of accountability.⁴⁸ Accordingly, political theorist Dennis Thompson recommends that corporations adhere to a democratic concept of responsibility which requires officials to acknowledge their agency in making decisions and provide a justification for the decision.⁴⁹ The requirement for accountability rests on the simple notion that “people who have power must justify their decisions to those who are significantly affected by those decisions.”⁵⁰ Meaningful accountability allows sanctions (positive or negative) to be imposed by those to whom the agent is accountable.⁵¹

By diluting the disciplinary power of the derivative lawsuit, courts have undermined director accountability. In theory, directors are accountable to shareholders through derivative lawsuits, shareholder voting, and the invisible hand of the market. In practice, each of these mechanisms fails to provide meaningful accountability.

Corporate statutes provide that shareholders elect directors who appoint corporate managers. In reality, however, the direct inverse is true. Shareholders of public companies have no practical ability to influence the selection of board nominees.⁵² Instead, managers and incumbent directors select board nominees who are “elected” by shareholders who have no alternative choices. Thus, year after year incumbent directors renominate themselves, virtually ensuring their perpetual reelection.

Although market forces may provide a measure of discipline by driving down stock prices or facilitating hostile takeovers, the market cannot provide the type of accountability political theorists demand. Markets cannot require directors to explain or justify their decisions. Although managers are sometimes motivated to explain their decisions to the investment community, generally they are not required to do so.

Because of the flaws in shareholder voting and market discipline as accountability mechanisms, the shareholder lawsuit represents the only forum corporate law provides through which directors could be held to account for poor decisions or oversight failures.⁵³ Unfortunately, the “no

Black et al. II, *supra* note 41, at 1063–64. Their tally excludes instances of out-of-pocket payments by directors who were also executives of the company sued, or payments made by controlling shareholders on their own behalf or on behalf of outside directors. *Id.* at 1063.

48. DENNIS F. THOMPSON, RESTORING RESPONSIBILITY: ETHICS IN GOVERNMENT, BUSINESS AND HEALTHCARE 3 (2005).

49. *Id.* at 5.

50. *Id.*

51. *Id.*

52. Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003).

53. Some commentators argue that reforms to the shareholder voting system could enhance executive and director accountability. *Id.* at 44.

liability” rule has stripped the shareholder suit of this potential power.⁵⁴ The business judgment rule, the special litigation committee, and the demand requirement all work to spare directors of the need to justify their actions.⁵⁵

Although some commentators claim that unsuccessful lawsuits promote accountability because such suits represent a nuisance to director defendants,⁵⁶ this argument is suspect. Procedural rules that bar discovery and depositions spare directors of the requirement to explain their actions. Virtually all cases are dismissed or settled short of trial, further protecting directors from public scrutiny.⁵⁷ Finally, under indemnification arrangements, corporations pay all of directors’ legal expenses. Thus, the financial and reputational costs posed by shareholder litigation are tightly circumscribed.

III. THE SOCIAL NORMS DEFENSE OF THE “NO LIABILITY” RULE

Although the existence of a “no liability” rule in corporate law is not subject to serious dispute, the rule’s desirability has been hotly contested. Although, the effects of the rule seem pernicious, many corporate scholars defend the rule.⁵⁸ The dominant defense of the “no liability” rule is that legal enforcement through shareholder litigation is unnecessary because market forces adequately discipline directors.⁵⁹ Scholars point to a number

54. The failure of the shareholder lawsuit as an accountability mechanism can be seen in data collected by Professors Robert Thompson and Randall Thomas. They report that most shareholder litigation in Delaware is class action litigation in the acquisition context, and that this is the only category of cases in Delaware in which plaintiffs have experienced any significant measure of success. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition Oriented Class Actions*, 57 VAND. L. REV. 133, 137 (2004) [hereinafter Thompson & Thomas, *New Look*]. Their data also suggest that the only effective judicial constraint on managerial self-dealing comes in the form of class action litigation in controlling shareholder cases. See Robert B. Thompson & Randall S. Thomas, *Shareholder Litigation: Reexamining the Balance Between Litigation Agency Costs and Management Agency Costs* 63 (unpublished manuscript, available at http://ssrn.com/abstract_id=336162) [hereinafter Thompson & Thomas, *Litigation Agency Costs*] (“[T]he overall pattern of settlements in our data [show that] judicial relief is reserved for cases where those who control the company have used that control to impose terms that favor themselves over the public shareholders.”). This finding is significant because the scenario in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), is one area of law where Delaware courts have tempered barriers to the enforcement of fiduciary duties. Under *Weinberger*, the business judgment rule does not apply, even when independent directors approved the challenged transaction. *Id.* at 703. Also as a direct class action, a *Weinberger* case is spared derivative litigation’s crippling procedural hurdles.

55. See *supra* notes 29–36 and accompanying text.

56. See, e.g., Jonathan Macey, *Delaware: Home of the World’s Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1134 (2005).

57. Thompson & Thomas, *New Look*, *supra* note 54, at 158.

58. See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 331 (1976).

59. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 95–96 (1991); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the*

of market forces that they claim act as a constraint against management misdeeds. These include product markets, the employment market for managers, and, most significantly, the securities markets.⁶⁰

According to these theories any corporation with ineffective management will fail to thrive in competitive markets. Unless corporations develop innovative products or deliver desirable services, they will lose market share to better managed companies. Managers of companies that fail to compete effectively face risk of replacement by their board, job loss precipitated by a corporate bankruptcy, or takeover.⁶¹ These competitive pressures motivate officers and directors to competently manage their companies and refrain from directing corporate assets to personal use.⁶²

Capital markets are said to add an additional source of discipline for poor managers. Capital markets respond to inept or unfair management practices by discounting the price investors will pay for a corporation's stock.⁶³ A depressed stock price, some argue, should prompt managers to implement business reforms in order to protect their jobs. If management fails to respond appropriately, the low stock price will attract hostile bidders seeking to acquire a controlling interest in the company. A successful hostile bidder can then replace the ineffective management team and make other strategic changes that further shareholder interests.⁶⁴

As many scholars have noted, there are significant flaws in the market-based defenses of the "no liability" rule.⁶⁵ The argument assumes market

Theory of the Corporation, 6 J. LEGAL STUD. 251, 262-73 (1977) (arguing that markets for products and services and the market for management control regulate management behavior).

60. Winter, *supra* note 59, at 264-66 (asserting that the market for products and services constrains corporate behavior because "management which chooses inefficient growth . . . will only reduce the share it might have appropriated directly for itself").

61. EASTERBROOK & FISCHER, *supra* note 59, at 95 ("Managers also face scrutiny in the labor markets. If sacked today, they may have trouble matching their income elsewhere.").

62. *Id.* at 4-5 ("Managers may do their best to take advantage of their investors but they find that the dynamics of the market drive them to act as if they had investors interests at heart.").

63. *Id.* at 18-22, 96-99; see also Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1430 (1989) (arguing that maintaining a governance structure which "reduces investors' expected returns will produce a corresponding reduction in price"); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965) ("[T]he market for corporate control gives to these shareholders both power and protection commensurate with their interest in corporate affairs.").

64. See Winter, *supra* note 59, at 266 ("Thus, if a firm is mismanaged, robbed, or overly attentive to nonprofit goals, the price of its shares will drop and others will perceive an opportunity to take over the corporation and install new and more efficient management to raise the share price.").

65. See, e.g., Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1462-70 (1992); Victor Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1420-27 (1985) (discussing why markets for managers and for securities are ineffective constraints on management behavior).

participants can detect whether managers are competent or effective. Unfortunately, systemic market failures and imperfections undermine any legitimate faith in these mechanisms. Furthermore, both critics and proponents of market-based regulation agree that the anti-takeover mechanisms permitted under state law severely weaken the disciplinary power of the takeover threat.⁶⁶ Most troubling, as WorldCom, Enron, and other scandals demonstrate, executives can easily obscure their own mismanagement for years by falsifying their corporations' financial reports, preventing markets from appropriately pricing their securities.⁶⁷ All of these market limitations have led to growing doubts about the empirical validity of the efficient market hypothesis upon which many of the market-based defenses rely.⁶⁸

A. THE LAW AND NORMS APPROACH

An alternative defense of corporate law's "no liability" rule is that social norms motivate directors and officers to govern corporations responsibly. Although flaws in the market-based defense of the "no liability" rule have been fully explored, the implications of the "social norms" argument have not been adequately examined. When subject to scrutiny, the arguments proffered in favor of norms governance fail to sustain the claim that the disciplinary power of social norms minimizes the need for legal sanctions for fiduciary breaches. Social norms have the potential to motivate good conduct, but they are also capable of supporting undesirable conduct.⁶⁹ For this reason, the norms-based justifications for the hands-off self-regulatory approach to corporate governance must be carefully examined.

The emergence of the "law and social norms" movement can be traced to Robert Ellickson's book, *Order Without Law*.⁷⁰ Professor Ellickson studied the dispute resolution practices of landowners in Shasta County,

66. See William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 180, 195–96 (1992) (arguing that anti-takeover mechanisms have led corporate practice to diverge from what market-based arguments assume); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169–70 (1981) (arguing that takeover defenses decrease shareholder welfare partly because tender offers function as a mechanism for regulating corporate management).

67. Fairfax, *supra* note 37, at 428–32 (citing Enron as an instance of a company's stock price failing to reflect the risk of mismanagement). The analyst fraud that burgeoned during the dot-com boom also raises doubts about the effectiveness of market discipline. See Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 148–52 (2002) (noting the problematic influence that investment analysts may have on investors).

68. See ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 175–77 (2d. ed. 2005). See generally Symposium, *Revisiting the Mechanisms of Market Efficiency*, 28 J. CORP. L. 499 (2003).

69. ELSTER, *supra* note 1, at 141.

70. See generally ROBERT C. ELICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991).

California.⁷¹ Two competing property rules governed who was responsible for the damage caused when a rancher's cattle wandered onto another person's property. In some parts of the county, the "open range" areas, cattle owners were not liable for property damage caused by their trespassing cattle.⁷² In "closed range" areas, however, the cattle owner was strictly liable for any such damage.⁷³

Ellickson found that Shasta County ranchers and farmers resolved disputes without regard to the formal legal rule that prevailed in their area.⁷⁴ Instead, residents were committed to an "overarching norm of cooperation among neighbors" and followed an informal rule that cattle owners are responsible for the acts of their animals.⁷⁵ According to Ellickson, Shasta County residents rarely appealed to the police or sued each other. Instead, they settled disputes by relying on a system of informal enforcement of social norms.⁷⁶ Ellickson's broad conclusion was that "informal systems of external social control are far more important than law in many contexts, especially ones where interacting parties have a continuing relationship and little at stake."⁷⁷

Ellickson's case study could simply be taken as evidence of the advantages of alternative dispute resolution or of the virtue of maintaining good relationships with neighbors. However, many scholars viewed it as something more: a basis for questioning the effectiveness of traditional regulatory practices. These scholars, inspired by the work of Ellickson and

71. *Id.* at 41.

72. *Id.* at 44. An exception to this rule exists if the trespass victim has enclosed her property with a "lawful fence." *Id.* at 45.

73. *Id.* at 3.

74. *Id.* at 52.

75. ELLICKSON, *supra* note 70, at 53.

76. These standards were enforced primarily through self-help measures, including negative gossip and threats against the offending owner's animals. *Id.* at 79-81. *But see* Barbara Yngvesson, *Beastly Neighbors: Continuing Relations in Cattle Country*, 102 YALE L.J. 1787, 1793-97 (1993) (reviewing *Order Without Law*). Professor Yngvesson disputes Ellickson's conclusion that law plays a minimal role in resolving these property disputes. *Id.* She cites instances of petitions, lobbying and law suits documented by Ellickson which he attributes to outliers who fail to conform to the community norms. *Id.*

77. Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 540 (1998) (restating the thesis of *Order Without Law*). Similarly, Lisa Bernstein asserted law's diminished relevance in dispute resolution among New York's diamond traders. *See* Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 115 (1992). Bernstein asserted that participants in the diamond industry rejected state-created law and replaced it with an elaborate system of internal rules "complete with distinctive institutions and sanctions, to handle disputes among industry members." *Id.* Like Ellickson, Bernstein seems captivated by the ability of a private regulatory system free of governmental intrusion to maintain social order. However, because, as she describes, the diamond club's arbitration judgments were ultimately enforceable in court, Bernstein's most sweeping conclusions are open to question. *Id.* at 129.

others, christened a new movement in legal scholarship, which they dubbed the “New Chicago School.”⁷⁸

Members of the New Chicago School have advanced the study of the relationship between social norms and individual behavior as a way to uncover mechanisms that could allow the government or social groups to exploit the power of norms to elicit or reinforce desirable social conduct.⁷⁹ They suggest that by harnessing social norms we can reduce our reliance on brute state power to maintain social order. Its proponents tend to view the government as a benign and nonintrusive “norms manager” that can best promote desirable conduct through indirect influence on social norms rather than direct legal commands enforced by state-imposed sanctions.⁸⁰

Thus, some law and norms scholars urge judges to exploit norms’ power by imposing nontraditional shaming penalties on criminal offenders.⁸¹ Through shaming, a criminal’s wrongful acts are publicized through newspaper ads, lawn signs, or bumper stickers.⁸² This form of punishment draws power not from the force of state action, but through the shame, embarrassment, and condemnation of peers triggered by the shaming sanction.⁸³ Advocates of shaming argue that it can be more effective at deterring criminal behavior than traditional sentences like fines or imprisonment—all at minimal cost to society.⁸⁴

Other scholars argue that law has an expressive function that can be used either to reinforce good norms or weaken undesirable norms. For example, Lawrence Lessig argues that legal reforms sometimes change the “social meaning” of conduct and can thus reduce the popularity of certain

78. Lawrence Lessig, *The New Chicago School*, 27 J. LEGAL STUD. 661, 661 (1998). A 1997 article called the “social norms” school “the most provocative new movement in the legal academy.” Jeffrey Rosen, *The Social Police*, NEW YORKER, Oct. 20 & 27, 1997, at 172. Law schools throughout the country hosted symposia on law and norms. See, e.g., Symposium, *Law, Economics and Norms*, 144 U. PA. L. REV. 1643 (1996); Symposium, *The Legal Construction of Norms*, 86 VA. L. REV. 1577 (2000); Symposium, *Social Norms, Social Meaning and the Economic Analysis of Law*, 27 J. LEGAL STUD. 537 (1998). More recently, the Legal Scholarship Network of the Social Science Research Network established an electronic journal devoted to the subject. See LSN Research Library, *Law, Norms and Informal Order* (Richard McAdams ed.), <http://www.ssrn.com/link/law-norms-informal-order.html> (last visited Nov. 12, 2006).

79. See generally ERIC A. POSNER, *LAW AND SOCIAL NORMS* (2000); Lessig, *supra* note 78, at 661.

80. See Lessig, *supra* note 78, at 661 (“Both the old school and new share an approach to regulation that focuses on regulators other than the law. Both, that is, aim to understand structures of regulation outside law’s direct effect The moral of the old school is that the state should do less. The hope of the new school is that the state can do more.”); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 907 (1996).

81. See Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 384–85 (1997).

82. Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 631–32 (1996).

83. See *id.* at 631–42.

84. See *id.*

types of socially undesirable behavior.⁸⁵ He asserts that changes in law have changed (or could change) the social meaning of dueling in the antebellum south, interracial marriage, cigarette smoking, and the use of seatbelts and motorcycle helmets.⁸⁶ Similarly, Cass Sunstein has argued that the government can sometimes act as an effective “norms manager.” He suggests that by targeting norms, regulators can reduce risky behavior more cheaply and effectively than traditional regulatory methods.⁸⁷

B. CORPORATE LAW AND NORMS ANALYSIS

Enthusiasm soon developed for applying the law and norms approach to corporate law analysis.⁸⁸ Corporate scholars found this line of inquiry fruitful for understanding why, in the absence of any real prospect of liability, directors seem to care about fulfilling their fiduciary duties.⁸⁹ For example, when considering mergers or tender offers, directors regularly consult lawyers and investment bankers to assure themselves that they are satisfying the duty of care.⁹⁰ Some scholars have given credit to social norms for motivating proper conduct by corporate officials.⁹¹

Broadly speaking, the corporate law and social norms literature divides itself into two camps. One group, represented by Professors Edward Rock and Michael Wachter, asserts that directors conform to social norms that prevail in the business world to avoid social sanctions such as shaming, ostracism, or embarrassment.⁹² Rock and Wachter view corporations as mechanisms for replacing contract-based legal governance with nonlegally enforceable governance mechanisms (i.e., norms).⁹³ They argue that corporate law “should be understood as protecting and perfecting this choice” of nonenforceable obligations and commitments.⁹⁴ They thus argue

85. Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 947, 956–58, 963–67 (1995) [hereinafter Lessig II]; see also Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. PA. L. REV. 2181, 2186–87 (1996).

86. Lessig II, *supra* note 85, at 964–68, 990, 1025.

87. Sunstein, *supra* note 80, at 908.

88. See generally Symposium, *Norms and Corporate Law*, 149 U. PA. L. REV. 1607 (2001).

89. Stout, *supra* note 45, at 8–10; Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1011–13 (1997).

90. See Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 688 n.50 (2002).

91. See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1269 (1999) (“Although legal standards of conduct are characteristically accompanied by liability rules or other enforcement regimes, even a legal standard of conduct that is unaccompanied by such a regime may be effective because of its impact on social norms.”).

92. See, e.g., Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1641 (2001); Rock, *supra* note 89, at 1013; David A. Skeel, *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1823–36 (2001).

93. Rock & Wachter, *supra* note 92, at 1622.

94. *Id.*

that courts must be careful not to undermine norms governance by unduly interfering in internal firm conflicts.⁹⁵

The professors' *laissez-faire* perspective leads them to support many of the doctrines and devices that constitute the "no liability" rule. Accordingly, they defend the business judgment rule because it facilitates self-governance by "preventing parties from turning to third-party adjudicators," which would undermine the self-governing quality of the relationship.⁹⁶ Although they seem to acknowledge the importance of a legal rule against self-dealing, they ultimately argue in favor of rulings that reflect the erosion of the prohibition.⁹⁷

For example, they praise the cleansing effects of independent director approval of self-dealing transactions because allowing such approval minimizes the need for judicial interference in corporate decisions.⁹⁸ They argue the duty of loyalty exists to prevent just "*enough* instances of self-dealing from slipping through that the overall incentive compatibility of the corporate form is not undermined."⁹⁹ However, they seem willing to accept a certain amount of opportunistic self-dealing as long as it does not vitiate shareholders' and creditors' willingness to participate in the corporate structure.¹⁰⁰ In their view, "the law plays the role of sheep dog, but does not intervene more than necessary."¹⁰¹

Another branch of corporate law and norms literature focuses on the importance of directors' internal motivations. Professors Lynn Stout and Margaret Blair argue that norms governance is rooted in two related concepts: trust and altruism.¹⁰² They first observe that directors of large corporations are entrusted with extraordinary power over vast resources and the livelihoods of thousands of employees.¹⁰³ Shareholders, employees, and creditors all ultimately depend on directors to execute their duties ably and faithfully. They assert that promoting values such as faith and trust should help motivate directors to perform responsibly.¹⁰⁴ In their view, "case law . . . can encourage corporate participants to internalize norms of cooperation through social framing—providing information about the social context of relationships within the firm."¹⁰⁵

95. *Id.* at 1666–67.

96. *Id.* at 1623.

97. *Id.* at 1661–63.

98. Rock & Wachter, *supra* note 92, at 1662–63.

99. *Id.* at 1661 (emphasis added).

100. *Id.* at 1662.

101. *Id.*

102. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1809–10 (2001); Stout, *supra* note 45, at 8–9.

103. Blair & Stout, *supra* note 102, at 1737.

104. *Id.* at 1738–39.

105. *Id.* at 1796.

Unlike Rock and Wachter, Professors Blair and Stout argue that market discipline and the fear of social sanctions likely provide a “weak constraint on opportunism within firms.”¹⁰⁶ Rather than relying on incentive compensation or liability schemes to elicit optimal behavior, they suggest that the law should instead demonstrate that we expect faithful performance for its own sake “by articulating a social expectation that directors will exercise due care.”¹⁰⁷ Although they are not clear on exactly how the law should play that role, they suggest that hortatory comments from judges in legal opinions will often suffice. They argue, for example, that “[w]hen the Delaware chancery court trumpets the importance of careful attention to fiduciary duties, directors and officers are likely to heed that call—even though they may have little or no external incentive for doing so.”¹⁰⁸

Related to this “trust”-based model of corporate governance, Professor Stout also has argued that legal structures should appeal to directors’ sense of altruism.¹⁰⁹ She points to social dilemma studies that show that people consistently engage in cooperative behavior and demonstrate a desire to help others.¹¹⁰ These studies suggest that, contrary to the central assumption of neoclassical economic theory, people are not inherently rational, selfish actors. Professor Stout argues that by appealing to directors’ altruistic tendencies, the law can help promote responsible corporate conduct.¹¹¹

These norms-based theories of governance provide a theoretical defense for corporate law’s “no liability” rule. By promoting self-governance through norm enforcement as preferable to a system of judicially imposed sanctions, theorists lend support to the existing *laissez faire* approach to corporate regulation. Whether the argument is that norms’ disciplinary power operates through shaming or through internalized preferences, both approaches support the conclusion that legal sanctions for fiduciary breaches are superfluous and might even impair the functioning of a norms governance regime.

Professors Rock and Wachter maintain that judicial interference undermines the self-governance mechanisms that are the *raison d’être* for the corporate form.¹¹² Similarly, Professors Blair and Stout warn against relying on sanctions as a deterrent mechanism, asserting that “attempts to provide

106. *Id.*

107. *Id.* at 1744.

108. Blair & Stout, *supra* note 102, at 1797.

109. Stout, *supra* note 45, at 13.

110. *Id.* at 10–13.

111. *Id.* at 14–15 (suggesting that “directors might be inclined to behave in an other-regarding fashion simply because a respected authority asks them to do so”); *see also* Michael B. Dorff, *Softening Pharaoh’s Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 815–19 (2003) (advocating the application of altruistic theory to resolve the problem of excessive executive compensation).

112. Rock & Wachter, *supra* note 92, at 1622.

external motivation for cooperative behavior can instead reduce cooperation by undermining corporate participants' *internal* motivations."¹¹³ Furthermore, they argue that an increased volume of fiduciary duty litigation will alert well-intentioned directors to others' shirking, and may thereby encourage them to adopt a less diligent posture toward their fiduciary obligations.¹¹⁴

IV. A CRITIQUE OF THE LAW AND NORMS APPROACH

The social norms arguments outlined above have considerable intuitive appeal. For most of us most of the time, the law remains in the background and is not the guiding force in our day-to-day behavior. Instead, much of our decision-making is automatic and reflexive, and is influenced by factors of which we may not be aware. Not only is this common sense, but this account of ordinary decision-making has been documented by psychologists.¹¹⁵ However, psychological theory fails to support many claims of norm theorists. Most importantly, psychological theory does not support the claim that norms, without support from law, can adequately regulate behavior.

This Part introduces criticisms of general law and norms scholarship before providing a more specific critique of the prescriptive claims of corporate law and norms scholars. The general critique of law and norms focuses on the absence of a coherent methodology. The specific critique of corporate law and norms focuses on the absence of empirical support for its prescriptions.

A. GENERAL LAW AND NORMS THEORIES

Scholars have criticized the law and norms school on a number of fronts. First, critics complain that the literature has largely ignored the wealth of knowledge on norm development available in the social science literature.¹¹⁶ Critics also charge that the law and norms literature lacks intellectual rigor found in the social sciences and has "fail[ed] to deliver on its promise of a new kind of interpretive method."¹¹⁷ On the whole, critics conclude that the law and norms school has done little to enhance our

113. Blair & Stout, *supra* note 102, at 1809.

114. *Id.*

115. See, e.g., Daniel Kahneman, *A Perspective on Judgment and Choice: Mapping Bounded Rationality*, 58 AM. PSYCHOLOGIST 697, 698–99 (2003).

116. See, e.g., Toni M. Massaro, *The Meanings of Shame: Implications for Legal Reform*, 3 PSYCHOL. PUB. POL'Y & L. 645, 648–49 (1997); Mark Tushnet, "Everything Old Is New Again": *Early Reflections on the "New Chicago School"*, 1998 WIS. L. REV. 579, 585–86 (1998); Robert Weisberg, *Norms and Criminal Law, and the Norms of Criminal Law Scholarship*, 93 J. CRIM. L. & CRIMINOLOGY 467, 474 (2003).

117. Weisberg, *supra* note 116, at 469. According to Professor Weisberg, the norms school offers "little distinct theory other than a few general concepts like conformity and esteem-seeking and a sense of fairness, and some borrowings from behavioral cognitive theory and game theory." *Id.* at 470.

understanding of how law affects behavior and, more importantly, how legal reform can encourage desirable conduct.¹¹⁸

One problem with the law and norms approach is a frequent underlying assumption that rules that evolve through social norms are superior to legal rules, simply because they originate through decentralized processes. These organic origins suggest to some that social norms reflect social groups' preferences and interests better than centrally imposed rules.¹¹⁹ In addition, many law and norms proponents strain to fit a theory of norm development within law and economics' rational choice framework.¹²⁰ They seek to modify rational choice theory to take account of norms, instead of adopting a more instructive analytical perspective.¹²¹ In doing so, they fail to account adequately for the strands of social science literature that question the value of rational choice theory as a basis for understanding law compliance.

Despite many norms theorists' faithfulness to a rational choice approach, important psychological research rejects the theory as a mode for understanding law compliance.¹²² Research by scholars such as Tom Tyler, John Darley, and Paul Robinson shows that, contrary to the tenets of rational choice theory, people do not focus on personal gains or losses in deciding whether to obey the law.¹²³ Rather, people consider "the relationship

118. Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1607 (2000) ("[W]hen it comes to using this more textured understanding of human experience to improve our ability to predict the effects of legal rules, the verdict is far less clear."); Tushnet, *supra* note 116, at 582. Professor Tushnet asserts, "there are reasons to think that there are better ways to study norms than to force them into a mold derived from a law and economics approach, or at least that there are literatures other than law and economics with which a dialogue on the level of theory would be productive." *Id.*

119. See, e.g., ELLICKSON, *supra* note 70, at 167–68. Jon Elster persuasively challenges this claim. ELSTER, *supra* note 1, at 147–48 ("Some norms do not make everybody better off: they make everybody worse off or they shift the balance of benefits to favour some people at the expense of others.")

120. See generally POSNER, *supra* note 79; Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997).

121. Alex Geisinger, *A Group Identity Theory of Social Norms and Its Implications*, 78 TUL. L. REV. 605, 615 (2004) (observing that the rational choice model has "provided the basic platform from which explanation of norm origin and development has proceeded"); Tushnet, *supra* note 116, at 579; Weisberg, *supra* note 116, at 467–78. Weisberg notes:

In its analytic mode, this school often seeks to redeem microeconomic approaches to law from excessive abstraction, to draw on corrections to rigid rational choice theory supplied by experimental psychology, to enrich rational choice theory with the deep strategic logic of game theory and, occasionally, in its focus on the phenomenon of "social meaning," to pay some fealty to cultural anthropology or the Humanities.

Weisberg, *supra* note 116, at 467–68 (footnotes omitted).

122. TOM TYLER, WHY PEOPLE OBEY THE LAW 21–24 (1990) (contrasting the instrumental approach to law compliance with the normative approach).

123. *Id.* at 24.

between various kinds of potential behavior and their assessments of what behavior is appropriate.”¹²⁴ These researchers identify individual moral values as the most important determinants of law-abiding behavior.¹²⁵ Their research links the sense of obligation to obey the law with individual and group perceptions of the legitimacy of the law and its enforcement mechanisms and practices.¹²⁶

This research on law compliance raises doubts regarding claims that raising the cost of an activity by invoking social sanctions can significantly alter the degree of law-abiding behavior.¹²⁷ Instead, such research suggests a more complex relationship between law, norms, and conduct than many law and norms scholars seem willing to embrace.¹²⁸ The studies emphasize the importance of individual moral values, which are influenced by both the substance of law and perceptions of its fairness, in terms of rules, procedures, and punishments.¹²⁹ Some implications of these findings for corporate law reform are further discussed in Part V.¹³⁰

B. CORPORATE LAW AND NORMS THEORIES

Corporate law and norms theorists often argue that the absence of any real prospect of personal liability for the breach of fiduciary duty is unobjectionable because social norms appropriately constrain the conduct of corporate officials. They maintain that even though courts rarely find liability for a breach of fiduciary duty, by stating important principles or criticizing errant directors and executives, judicial opinions provide meaningful guidance to directors which motivates them to behave responsibly.

124. *Id.*

125. *Id.* at 64–66 (“The most important normative influence on compliance with the law is the person’s assessment that the law accords with his or her sense of right and wrong . . .”).

126. *See id.* at 57 (“Those who regard legal authorities as having greater legitimacy are more likely to obey the law in their everyday lives.”); *see also* Paul H. Robinson & John M. Darley, *The Role of Deterrence in the Formulation of Criminal Law Rules: At Its Worst When Doing Its Best*, 91 GEO. L.J. 949, 982 (2003) [hereinafter Robinson & Darley, *Deterrence*] (reporting that people obey the law because they feel “a moral imperative to ‘do as the law says you should do’”).

127. *See* TYLER, *supra* note 122, at 44 (concluding that “[p]eer disapproval . . . seems an unlikely source of pressure to obey the law”).

128. *See* Massaro, *supra* note 116, at 692 (arguing that shaming proponents “underestimate the complexities of manipulating shame and influencing shame norms”); Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. L. REV. 453, 473 (1997) [hereinafter Robinson & Darley, *Desert*] (“[P]assing a law cannot itself create a norm, and not passing a law against certain conduct cannot make that conduct morally acceptable to the community.”).

129. *See* TYLER, *supra* note 122, at 172 (concluding that people “focus most strongly on questions of procedural justice” when people evaluate legal authorities based on their personal experiences); Robinson & Darley, *Desert*, *supra* note 128, at 477 (arguing that the criminal law’s ability to influence social norms is “directly proportional to criminal law’s moral credibility”); *cf.* Massaro, *supra* note 116, at 697 (arguing that reliance on shaming functions may undermine general perceptions of the legitimacy of the criminal justice system).

130. *See infra* text accompanying notes 224–97.

Although corporate law and norms theorists are correct to emphasize the importance of directors' internal motivations and values in ensuring responsible job performance, they place undue faith in the ability social norms to motivate directors to act appropriately.¹³¹ Because social norms are fluid and vary from group to group, we cannot rely on them to prevent corporate misconduct. Even when social norms do lead people to behave appropriately, such happy occurrences shed little light on the proper response to those who fail to comply both with the law and corresponding social norms.

1. Theoretical Flaws

The norms governance view oversimplifies the complex relationship between law and social norms. In reality, the law both reflects and shapes norms. Law, the vigor with which it is enforced, and the severity of sanctions for its violations all influence our understanding of what our moral obligations are.¹³² Because the law helps to shape norms, norms cannot be expected to compensate for a failure to enforce the law. This dynamic relationship between law and norms means that courts' systematic failure to enforce directors' legal obligations is cause for serious concern. A lax enforcement approach implies to directors, shareholders, and society generally that the fiduciary duties of officers and directors are less morally important than duties or obligations that are more vigorously enforced.¹³³

Despite the troubling moral implications of the "no liability" rule, corporate law and norms theorists argue that judges are helping to shape desirable social norms among directors despite their unwillingness to seriously probe director conduct.¹³⁴ They argue that judges, through their legal opinions, telegraph to directors what society expects of them.¹³⁵ These judicial opinions are presumed to carry moral force that helps discourage fiduciary breaches even when courts ultimately decline to impose liability.¹³⁶

131. Blair & Stout, *supra* note 102, at 1796–99.

132. See generally TYLER, *supra* note 122.

133. See TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 114 (2006) (arguing that the failure to enforce legal rules promotes disrespect for the law).

134. Rock, *supra* note 89, at 1016–17.

135. See, e.g., Blair & Stout, *supra* note 102, at 1744; Rock & Wachter, *supra* note 92, at 1694–97; Stout, *supra* note 45, at 15 (suggesting that judicial opinions can encourage directors to fulfill their duties not by threatening them with the prospect of liability but "by expressing and reinforcing social norms of careful and loyal fiduciary behavior").

136. See Rock, *supra* note 89, at 1039; Skeel, *supra* note 92, at 1854–57 ("Even if she does not impose monetary liability, for instance, a judge can shame an offending director by explicitly criticizing her in the published opinion for the case."); see also Blair & Stout, *supra* note 102, at 1797 ("When the Delaware chancery court trumpets the importance of careful attention to fiduciary duties, directors and officers are likely to heed that call—even though they may have little or no external incentive for doing so.").

Corporate law and norms theorists unjustifiably diminish the role liability plays in conveying an effective message to directors. When courts assert that conduct is morally questionable, yet legally permissible, they convey a mixed message that enables directors to conclude reasonably that the conduct in question was not that bad. The “no liability” rule thus undermines the positive role judges could play in encouraging the development of desirable social norms among directors.

The derivative litigation surrounding former Walt Disney Company President Michael Ovitz’s lavish severance package demonstrates the dubious nature of the claim that weak judicial exhortations positively influence board norms.¹³⁷ In a series of decisions, Delaware courts repeatedly condemned the Disney board’s conduct, but ultimately declined to impose liability for its lapses in handling the hiring and firing of Disney executive Michael Ovitz. The courts stated in various opinions that although the Board’s conduct fell short of ideal corporate governance standards, because Delaware corporate law requires far less, no breach of duty occurred.¹³⁸

The trial court’s 2005 decision regarding the conduct of Disney CEO Michael Eisner is illustrative of this problem. With regard to Eisner’s conduct in hiring Ovitz and determining his compensation package, the chancellor found:

Eisner’s actions in connection with Ovitz’s hiring should not serve as a model for fellow executives and fiduciaries to follow. His lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement. He prematurely issued a press release that placed significant pressure on the board to accept Ovitz and approve his compensation package in accordance with the press release. To my mind these actions fall far short of what shareholders expect and demand from those entrusted with a fiduciary position. Eisner’s failure to better involve the board in the process of Ovitz’s hiring, usurping the role

137. See generally *In re Walt Disney Co. Derivative Litig.*, No. 411, 2005, 2006 WL 1562466 (Del. June 8, 2006); *In re Walt Disney Co. Derivative Litig.*, No. Civ.A. 15452, 2005 WL 1875804 (Del. Ch. Aug. 9, 2005); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003); *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998). For a more complete summary of facts and issues in the litigation, see Jones, *supra* note 28, at 651–53.

138. *Walt Disney*, 2005 WL 1875804, at *1–2 (stating that “there are many aspects of defendants’ conduct that fell significantly short of the best practices of ideal corporate governance” but concluding that “the director defendants did not breach their fiduciary duties or commit waste”).

for himself, although not in violation of law, does not comport with how fiduciaries of Delaware corporations are expected to act.¹³⁹

Despite asserting that Eisner's conduct fell "far short of what shareholders expect and demand" from a fiduciary, that his actions did not comport with "how fiduciaries of Delaware corporation are expected to act," and even that Eisner had "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom,"¹⁴⁰ the chancellor concluded that "Eisner acted in good faith and did not breach his fiduciary duty of care because he was not grossly negligent."¹⁴¹

One less familiar with Delaware's corporate jurisprudence might expect that conduct falling "far short" of how fiduciaries are expected to act would *ipso facto* constitute a breach of fiduciary duty. Similarly, one might conclude that a senior officer who acts without board authorization on an important, and ultimately ill-advised, corporate decision would not be found to have acted in good faith.¹⁴² Indeed, the Disney decision makes one wonder why the law requires corporations to have directors and imposes duties on them if the board's authority can be usurped so readily with no adverse consequences for either the usurper or the supine directors.¹⁴³

To many, the result in the Disney litigation is evidence of the emptiness of corporate law. Still others speculate that, as a community, directors are chagrined when their peers' conduct is publicly condemned in this manner.¹⁴⁴ They argue that such opinions will spur other directors to attend more vigorously to their duties.¹⁴⁵ This conclusion, although plausible, is highly questionable. It is more likely that directors will conclude that if the Disney board's conduct satisfies fiduciary standards then anything goes, and minimal efforts at simulating informed discussions will continue to protect directors from liability.¹⁴⁶

139. *Id.* at *41 (footnote omitted).

140. *Id.*

141. *Id.*

142. See Nowicki, *supra* note 23, at 20.

143. See Lawrence E. Mitchell, *The Trouble with Boards* 8 (George Wash. Univ. Law Sch. Pub. Law & Legal Theory Working Paper, Paper No. 159, 2005), available at <http://ssrn.com/abstract=801308>.

144. Macey, *supra* note 56, at 1134 (arguing that directors "do not like to be made the object of public scorn and ridicule").

145. Martha Neil, *Disney Case Has No Storybook Ending*, A.B.A. J. EREPORT, Sept. 6, 2005, available at Westlaw, 4 No. 35 ABAJEREP 5 (quoting corporate commentators who speculate that the Disney decision will spur directors to be more attentive). Chancellor Chandler seems to expect as much as he states "that the Opinion may serve as guidance for future officers and directors—not only of The Walt Disney Company, but of other Delaware corporations." *In re Walt Disney Co. Derivative Litig.*, No. Civ. A. 15452, 2005 WL 2056651, at *2 (Del. Ch. Aug. 9, 2005).

146. See Recent Case, *In re Walt Disney Co. Derivative Litigation*, 119 HARV. L. REV. 923, 927–28 (2006).

2. Empirical Weaknesses

In addition to the logical flaws in the case for norms governance, empirical data show that norms governance does not work as well as its advocates claim. Widespread agreement exists that directors should follow the best practice principles set forth by the American Law Institute (“ALI”) and other prominent commentators.¹⁴⁷ Yet, despite corporate leaders’ professed acceptance of the ALI’s monitoring model, studies show that director behavior typically falls far short of these ideals.

a. The Ideal

Perhaps because little specific judicial guidance is available about how directors should fulfill their fiduciary obligations, most corporations and their directors aspire to follow best practice standards recommended by various independent organizations. These standards serve as an informal guide to directors in structuring their operation as a body. The ALI’s *Principles of Corporate Governance* (“ALI Principles”) are the most widely recognized statement of best practice standards.¹⁴⁸

The ALI Principles embraces a monitoring model of board governance under which the board’s main role is to oversee management’s performance.¹⁴⁹ In this role, directors oversee the corporation’s strategic direction, evaluate management performance, and, when necessary, take steps to replace management.¹⁵⁰ The board also serves as a sounding board,

147. Eisenberg, *supra* note 91, at 1279; Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 797–98 (2001) [hereinafter Langevoort, *Human Nature*] (observing the success of efforts to promote the monitoring model).

148. See generally AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1992) [hereinafter ALI PRINCIPLES] (outlining recommended procedures for corporate governance).

149. Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237, 237–40 (1997). For critiques of the monitoring model as currently implemented, see Mitchell, *supra* note 143, at 2 (arguing that the monitoring model has “become an institution of corporate governance that is essentially a fraud, designed not to govern but to protect directors from liability”) and Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 658–59 (1982) (questioning the ability of independent directors to fulfill the monitoring model’s mandate).

150. The ALI recommends the following tasks for a well-functioning board:

- (1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives.
- (2) Oversee the conduct of the corporation’s business to evaluate whether the business is being properly managed.
- (3) Review and, where appropriate, approve the corporation’s financial objectives and major corporate plans and actions.

reviewing management decisions and providing a check on overreaching.¹⁵¹ This monitoring model has been endorsed by trade groups and other organizations concerned with corporate governance, such as the National Association of Corporate Directors, the Business Roundtable, and the Council of Institutional Investors. Each of these organizations has adopted its own corporate governance standards which essentially mirror the ALI's recommendations.¹⁵²

b. The Reality

To perform the tasks set out in the monitoring model, directors must be engaged, skeptical, well-informed, independent, objective, and highly-motivated.¹⁵³ Unfortunately, the reality of board performance departs dramatically from this ideal. Seminal studies of directors suggest that even in the best of circumstances, directors rarely perform the tasks essential to the monitoring model's success.¹⁵⁴ Recent reports from independent investigations into the WorldCom and Enron debacles also raise serious doubts about directors' willingness and ability to police corporate executives as the monitoring model requires.

i. The Classic Studies

In the 1970s, Harvard Business School Professor Myles Mace interviewed hundreds of directors and executives of large and medium-sized public corporations.¹⁵⁵ Mace concluded that directors were generally passive

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- (4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements.
 - (5) Perform such other functions as prescribed by law, or assigned to the board under a standard of the corporation.

ALI PRINCIPLES, *supra* note 148, § 3.02(a). For directors to perform their monitoring duties, the *ALI Principles* maintains that a board should be comprised of at least a majority of independent directors who lack a "significant relationship with the corporation's senior executives." *Id.* § 3A.01(a). Only directors who are free from corrupting ties with management can credibly evaluate the performance of the corporation's senior executive officers. *Id.* § 3A.01 cmts. c–d.

151. *Id.*

152. See generally THE BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (Nov. 2005) (on file with Iowa Law Review); COUNCIL OF INSTITUTIONAL INVESTORS, CORPORATE GOVERNANCE POLICIES (Apr. 2006) (on file with Iowa Law Review); NATIONAL ASSOCIATION OF CORPORATE DIRECTORS, GOVERNANCE GUIDELINES (on file with Iowa Law Review).

153. See, e.g., PAUL P. BROUNTAS, BOARDROOM EXCELLENCE 49–54 (2004) (describing the necessary traits for an effective director); Langevoort, *Human Nature*, *supra* note 147, at 797–98.

154. See MYLES L. MACE, DIRECTORS: MYTH AND REALITY 41 (1971); see also JAY W. LORSCH & ELIZABETH MACIVER, PAWNS OR POTENTATES: THE REALITY OF AMERICA'S CORPORATE BOARDS 6 (1989).

155. MACE, *supra* note 154, at 3.

and deferential to the president, springing to action only in times of crisis.¹⁵⁶ Although Mace found that boards serve several useful functions,¹⁵⁷ the method of their selection, their close affiliations with management, and the limitations on their time all assured that, for the most part, their presence within the corporate structure was merely ceremonial.¹⁵⁸

In 1989, Harvard Business School Professor Jay Lorsch and Elizabeth MacIver conducted another comprehensive study of corporate boards.¹⁵⁹ While their conclusions were more positive than Mace's, they nonetheless confirmed a continuing gap between ideal board performance and reality.¹⁶⁰ The authors found that a number of undesirable norms prevail in the boardroom. For example, they observed that directors were expected "above all, to treat the CEO with respect" and, thus, avoid embarrassing him in board meetings.¹⁶¹ Eschewing open criticism, directors tended to couch their objections to management proposals in the form of "penetrating" questions.¹⁶² Outside directors also refrained from contacting each other between board meetings, which they viewed as "dealing behind the chairman's back."¹⁶³ The result of these suppressive norms was that board meetings that purported to be frank and open discussions, in actuality, were often merely "a charade of productive, problem-solving discussions."¹⁶⁴

Lorsch and MacIver also confirmed Mace's findings that because most directors are busy people with demanding full-time jobs, they devote relatively little time to their board duties.¹⁶⁵ These time constraints, coupled with directors' insurmountable informational disadvantages, vis-à-vis the CEO, meant that they deferred almost slavishly to the CEO's wishes, except in times of crisis.¹⁶⁶

156. *Id.* at 27–39, 41.

157. In particular, Mace found that directors serve as a valuable sounding board for executives, allowing them to test out new ideas and business proposals. Directors also provided a valuable disciplining role. Regular board meetings prompted executives to prepare detailed reports, to explain financial results, and to justify their business decisions and proposals. *Id.* at 10–27.

158. *Id.* at 107–10.

159. LORSCH & MACIVER, *supra* note 154, at ix–x.

160. *Id.* at 1–4.

161. *Id.* at 93.

162. *Id.*

163. *Id.* (quoting from a director interview). This practice and some others described by Mace and Lorsch and MacIver have been superseded by intervening governance reforms including those required by the Sarbanes–Oxley Act and the self-regulatory organizations ("SROs") listing standards. For example, SRO rules require directors to meet in executive session outside the presence of the CEO, a practice that directors whom Lorsch and MacIver interviewed described as a sign of disloyalty.

164. LORSCH & MACIVER, *supra* note 154, at 94–95.

165. *Id.* at 24–25.

166. *Id.* at 170–71.

ii. Recent Evidence

The Mace and Lorsch and MacIver studies are clearly dated.¹⁶⁷ Much has changed in the corporate governance landscape since these studies were conducted. Lorsch's current view is that corporate boards are more active than at the time of his study.¹⁶⁸ In support, he cites the current focus on director independence and best practice standards and the increased incidence of boards firing underperforming CEOs.¹⁶⁹

Although Professor Lorsch's optimism is heartening, the independent investigations that followed the WorldCom and Enron scandals reveal that the pattern of board conduct reported by Mace and Lorsch and MacIver has continued at many U.S. companies.¹⁷⁰ An unprecedented scale of fraud was revealed at Enron and WorldCom, two of the country's most respected corporations, in late 2001 and 2002. Whether measured in terms of the magnitude of investor losses, the number of jobs eliminated, the size of the bankruptcy filing, or the sheer audacity of the perpetrators, these scandals surpassed all that had come before.¹⁷¹

167. See *supra* note 163.

168. Martin Lipton & Jay W. Lorsch, *The Professionalization of Corporate Directors*, in JAY W. LORSCH ET AL., *RESTORING TRUST IN AMERICAN BUSINESS* 71, 72 (2005).

169. *Id.*

170. Lorsch and Lipton acknowledge the significance of counterexamples such as Enron and thus conclude the further board reform is necessary. *Id.* at 72–73.

171. Enron filed for bankruptcy in December 2001, following the restatement of five years of operating results, the opening of an SEC probe, and the plummeting of its stock price due to investor concerns about its dealings with outside partnerships run by CFO Andrew Fastow. At the time, Enron's bankruptcy was the largest in U.S. history (its bankruptcy is now second only to WorldCom). Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy*, WALL ST. J., Dec. 3, 2001, at A3. For authoritative accounts of Enron's accounting shenanigans, see generally William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002) and ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy Rapaport & Bala Dharan eds., 2004). Former Chairman and CEO Kenneth Lay and former CEO Jeffrey Skilling were convicted on charges arising from their roles in the scandals. Mr. Lay died of a heart attack on July 5, 2006. Because he died before his conviction was finally appealed, his conviction will likely be vacated. See Ashby Jones & John R. Emshwiller, *Quirk of U.S. Law Exonerates Lay, Possibly Hindering Asset Seizure*, WALL ST. J., Jul. 7, 2006, at C23; Greg Farrell, *Disposition of Ken Lay's Wealth in Limbo with Conviction Likely to Be Vacated, Are Funds Forfeited?*, USA TODAY, Jul. 7, 2006, at 2B.

WorldCom filed for bankruptcy on July 21, 2002. With \$107 billion of assets and \$41 billion of debt, its bankruptcy remains the largest in U.S. history. Simon Romero & Riva D. Atlas, *WorldCom Files for Bankruptcy; Largest US Case*, N.Y. TIMES, July 22, 2002, at A1; Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview; Extra Level of Scrutiny in WorldCom's Bankruptcy*, N.Y. TIMES, July 23, 2002, at A1. The bankruptcy filing followed the company's disclosure that it had improperly accounted for \$3.8 billion in expenses. Investigators found that WorldCom's executives had improperly failed to deduct \$4 billion in expenses from its income statement. In 2004, WorldCom restated its results for 2000 and 2001, reducing its pretax income for the period by \$74 billion. Gretchen Morgenson, *10 Ex-Directors from WorldCom to Pay Millions*, N.Y. TIMES, Jan. 6, 2005, at A1.

In addition to WorldCom and Enron, contemporaneous scandals revealed similar failures to detect fraud in other major companies. For example, telecom companies Global Crossing and Qwest Communications also collapsed in accounting scandals. Among other accounting tricks, Qwest and Global Crossing engaged in sham capacity swaps, which both companies used to artificially inflate their revenue.¹⁷² The breadth of accounting misconduct in American corporations extended beyond these headline cases. Between 1997 and 2002, ten percent of all listed companies restated their financial results at least once.¹⁷³ The number of SEC enforcement actions for accounting fraud also increased dramatically during this period, further suggesting that such improper accounting practices were widespread.¹⁷⁴

To many, these scandals indicated deep flaws in the governance structure of American corporations. In response to such concerns, the corporations and courts appointed respected legal experts to investigate what went wrong. The court handling WorldCom's landmark bankruptcy proceeding appointed former SEC chairman Richard Breeden as "Corporate Monitor" of WorldCom.¹⁷⁵ Mr. Breeden prepared a report analyzing the weaknesses in the company's governance structure that contributed to its unprecedented fraud.¹⁷⁶ Mr. Breeden concluded that even though WorldCom's board satisfied the formalistic requirements of the *ALI Principles*, they failed to adhere to the most important principle—providing effective oversight.¹⁷⁷ He found that WorldCom's directors "consistently ceded power over the direction of the Company to [CEO Bernard]

172. Other prominent companies involved in accounting irregularities during the late 1990s included AOL-Time Warner, Rite Aid, and Xerox. See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 937 (2003).

173. KLEIN & COFFEE, *supra* note 35, at 182; Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. (forthcoming 2006), available at <http://ssrn.com/abstract=928482>.

174. See generally MARK S. BEASLEY ET AL., FRAUDULENT FINANCIAL REPORTING (1987–1997). The SEC's Accounting and Auditing Enforcement Release (AAER) series provides a comprehensive source of alleged cases of financial fraud in the US. *Id.* at 11. The AAERs are numbered sequentially beginning with No. 1 in 1982, reaching No. 651 in 1995, and growing dramatically to No. 2200 by mid-2005. Selected AAERs are available at www.sec.gov/divisions/enforce/friactions.shtml.

175. 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. 13 (2003) [hereinafter RESTORING TRUST], available at <http://www.thedirectorscollege.com/images/downloads/Breeden%20Report%20Restoring%20Trust.pdf>. For an additional account of the governance failures at WorldCom see FIRST INTERIM REPORT OF DICK THORNBURGH, BANKRUPTCY COURT EXAMINER (2002); SECOND INTERIM REPORT OF DICK THORNBURGH, BANKRUPTCY COURT EXAMINER (2003).

176. RESTORING TRUST, *supra* note 175, at 14–15.

177. *Id.* at 25–34

Ebbers,”¹⁷⁸ who “was allowed nearly imperial reign over the affairs of the Company, without the board of directors exercising any apparent restraints on his actions”¹⁷⁹

Most emblematic of the board’s failures was its acquiescence to \$400 million in corporate loans from WorldCom to Ebbers.¹⁸⁰ These loans, which Ebbers never repaid, were arranged by two of his close associates on the board and blindly ratified by the full board.¹⁸¹ The board also failed to detect the massive financial fraud that WorldCom’s executives perpetrated.¹⁸² They did not apprise themselves of fatal weaknesses in WorldCom’s financial controls or the many ethical lapses of Ebbers and other senior executives who orchestrated the company’s massive accounting fraud.¹⁸³

Enron’s board of directors appointed a Special Committee chaired by William Powers, Dean of the University of Texas Law School, to investigate the circumstances leading to Enron’s collapse. The Special Committee reached conclusions similar to the WorldCom report regarding the dysfunctional qualities of the Enron Board.¹⁸⁴ Like WorldCom’s board, Enron’s directors failed to familiarize themselves with details of the company’s financial statements, unwisely acceded to management requests for departures from the code of conduct, and failed to ask tough questions of management necessary in light of the numerous conflicts of interests permitted by the board.¹⁸⁵

For example, the board repeatedly approved waivers of Enron’s Code of Conduct to allow the company to enter into transactions with entities controlled by CFO Andrew Fastow and other senior executives. These partnerships ultimately served as vehicles for the company’s massive accounting fraud and facilitated at least \$30 million in illicit payments to Fastow.¹⁸⁶ In addition to its reckless waivers of Enron’s Code of Conduct, the board failed to institute or follow adequate procedures to monitor the approved transactions.¹⁸⁷ These oversight failures played a significant role in furthering the fraudulent schemes of Enron’s management team.¹⁸⁸

178. *Id.* at 1.

179. *Id.* at 1–2, 25.

180. *Id.* at 28.

181. RESTORING TRUST, *supra* note 175, at 28.

182. *Id.* at 31–32.

183. *Id.* at 31–35, 45.

184. *See* SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., REPORT OF INVESTIGATION 3–5 (2002).

185. *Id.*

186. *See id.* at 22–24.

187. *Id.* at 10.

188. *See id.*

What distinguishes Enron and WorldCom from many other public companies is not the passivity and insouciant nature of their boards, but the extent of corruption of the corporations' top executives and the extraordinary duration and scope of the fraud they were able to perpetrate.¹⁸⁹

C. SOCIAL PSYCHOLOGY

Insights from psychologists on basic motivations in human behavior also cast doubt on the soundness of the central prescriptive claims of corporate law and norms theorists. Because of basic human tendencies including conformity, consistency, and self-justification, any self-contained system of norms-based governance is bound to deteriorate over time and allow increasingly unethical conduct to occur.

A standard argument in defense of norms governance can be termed the "competence argument"—the assertion that because directors are successful, motivated individuals with hard-earned reputations for integrity, they are eminently capable of policing themselves and their peers.¹⁹⁰ A wealth of psychological research suggests that the opposite is true. Norms governance fails because without an external corrective mechanism, acceptable norms drift and become replaced with undesirable norms. As unethical conduct becomes commonplace, it becomes more widely tolerated. Such unraveling of ethical standards is destined to continue absent credible external checks on misconduct.¹⁹¹

Certain aspects of board culture such as passivity and deference to the CEO allow chronic corporate governance problems to fester.¹⁹² These problems, which include excessive executive compensation, accounting fraud, and earnings management, suggest that a self-governance system is incapable of resolving the most intractable problems in corporate law.¹⁹³

1. Conformity

The first psychological phenomenon that undermines directors' ability to exercise independent oversight is the tendency toward conformity. The extent to which people are willing to suspend their individual judgments in

189. See *supra* text accompanying notes 172–74.

190. *Smith v. Van Gorkom*, 488 A.2d 858, 894 (Del. 1985) (McNeilly, J., dissenting) (listing defendants' professional qualifications and experience and arguing "[d]irectors of this caliber are not ordinarily taken in by a 'fast shuffle'").

191. See John M. Darley, *The Cognitive and Social Psychology of Contagious Organizational Corruption*, 70 BROOK. L. REV. 1177, 1189–91 (2005).

192. See *supra* notes 147–89 and accompanying text.

193. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 1–12 (2004) (examining how corporate governance structures fail in the area of executive compensation); ARTHUR LEVITT, *TAKE ON THE STREET* 149–74 (2002) (describing prevalent earnings management tactics).

order to conform to a group consensus was firmly established by Solomon Asch.¹⁹⁴ In these famous experiments, individuals were asked to judge the relative length of lines. The correct answer was both simple and obvious, yet when research confederates first gave an incorrect answer research subjects agreed thirty-seven percent of the time.¹⁹⁵ Asch's findings show that social influence can often overwhelm a person's confidence in his own judgment even when the issue is neither ambiguous nor complex. The tendency to conform can easily lead smart, competent people astray, causing them to substitute the erroneous judgments of others for their own rational evaluations.

Conformity tendencies are even stronger when one is subject to the influence of an attractive or appealing group. This phenomenon, known as "identification," causes people to adopt values and attitudes, not in order to obtain a reward or avoid a punishment, but just to "be like" the admired person or group.¹⁹⁶ Theorists assert that social identity helps people foster a sense of belonging and strengthens their sense of place within society.¹⁹⁷ A person typically adopts a number of social identities that serve as a guide to behavior. Theorists speculate that the influence of "social identity" affects the development of group norms.¹⁹⁸ These self-selected social identities lead to conformity to a group prototype, a stereotypical version of the group member.¹⁹⁹

This group identity concept helps explain board conduct. As corporate scholars have long observed, "[t]he process by which board members are selected, the criteria by which their candidacy and continued service are evaluated, and the motives and rewards that compel nominees and directors to serve on the board all interact to form a highly cohesive group of mutually attractive individuals."²⁰⁰ Some scholars argue that the pull of

194. Solomon E. Asch, *Opinions and Social Pressure*, SCI. AM., Nov. 1955, at 31. Stanley Milgram's well-known obedience studies in which unwitting subjects administered what they believed to be painful and potentially deadly shocks to other research participants also demonstrate our sometimes pathological propensity for conformity. See generally Stanley Milgram, *Behavioral Study of Obedience*, 67 J. ABNORMAL & SOC. PSYCHOL. 371 (1963).

195. Asch, *supra* note 194, at 31–35. In the fifty years since Asch's study, the same results have been obtained consistently in replications of the experiment. ELLIOT ARONSON, *THE SOCIAL ANIMAL* 17 (9th ed. 2004).

196. ARONSON, *supra* note 195, at 29.

197. John C. Turner, *Social Categorization and the Self-Concept: A Social Cognitive Theory of the Group*, 2 ADVANCES IN GROUP PROCESSES 77, 94–95, 115 (1985).

198. Geisinger, *supra* note 121, at 632.

199. *Id.* at 638; Michael A. Hogg et al., *A Tale of Two Theories: A Critical Comparison of Identity Theory with Social Identity Theory*, 58 SOC. PSYCHOL. Q. 255, 260 (1995).

200. James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS., Summer 1985, at 83, 98.

group cohesion is partly to blame for the directors' oversight failures in the Enron scandal.²⁰¹

Directors of large public corporations are members of a surprisingly homogeneous group. They overwhelmingly share common social, economic, racial, and religious backgrounds.²⁰² These common characteristics help cement a culture that emphasizes shared goals and values and discourages open dissent. Problems highlighted in studies of boards—an unwillingness to ask discerning questions, a desire to conceal ignorance, and the perceived obligation to support the CEO—can be explained in part by the tendency to conform and the desire to fit in.

A legal regime can counteract the tendency toward conformity by providing an accountability mechanism that emphasizes accuracy as an objective. Psychological studies confirm the view of social theorists that accountability—a requirement to explain one's decision to others—can weaken the otherwise strong pressure to conform to peer judgments.²⁰³ As succinctly put by one psychologist, “people will go along in order to get along unless they know that they will be held accountable for a dumb, compliant decision.”²⁰⁴

Board studies also support the view that increased accountability can improve corporate decisionmaking. Executives acknowledge that their perfunctory accountability to the board strengthens their decision-making practices.²⁰⁵ Knowing that they will have to account to the board for their decisions compels executives to examine the costs and benefits of their proposals and develop a coherent rationale for a proposed course of action.²⁰⁶ If directors knew they might be required to account to courts for their decisions or oversight failures, they should be similarly motivated to act with more independence and objectivity.²⁰⁷

201. Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1238–39 (2003) (arguing that ingroup bias contributed to the Enron board's failure to detect and prevent the company's massive fraud).

202. See KORN FERRY INT'L, 26TH ANNUAL BOARD OF DIRECTORS STUDY 11 (1999) (reporting that 6% of all publicly held Fortune-listed company directors are ethnic minorities and 10% are women); LORSCH & MACIVER, *supra* note 154, at 18 (reporting that 93.8% of Fortune 1000 directors are white males, two-thirds are over fifty-five years old and 63% are CEOs of other corporations); Cox & Munsinger, *supra* note 200, at 106; Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 799–803 (reviewing current data on board diversity).

203. Andrew Quinn & Barry R. Schlenker, *Can Accountability Produce Independence? Goals as Determinants of the Impact of Accountability on Conformity*, 28 PERSONALITY & SOC. PSYCHOL. BULL. 472, 480 (2002).

204. ARONSON, *supra* note 195, at 21.

205. MACE, *supra* note 154, at 23–27.

206. *Id.*

207. See *infra* notes 224–33 and accompanying text.

2. Consistency

Directors' ability to police themselves and the executives they monitor is also affected by the desire to act consistently with prior commitments. That is, "once we make a choice or take a stand, we will encounter personal and interpersonal pressures to behave consistently with that commitment."²⁰⁸ The desire for consistency leads to the psychological discomfort that psychologists label cognitive dissonance, which occurs when a person simultaneously holds two inconsistent cognitions or beliefs.²⁰⁹ People seek to reduce dissonance by changing one or another cognition, by avoiding dissonant information, or by seeking out additional consonant information.²¹⁰ The effects of cognitive dissonance often detract from the ability to process important information rationally.

Under widely accepted best practice principles, "independent" directors should be detached, disinterested, and armed with a healthy skepticism toward executives and their fellow directors. Such lofty expectations are unlikely to be realized when one considers the power of bonds of friendship and collegiality that are emphasized in board culture. This culture of collegiality, coupled with the psychological desire for consistency, means that so-called "independent" directors are unlikely to exhibit the very qualities of independence and objectivity that are essential for the monitoring model's success.

To illustrate, imagine a director, Smith, who holds the following "cognitions" or beliefs about his fellow director, Jones. Jones is a nice guy who went to an Ivy League college and business school, just like Smith. Jones is the CEO of a successful multi-national company, belongs to his local church, and plays a leadership role in his community. All of these factors cause Smith to think of Jones as a likable and highly respected person. As such, Smith is likely to resist any allegations that Jones is trying to line his pockets through an unfair sweetheart deal with the corporation.

Faced with the prospective psychological discomfort of holding inconsistent cognitions, Smith, if asked to approve a transaction between Jones and the corporation, is likely to deflect information that suggests the deal is unfair. Dissonance theory predicts he will not actively seek out negative information about the deal. He will likely minimize the importance or reliability of any negative information he encounters. Finally, he may seek out additional information to support the deal that counteracts the impact of any negative information he receives. Given such biases, Smith can hardly be expected to serve as an impartial arbiter of the transaction between Jones

208. ROBERT B. CIALDINI, *INFLUENCE: SCIENCE AND PRACTICE* 53 (4th ed. 2001).

209. *See generally* LEON FESTINGER, *A THEORY OF COGNITIVE DISSONANCE* (1962).

210. ARONSON, *supra* note 195, at 154-56.

and the corporation.²¹¹ This tendency calls into question the effectiveness of disinterested director approval in protecting corporations and their shareholders from executive overreaching.

If independent directors knew that courts would have the final word on the appropriateness of the insider deals they approve, they might consider the facts more objectively, as they would expect the courts to do. Unfortunately, the basic tenets of corporate law provide assurance that such decisions will not be independently reviewed. The absence of director accountability in these transactions accommodates the propensity to interpret information in a way that satisfies the desire for consistency.

3. Self-Justification

In addition, the desire to justify one's actions can decrease a director's willingness to acknowledge or remedy actions in violation of fiduciary duties. The urge to justify one's actions becomes more acute when the act in question reflects poorly on one's own moral character. This is because the effects of dissonance are strongest when the self-concept is threatened.²¹² Because most people like to think of themselves as moral and decent, one's knowledge that one has committed an immoral act creates dissonance with this otherwise positive self-concept.²¹³ A common mechanism for reducing dissonance related to the self-concept is self-serving rationalization of the immoral behavior.²¹⁴

Psychological studies confirm this tendency toward self-justification. In a classic study, sixth-grade children were tempted to cheat in a contest under conditions in which they believed their cheating would not be detected.²¹⁵ Those children who succumbed to temptation and cheated in the contest later expressed more lenient attitudes toward cheating than they held before the experiment.²¹⁶ In contrast, children who were similarly tempted to cheat but resisted later adopted a more stringent attitude toward cheating than they had previously expressed.²¹⁷

The tendency to rationalize immoral behavior to protect the self-concept is observable throughout the general population.²¹⁸ However, it is likely that directors' propensity toward self-justification is even stronger than

211. See BEBCHUK & FRIED, *supra* note 193, at 33–34 (describing how dissonance affects executive compensation decisions); see also Cox & Munsinger, *supra* note 200, at 84–85.

212. ARONSON, *supra* note 195, at 169.

213. *Id.*

214. *Id.* at 170.

215. Judson Mills, *Changes in Moral Attitudes Following Temptation*, 26 J. PERSONALITY 517, 520–23 (1958).

216. *Id.* at 531.

217. *Id.*

218. ARONSON, *supra* note 195, at 160–61.

that of an ordinary person who occupies a lower social status.²¹⁹ Dissonance effects are greatest when people feel personally responsible for their actions and their actions have serious consequences, which is typically the case with board decisions that often affect the well-being of shareholders, employees, and the economy as a whole.

Studies also show that people with high self-esteem, a quality typical of directors, experience higher levels of dissonance when implicated in immoral actions than those with low self-esteem.²²⁰ This is because their involvement in misconduct stands starkly at odds with their otherwise positive self-concept.²²¹ Although high self-esteem can serve as a buffer against immoral behavior, when people with high self-esteem succumb to the temptation to self-deal or fail to prevent gross misconduct, they are more likely than the average person to experience the type of attitude change that leads to norm erosion.²²²

The various psychological phenomena discussed in this section create a danger that the standards by which directors assess their own conduct and that of the executives they monitor will unravel in a cycle of continuous decline.²²³ Without the prospect of external intervention, directors will tend to disregard and, if necessary, rationalize executive misconduct up to the point that they confront incontrovertible evidence of wrongdoing or impending financial disaster. The problem is not that most directors are inherently corrupt, lazy, or immoral. Rather, these unconscious influences will affect even the most intelligent and well-intentioned individuals. Thus, the institutional structure in which directors operate must provide some rigidity to compensate for the flexibility and fluidity of moral judgments.

219. *Id.* at 170.

220. *Id.* at 186; *see also* Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 974 (2002). Professor Langevoort also notes that those with high self-esteem are slow to recognize problems attributable to their own actions. *Id.*

221. ARONSON, *supra* note 195, at 186–87. Professor Aronson's views on the role of the self in cognitive dissonance have been challenged by other social psychologists. *See* Jeff Stone & Joel Cooper, *A Self-Standards Model of Cognitive Dissonance*, 37 J. EXPERIMENTAL SOC. PSYCHOL. 228, 229–30 (2001) (summarizing competing theories on the role of the self in dissonance).

222. ARONSON, *supra* note 195, at 186–88.

223. *See* Darley, *supra* note 191, at 1186. Darley argues that when an action that many people think is wrong goes uncriticized, it becomes acceptable as moral due to what he calls a "pluralistic ignorance" of other observers' disapproval. *Id.*; *see also* Maria Merritt et al., *Moral Disintegration: Character and the Vagaries of Reason* (Jan. 25, 2005) (unpublished manuscript, on file with Iowa Law Review).

V. REFORMING THE DIRECTOR LIABILITY SCHEME

A. THE NEED FOR ACCOUNTABILITY

Social psychologists have found that requiring accountability can counteract the distorting impact of conformity and consistency.²²⁴ As shown here, markets, norms, and shareholder voting all fall short as mechanisms for accountability. Social norms do influence behavior, but without an accountability mechanism such norms are susceptible to erosion that undercuts their usefulness as a system of social control.

If judges were willing to impose penalties for fiduciary breaches, shareholder litigation could help promote accountability for corporate wrongdoing. In theory, such litigation could serve to influence positively the development of corporate norms and thus improve director conduct. Such litigation would raise the salience of directors' ethical obligations, reminding directors and the public of the importance of fiduciary duties, and the harm suffered when directors violate these duties.²²⁵ In addition, public scrutiny of director conduct may create dissonance for directors that could lead to self-correcting actions. Studies show that dissonance created by confronting people with evidence of their own hypocrisy (such as a prior failure to meet one's own conduct standards) can lead to sustained behavioral change.²²⁶

An enforcement strategy that promotes accountability through litigation-generated scrutiny has led to meaningful reforms in the financial services industry. New York Attorney General Eliot Spitzer led a series of high-profile investigations of widespread abuses in the brokerage, mutual fund, and insurance industries.²²⁷ The public exposure of the endemic conflicts in these industries compromised executives' ability to continue rationalizing the unethical practices. Faced with irrefutable evidence of illegal conflicts and fraud, business leaders agreed to fundamental reforms

224. See *supra* notes 203–04 and accompanying text.

225. Robinson & Darley, *Desert*, *supra* note 128, at 472 (“Every time criminal liability is imposed it reminds us of the norm prohibiting the offender’s conduct and confirms its condemnable nature.”).

226. ARONSON, *supra* note 195, at 193–95; see also Elliot Aronson, *The Return of the Repressed: Dissonance Theory Makes a Comeback*, 3 PSYCHOL. INQUIRY 303, 307–08 (1992); Carrie B. Fried, *Hypocrisy and Identification with Transgressions: A Case of Undetected Dissonance*, 20 BASIC & APPLIED SOC. PSYCHOL. 145, 145–46 (1998) (describing hypocrisy paradigm); Blake M. McKimmie et al., *I’m a Hypocrite but So Is Everyone Else: Group Support and the Reduction of Cognitive Dissonance*, 7 GROUP DYNAMICS 214, 221 (2003) (stating that social support from a salient in-group can reduce the dissonance impact of hypocrisy); Jeff Stone et al., *Inducing Hypocrisy as a Means of Encouraging Young Adults to Use Condoms*, 20 PERSONALITY & SOC. PSYCHOL. BULL. 116, 118–21 (1994) (reporting that subjects in “hypocrisy” condition were more likely to purchase condoms after making an AIDS-prevention presentation).

227. See Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 117–21 (2004).

and renounced conduct that had been widely accepted and practiced within their industries.²²⁸ Mr. Spitzer relied in part on the glare of publicity to pressure corporate leaders to account for their management and oversight failures. The sanctions he exacted included significant penalties, leadership changes at the highest levels, and preventative structural reforms.²²⁹

Some corporate scholars are skeptical about the ability of accountability to improve director decisionmaking. For example, Professor Donald Langevoort argues that accountability may have the perverse effect of strengthening biases that result from the desire for consistency.²³⁰ Professor Langevoort is correct to point out that accountability for its own sake is not a cure-all. We must be careful to specify to whom and for what goals directors are accountable.²³¹ However, accountability can be effective in improving decisions when the stated goal is accuracy, rather than a social goal such as pleasing the person or group to whom one will be accountable.²³² A review of psychological research on accountability concludes that independent decisionmaking is most likely to occur when decisionmakers know before forming an opinion that “they will be accountable to an audience (a) whose views are unknown; (b) who is interested in accuracy; (c) who is interested in processes rather than specific outcomes; (d) who is reasonably well-informed; and (e) who has a legitimate reason for inquiring into the reasons behind participants’ judgments.”²³³

228. Merrill Lynch agreed to pay \$100 million to settle charges related to Mr. Spitzer’s investigations of conflicts of interest at the firm. *Id.* at 118. The company also agreed to reform its stock research practices. *Id.* A broader investigation led by Mr. Spitzer, the SEC, and several other states resulted in a \$1.4 billion global settlement by ten Wall Street firms and their agreement to reform research practices. *Id.* at 119. In response to allegations of market timing and late trades by mutual fund investors, Putnam Investments fired its CEO and replaced him with a reformer who pledged to clean up the company. *Id.* at 120–21. Putnam ultimately settled charges brought by Massachusetts and the SEC, agreeing to pay \$110 million in fines and restitution. *Id.* More recently, insurance giant AIG reached a \$1.6 billion settlement with the SEC and the New York Attorney General in connection with its involvement in insurance bid-rigging and accounting fraud. Ian McDonald & Kara Scannell, *AIG Agrees to \$1.6 Billion Settlement—Big Insurer Is Set to Pay SEC, State of New York to Resolve Accounting Case*, WALL ST. J., Feb. 9, 2006, at C8.

229. Eliot Spitzer, Op-Ed., *Strong Law Enforcement Is Good for the Economy*, WALL ST. J., Apr. 5, 2005, at A18.

230. See Langevoort, *Human Nature*, *supra* note 147, at 826–27.

231. See Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCHOL. BULL. 255, 259 (1999); John Pennington & Barry R. Schlenker, *Accountability for Consequential Decisions: Justifying Ethical Judgments to Audiences*, 25 PERSONALITY & SOC. PSYCHOL. BULL. 1067, 1074 (1999) (reporting that the audience to whom participants had to justify their decision had a significant impact on their judgments and justifications).

232. Serena Chen et al., *Getting at the Truth or Getting Along: Accuracy- Versus Impression-Motivated Heuristic and Systematic Processing*, 71 J. PERSONALITY & SOC. PSYCHOL. 262, 272–74 (1996).

233. Lerner & Tetlock, *supra* note 231, at 259. Director accountability to courts, like those in Delaware that specialize in corporate law adjudication, should satisfy the criteria for the type of accountability that mitigates conformity effects. *Id.*

B. THE CHALLENGE OF DETERRENCE

The task of revitalizing shareholder litigation to enhance director accountability is neither simple nor straightforward. The cure is not simply to replace a lax regime with a harsh one. Psychological research suggests that harsh penalty schemes will not solve the problem of properly motivating directors any better than the legal abdication promoted by law and norms scholars. Instead, such research suggests that the current measure of damages for fiduciary breaches may be as counterproductive as the “no liability” rule from the standpoint of providing director accountability.

Widespread voluntary compliance with law is essential to maintaining social order. To elicit a high degree of voluntary compliance, a legal regime must combine appropriate substantive standards that reflect social values with appropriate sanctions to act as a constraint on deviators.²³⁴ As one example, our income tax regime relies primarily on self-reporting by taxpayers. These self-reporting obligations are supported by a monitoring system and a penalty regime for those who fail to fulfill their obligations. Despite these mechanisms, the actual risk of being detected for cheating on taxes remains low. Thus, the fear of being caught cannot explain why people pay taxes.²³⁵ Instead, theorists speculate that people pay taxes because they believe they should and because they believe their fellow citizens are also doing their part.²³⁶ If either of these beliefs were seriously undermined, compliance rates would likely falter.

Classic deterrence theory holds that to deter an activity the perceived net cost of the activity must exceed the perceived net benefit.²³⁷ Under this model, the best way to discourage fiduciary breaches is to increase penalties or the likelihood of detection. However, recent scholarship on law compliance challenges the presumption that increasing the severity of penalties can enhance law’s deterrent capacity.²³⁸

234. Robinson & Darley, *Deterrence*, *supra* note 126, at 982 (“A legal code that is perceived as having moral credibility can provide a clear set of guidelines around which childhood and adolescent socialization can coalesce.”).

235. TYLER, *supra* note 122, at 22.

236. *Id.*; Kahan, *supra* note 82, at 354; *see also* ELSTER, *supra* note 1, at 212–14 (describing such thinking as “everyday Kantianism”).

237. This is the classic utilitarian approach first advanced by Jeremy Bentham. *See generally* JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (Wilfrid Harrison ed., 1960). The modern formulation is credited to Gary Becker. *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 176–77 (1968); *see also* Michael A. Perino, *Enron’s Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes–Oxley Act of 2002*, 76 ST. JOHN’S L. REV. 671, 674–76 (2002) (applying the deterrence model to assess the likely impact of the Sarbanes–Oxley reforms).

238. Robinson & Darley, *Deterrence*, *supra* note 126, at 982. Most scholars who question the deterrent capability of law focus on criminal law. These scholars acknowledge that their arguments may not apply squarely to corporate law or other white collar crimes. For one thing, the target group for corporate regulation is limited to a few thousand public company directors and executives. Furthermore, deviant personalities are not prevalent in corporate management

Harsh penalties for violations of law can actually undermine rates of law compliance.²³⁹ Harsh penalty schemes can create two types of problems. First, courts may be unwilling to impose the legal sanctions called for under existing law. Second, harsh penalty schemes may undermine the internalization of proper moral values.²⁴⁰

1. The Nullification Effect of Harsh Liability Rules

One reason that corporate law fails to effectively deter nonfeasance may be the enormous scope of potential liability for directors, which detracts from the legitimacy of the corporate liability scheme. A fiduciary breach, if proven, subjects each director to liability for the full amount of damages suffered by the corporation as a result of the negligent (or grossly negligent) decision.²⁴¹ The measure of damages is not directly related to an individual director's degree of culpability or the benefit received by the director. Instead, legal penalties are determined by the amount of economic harm that results from the flawed decision.²⁴² For a multibillion dollar company, a single mistake could mean millions of dollars of damages to be borne by the directors.

Even for a director who erred in approving a transaction or who disregarded evidence of misconduct, such a result seems unfair. A director who lacked intent to harm the corporation or was unaware of the potential consequences of a failure to act is not the most blameworthy agent for the corporation's losses. The most culpable wrongdoer is more likely to be an executive or controlling shareholder seeking personal gain at the shareholders' expense. This disconnect between the degree of culpability and the level of penalties called for under corporate law violates basic intuitions of desert.²⁴³ The departure from the community's standards of

to the same extent as among street criminals. Finally, because directors and executives generally are both wealthy and well-educated, they can be expected to understand their legal obligations and have access to expert advice as to whether their conduct violates law and the prospective consequences for such violations. *Id.* at 954; *see also* Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA L. REV. 1295, 1311–16 (2001) (examining the rationales for the divergent policy approaches to the treatment of corporate wrongdoing and ordinary street crime).

239. Robinson & Darley, *Deterrence*, *supra* note 126, at 984–87.

240. *See* Blair & Stout, *supra* note 102, at 1809 (“[A]ttempts to provide external motivations for cooperative behavior can instead reduce cooperation by undermining corporate participants' internal motivations.”).

241. *See supra* notes 24–25 and accompanying text.

242. *Id.*

243. Robinson & Darley, *Desert*, *supra* note 128, at 490 (“There seems a strong consensus . . . that the degree of an offender's liability should follow to a considerable degree the person's level of culpability toward the conduct constituting the offense.”).

fairness can undermine the legitimacy of the regulatory system and weaken the perceived obligation to comply with law.²⁴⁴

The famous *Smith v. Van Gorkom*²⁴⁵ case demonstrates the perceived disproportionality of punishment for violations of the duty of care. In *Van Gorkom*, the court ruled that directors had breached their duty of care by approving a merger in a grossly uninformed manner.²⁴⁶ After making this determination, the supreme court remanded the case to the trial court to determine damages, which were to be calculated as the difference between the \$55 per share paid to shareholders and the “fair value” of the shares at the time of the merger.²⁴⁷ If the lower court had determined that the fair price had been \$65 per share, for example, the ten directors, none of whom had received a direct benefit from the transaction, would have faced an aggregate of more than \$130 million in damages.²⁴⁸ The case eventually settled for \$22 million, most of which was paid by insurance and affiliates of the acquiring company.²⁴⁹

The disproportionate (and arguably undeserved) penalties that can be imposed for breach of fiduciary duty create a risk of nullification that has been realized in corporate law. As scholars have noted, “courts have proven remarkably reluctant to impose liability where no element of self-dealing or personal benefit was present.”²⁵⁰ If penalties are perceived as unduly harsh, judges and legislators may devise ways to avoid imposing liability and high damage awards.²⁵¹ On this score, the states’ legislative response to *Van Gorkom* is instructive. Shortly after the decision, Delaware’s legislature added Section 102(b)(7) to the state’s corporation code.²⁵² This provision permits

244. *Id.* at 493. The authors point to “three strikes” laws as an example of disproportionate punishment that “undercuts the law’s moral credibility.” *Id.*

245. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

246. *Id.* at 893.

247. *Id.*

248. CHARLES R. T. O’KELLY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 258 (4th ed. 2003). Because of joint and several liability, the company’s wealthiest directors might have been required to pay more than their *pro rata* share of the damages, as any portion of the damages left unpaid due to any directors’ insolvency would be apportioned to the remaining solvent directors.

249. *Id.*

250. 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).

251. *Id.* at 309 (observing that “[t]he paucity of cases imposing liability on corporate officials for violations of the duty of due care suggests the existence of . . . a phenomenon” of judicial nullification); Donald E. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 664 (1996) [hereinafter Langevoort, *Capping Damages*] (“I sense that some of the excessive judicial hostility to securities class actions that we have seen in recent years may be driven by [the] emotion: that protecting those who commit fraud may be preferable to subjecting them (and innocent investors) to draconian liability.”).

252. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). All 50 states have amended their statutes to permit limitations on director liability.

corporations to eliminate directors' monetary liability for most duty of care violations. Although judicial nullification is not justifiable, social scientists assert it is predictable. Ironically, although judicial nullification is a response to the perceived illegitimacy of the law, it further erodes the law's legitimacy by promoting and popularizing disrespect for the law.²⁵³

2. The Need for Internalization of Values

Threats of severe sanctions also create external justifications and motivations for compliance that may interfere with corporate leaders' internalization of ethical values. The law should encourage officials to uphold their fiduciary duties because they believe they ought to, not merely because they hope to avoid liability. Yet the task of inducing voluntary compliance with the law proves more complicated than classical deterrence formula suggests.²⁵⁴

Psychologists' attitude change studies demonstrate that persuading a person to commit a counterattitudinal act—an act inconsistent with one's prior attitudes or beliefs—creates dissonance that can cause the person to revise the relevant attitude or belief. However, counter to the logic of deterrence theory, the larger the reward offered to induce a counterattitudinal act, the smaller the measured amount of attitude change.²⁵⁵ Psychologists theorize that when a strong external justification (such as a large reward) is provided for a counterattitudinal act, less dissonance occurs and therefore attitude change is minimal. Similarly, mild threats have been found to be more effective than severe threats in inducing lasting behavioral change.

In studies conducted in the 1960s, researchers sought to discourage children from playing with a certain attractive toy. Some children received a mild admonishment while others received a sterner warning. When the researcher left the room, all of the children obeyed his instructions. At a later date, the same children were given the opportunity to play with the forbidden toy and were not explicitly prohibited from doing so. The children who previously received the mild threat avoided the toy, while children in the severe threat condition sought it out.²⁵⁶ Based on these findings, psychologists warn that relying on harsh threats and large rewards as disciplinary methods can interfere with internalization of moral values.²⁵⁷

253. See FRANKEL, *supra* note 133, at 114.

254. See *supra* text accompanying notes 230–31.

255. Leon Festinger & James M. Carlsmith, *Cognitive Consequences of Forced Compliance*, 58 J. ABNORMAL & SOC. PSYCHOL. 203, 208 (1959).

256. Jonathan L. Freedman, *Long-Term Behavioral Effects of Cognitive Dissonance*, 1 J. EXPERIMENTAL SOC. PSYCHOL. 145, 148–51 (1965); see also Elliot Aronson & J. Merrill Carlsmith, *Effect of the Severity of Threat on the Devaluation of Forbidden Behavior*, 66 J. ABNORMAL & SOC. PSYCHOL. 584, 585–86 (1963).

257. CIALDINI, *supra* note 208, at 82–83; ARONSON, *supra* note 195, at 171–75.

When an external justification becomes the salient rationale for good behavior, the desired behavior may occur only in the presence of an authority figure.²⁵⁸

This research suggests that moderate penalties for director negligence may better motivate them to serve effectively than would harsh sanctions. Consider that directors (most of whom are quite wealthy) get relatively little pay for their time. Standard economic analysis would suggest that, given the value of their time, the significant opportunity costs imposed, and the low marginal utility of director compensation, few directors would be willing to serve in the role.²⁵⁹ The stark absence of an adequate material justification for board service has led directors to develop an array of internal justifications for accepting board positions. Directors report that the most significant motivations for board service are intangible rewards: intellectual stimulation and exposure to new ideas.²⁶⁰ Directors also report that their least important motivation is financial remuneration in the form of directors' fees or equity.²⁶¹

If nominal compensation is sufficient to entice directors to join boards and develop their own internalized motivations for continued service, an enforcement system backed by mild threats could motivate directors to serve responsibly and capably.²⁶² The advantages of mild sanctions over draconian penalties are two-fold: (1) the mild threat is more likely to be imposed; and (2) it may be more effective at inducing voluntary compliance.²⁶³ The challenge for policymakers lies in calibrating penalties such that they are sufficient to elicit compliance (there must be some identifiable consequence of misconduct), but not so severe that the threat itself constitutes an independent justification for complying with fiduciary obligations.

This is a complicated calculus because what constitutes "sufficient" motivation for a particular act varies from person to person.²⁶⁴ For many directors, the mild rebuke of another director may provide sufficient motivation for their own appropriate conduct. For many others, however, a more serious threat may be necessary to persuade them to take their fiduciary obligations seriously.²⁶⁵

258. See Freedman, *supra* note 256, at 154 (discussing tendency of children in experiment to follow instructions when experimenter is present).

259. Professor Stout makes a similar point. See Stout, *supra* note 45, at 4.

260. LORSCH & MACIVER, *supra* note 154, at 28.

261. *Id.* at 29.

262. CIALDINI, *supra* note 208, at 84–87 (describing the phenomenon as "growing legs to stand on"). Professor Aronson calls this the justification of effort. ARONSON, *supra* note 195, at 175–78.

263. Robinson & Darley, *Desert*, *supra* note 128, at 477–78.

264. CIALDINI, *supra* note 208, at 84.

265. *Id.* Professor Cialdini illustrates this dilemma with the example of a parent teaching a child the value of honesty:

C. CALIBRATING DIRECTOR LIABILITY TO PROMOTE ACCOUNTABILITY

This section proposes a net-worth-based penalty scheme for directorial negligence that will enhance the disciplinary power of corporate law. It argues that the 2005 WorldCom Shareholder Litigation Settlement provides a sensible model for calibrating sanctions for negligent director conduct. In that settlement, WorldCom's independent directors agreed to contribute a percentage of their personal assets toward the settlement of securities fraud claims brought by WorldCom investors.²⁶⁶

The proposal maintains that negligent directors should pay personally when they breach their fiduciary duties. However, such payments should be calibrated so that each director suffers a financial setback, but no director is financially devastated. A requirement for out-of-pocket payments restores a degree of personal accountability that currently is absent from most settlements of shareholder lawsuits.²⁶⁷ In addition to furthering the goal of personal accountability, such calibrated sanctions would better reflect directors' degree of culpability than the current theoretical measure of damages.

Reducing the scope of director liability is justified only if: (1) liability awards become more common, thus raising the standard of conduct mandated by courts; and (2) payments of some significance are made by directors and executives in disposition of meritorious claims. The ultimate goal of such reform is to motivate directors to invest the time and demand the information and resources necessary to effectively monitor managers to prevent or redress corporate misconduct.²⁶⁸

1. Prior Proposals

Other scholars have proposed capping damage awards in shareholder lawsuits brought under corporate and securities laws. In 1985, Professors

A strong clear threat . . . might well be effective when the parents are present or when the girl thinks she can be discovered. However, it will not achieve the larger goal of convincing her that she does not want to lie because she thinks it is wrong. To do that a much subtler approach is required. A reason must be given that is strong enough to get her to be truthful most of the time but is not so strong that she sees it as the obvious reason for her truthfulness.

Id.

266. See *infra* note 289.

267. See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1498–99 n.41 (1996) (noting that only .04 percent of settlement amounts in class action securities claims were paid by individual defendants) (citing FREDERICK C. DUNBAR & VINITA M. JUNESA, RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? 9 (Nat'l Econ. Research Assocs. 1993)).

268. See THOMPSON, *supra* note 48, at 256 (calling for reforms aimed at creating structures "in which normal, ordinarily conscientious people will understand their main responsibility to be watching for problems and warning the appropriate officials about them").

John Coffee and Donald Schwartz proposed limiting damages available for the breach of duty of care.²⁶⁹ A variation of their proposal was included in draft versions of the *ALI Principles*, which recommended capping damage awards against individual defendants for “non-intentional” breaches of the duty of care.²⁷⁰ Two alternative limits were proposed. Tentative Draft No. 1 proposed a dollar limit of \$200,000 per individual defendant. Council Draft No. 5 adopted a contract-based approach that would have required defendants to disgorge any compensation received from the corporation during the year the violation occurred.²⁷¹

The final *ALI Principles* endorse the concept of permitting charter-based limits on director liability.²⁷² In the meantime, most states amended their statutes to authorize the reduction or elimination of liability for certain fiduciary breaches. Most of these provisions went far beyond what the *ALI Principles* recommend in that they *eliminate* rather than merely cap directors’ liability.²⁷³ When combined with expanded indemnification rights, these provisions mitigate instead of enhance director accountability, and thus conflict with the spirit of the *ALI Principles*.

More recently, scholars have proposed capping damages in open-market securities fraud cases. Janet Cooper Alexander recommends replacing the private cause of action for 10b-5 violations with a regulatory remedy.²⁷⁴ She envisions a civil fine scaled according to the level of culpability that the violator would pay to the federal treasury.²⁷⁵ She likens such a remedy to penalties payable in private civil litigation under the federal environmental laws.²⁷⁶ To preserve incentives for private enforcement of the securities laws’ anti-fraud provisions, private plaintiffs

269. Coffee & Schwartz, *supra* note 250, at 317 (suggesting penalties keyed to the financial circumstances of the defendant). To address the problem of judicial nullification, Professors Coffee and Schwartz proposed that damages in cases exclusively involving the breach of duty of care be capped at the greater of an individual defendant’s highest annual gross income during the preceding five years or the aggregate director’s fees received by such defendant. *Id.* at 335.

270. Virginia has adopted a liability cap that approximates the ALI proposal included in Tentative Draft No. 1. Damages for “non-willful” breaches of duty of care are limited to the greater of \$100,000 or the cash compensation received during the year preceding the breach. VA. CODE ANN. § 13-1-692.1 (2001). A cap on damages was also included in the ALI’s proposed Federal Securities Code. AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE § 1708(c)(2) (1980); *see also* Coffee & Schwartz, *supra* note 250, at 318.

271. *See* John C. Coffee, Jr., *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789, 823 (1984). *But see generally* James D. Cox, *Searching for the Corporation’s Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project*, 1982 DUKE L.J. 959; Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983) (objecting to the ALI proposals).

272. ALI PRINCIPLES, *supra* note 148, § 7.19.

273. DeMott, *supra* note 38, at 297.

274. Alexander, *supra* note 267, at 1508–13 (proposing a privately enforceable regulatory remedy for 10b-5 violations).

275. *Id.* at 1509.

276. *Id.* at 1509–10.

and their attorneys would receive bounty payments and legal fees.²⁷⁷ Professor Langevoort has advanced a similar proposal to cap damages available in fraud on the market claims.²⁷⁸ Professor Langevoort recommends a model based upon the civil penalty provisions of the Securities Enforcement Remedies Act and Penny Stock Reform of 1990.²⁷⁹ He envisions a penalty system graded according to a violator's level of culpability and the degree of harm the violator causes.²⁸⁰ For companies, he recommends that penalties be pegged to a percentage of a readily measurable figure such as market capitalization, net assets or gross income, and setting penalties for executives at a multiple of the executive's annual compensation or his pecuniary benefit from the fraud.²⁸¹

Existing exoneration provisions and proposed liability caps fail to appropriately balance the goals of providing accountability and avoiding undue retribution. One problem with the prior proposals is that any dollar amount proposed as a damages cap is necessarily arbitrary and may be insufficient to induce the desired behavior.²⁸² In addition, any absolute cap will require adjustment over time to account not only for general inflation but also for inflation in compensation to executives and directors.²⁸³ More challenging from a policy standpoint is that the significance of the damage award for any individual defendant will vary depending on the defendant's financial situation.²⁸⁴ Finally, common insurance and indemnification practices detract from corporate law's deterrent capacity.²⁸⁵ The ready availability of third-party resources to cover costs associated with shareholder lawsuits means that directors are rarely held to account personally for oversight failures.²⁸⁶

277. *Id.* at 1519–20.

278. Langevoort, *Capping Damages*, *supra* note 251, at 641–43.

279. *Id.* at 659 (discussing Securities Enforcement Remedies Act and Penny Stock Reform of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C. (2000))).

280. *Id.* at 659–60.

281. *Id.* at 660–62. Professor Langevoort recommends an absolute cap of \$10 million in penalties for corporations.

282. Coffee, *supra* note 271, at 822.

283. See Langevoort, *Capping Damages*, *supra* note 251, at 658.

284. Consider, for example, Virginia's director liability cap equal to the greater of \$100,000 or one year's compensation. VA. CODE ANN. § 13-1-692.1 (2001). These amounts may be insignificant to an outside director who as the CEO of another corporation earns tens of millions of dollars per year. See BEBCHUK & FRIED, *supra* note 193, at 1 (reporting average real pay of CEOs in 2000 as \$14.7 million per year). Disgorgement of directors fees may also be a weak deterrent because directors report that their director compensation is not an important motivation for board service. See *supra* text accompanying note 261; LORSCH & MACIVER, *supra* note 154, at 28–29.

285. See *supra* text accompanying notes 37–43.

286. See Alexander, *supra* note 267, at 1512 (recommending that certain sanctions for securities fraud be uninsurable).

2. The WorldCom Model

The recent settlement reached in *In re WorldCom, Inc. Securities Litigation*²⁸⁷ addresses many of these concerns and thus serves as a promising model for reforming adjudication and settlement practices in derivative litigation. Although the settlement was procured in a securities fraud action, the alleged director misconduct was of the sort that would constitute a duty of care violation.²⁸⁸ As part of the settlement, twelve former independent directors of WorldCom agreed to contribute \$24.75 million in personal assets toward a \$60.75 million settlement fund for the benefit of defrauded WorldCom investors.²⁸⁹ Each director agreed to pay out-of-pocket twenty percent of his or her net worth (excluding primary residences and retirement funds) toward the settlement.²⁹⁰ The settlement represents one of the few times in modern history that outside directors have had to pay personally to settle charges made in connection with their failure to discharge their oversight duties.

Shortly after the WorldCom settlement was announced, ten former Enron directors agreed to personally pay \$13 million toward a \$168 million settlement of a securities fraud claim.²⁹¹ Unlike the WorldCom settlement, for which the directors' contribution was calculated based on net worth, the Enron directors' contribution was based on ten percent of their pre-tax profits from sales of Enron stock.²⁹²

The personal payments agreed to in the WorldCom and Enron settlements are significant, yet not severe enough to create the impression of unjust punishment that has undermined the legitimacy of existing director liability schemes. Many can agree that directors should not face financial ruin for mistakes in judgment from which they did not benefit. Yet, courts should not completely relieve directors of responsibility for the consequences of their actions or inaction. The WorldCom settlement deftly

287. *In re WorldCom, Inc. Sec. Litig.*, 388 F. Supp. 2d 319 (S.D.N.Y. 2005).

288. Thompson & Sale, *supra* note 3, at 903–05.

289. The settlement followed more than twenty months of negotiations and was finally approved on September 21, 2005, by Judge Denise Cote of the Southern District of New York. *WorldCom*, 388 F. Supp. 2d at 319. The lead plaintiff in the case was the New York State Common Retirement Fund and after the settlement was announced, New York State Comptroller Alan Hevesi stated that he “felt personally that this would be unfair and not a deterrent for future failures on the part of directors if they weren’t held personally liable.” *The Director’s Cut*, WALL ST. J., Jan. 13, 2005, at A12; *see also* Joan S. Lublin et al., *Directors Are Getting the Jitters—Recent Settlement Tapping Executives’ Personal Assets Put Boardrooms on Edge*, WALL ST. J., Jan. 13, 2005, at B1; Gretchen Morgenson, *10 Ex-Directors from WorldCom to Pay Millions*, N.Y. TIMES, Jan. 6, 2005, at A1.

290. *WorldCom*, 388 F. Supp. 2d at 325.

291. Rebecca Smith & Jonathan Weil, *Ex-Enron Directors Reach Settlement*, WALL ST. J., Jan. 10, 2005, at C3.

292. *Id.*

navigates between these two extremes because, by design, each defendant can afford to pay the penalty.

3. Likely Objections

One objection to a requirement that directors' personal assets be placed in jeopardy is the argument that such a provision would deter qualified directors from serving. When considered carefully, however, this argument seems a red herring. Many high-risk activities are accompanied by the threat of liability for negligent action. Nonetheless, many intelligent people continue to engage in such activities. As examples, doctors, lawyers, and accountants continue to practice their professions despite the risk of significant malpractice liability. Although such professionals can insure themselves against some of these risks, they typically bear the costs of increases in premiums related to their own claims histories.

More specifically, however, this proposed liability reform is aimed at relieving directors of the speculative risk of limitless liability, and should thus provide comfort to skittish directors. It provides complete protection of each director's primary residence and retirement assets, regardless of value—assets that form the basis of financial security. It also ensures the protection of the vast proportion of directors' remaining assets (eighty percent in *WorldCom*), no matter how grand or modest. What likely worries directors most is unpredictable, ruinous financial liability, rather than the risk of liability itself. Calibrated sanctions for negligent action squarely address such concerns.

It is also important to note that *WorldCom* was unique in terms of the magnitude of investor losses and the strength of evidence of director negligence, which would have hindered the directors' assertion of a due diligence defense.²⁹³ For these reasons, the twenty percent of net worth figure for assessing personal contributions represents a high-water mark for directors' personal payments. In a less egregious case, a smaller proportion of assets would be an appropriate penalty. Accountability can be enhanced whenever directors have to make personal payments. The specific amount of such payments is less important than their very existence.

Some critics may also question whether the recommended reforms represent the best approach to enhancing director accountability. For example, proxy reforms that empower shareholders to more easily replace directors could enhance director accountability. Such reforms may be preferable to relying on ex post litigation to remedy poor decisions. Although shareholder voting reforms represent important avenues for promoting accountability among corporate leaders, revitalizing shareholder

293. Black et al. II, *supra* note 41, at 1128 (describing *WorldCom* and Enron as "perfect storm" scenarios for out-of-pocket payouts by outside directors).

litigation remains an essential step in restoring meaning to the concept of fiduciary duty.²⁹⁴

The adoption of a net-worth-based determination of damages for negligent directors may also require abandoning the tort-based compensatory scheme which underlies corporate liability theory.²⁹⁵ In light of widely expressed doubts about shareholder litigation's potential as a compensatory mechanism, the explicit shift in objectives may be overdue.²⁹⁶ The compensation objective is ill-served under the current regime. The circularity of payments—from company to insurer in the form of premiums and then from insurer to the company in settlement of a derivative claims—is perverse.²⁹⁷ In addition, the high volume of trading in corporate securities means that the shareholders who benefit at the time a corporation receives recovery are not necessarily the same individuals who suffered from the wrongdoing. For these reasons and others, explicitly acknowledging shareholder litigation's primary objectives as providing accountability and deterrence is warranted.²⁹⁸

VI. CONCLUSION

Because neither markets nor social norms can induce ideal conduct from corporate directors, a credible accountability mechanism is necessary to provide an external check on managerial overreaching. Shareholder litigation, if properly reformed, could serve as an effective accountability mechanism. However, in order to motivate directors to attend diligently to their duties, judges must do more than chide misguided directors in their opinions. They must also demonstrate a willingness to find liability when director conduct falls short of acceptable standards.

The proposed reforms to director liability standards can best be achieved through changes in settlement practices in derivative litigation. More and more securities fraud settlements have required structural

294. Others may argue that vigorous enforcement of the duty of care would inappropriately disadvantage important corporate constituencies such as employees and creditors by encouraging shareholders to “use lawsuits as strategic devices to extract rents.” Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 300 (1999). In addition, certain types of shareholders (such as hedge funds and mutual funds that pursue short term strategies) may use lawsuits to pursue private objectives at the expense of longer-term investors. See generally Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006). While curbing abuse of shareholder litigation is an important concern, it should not distract attention from the important need for directors to be accountable to *somebody*. In the system promoted here, directors would ultimately be accountable to courts rather than shareholders, although shareholders would retain sole power to seek judicial review of questionable corporate actions.

295. See Coffee & Schwartz, *supra* note 250, at 302–05.

296. *Id.* at 302; Alexander, *supra* note 267, at 1500–07; Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84–85 (1991).

297. Langevoort, *Capping Damages*, *supra* note 251, at 648–50.

298. *Id.* at 643–51.

corporate governance reforms and personal payments from culpable wrongdoers.²⁹⁹ The absence of lead-plaintiff provisions in corporate law means institutional investors lack bargaining power to initiate such reforms. However, judges could insist on greater director accountability when reviewing preliminary motions and proposed settlements.³⁰⁰ Judges have wide discretion in ruling on settlement proposals and in deciding whether a case will proceed to discovery or trial. In reviewing settlements, judges should reject proposals that do not include personal payments by executives or directors where credible evidence exists of misconduct or gross negligence. Judges should also indicate a strong risk of liability in appropriate cases in order to persuade directors and other individual defendants to agree to out-of-pocket payments.

Reducing the weight of prospective liability might encourage judges to impose liability more often. Linking directors' personal contributions to settlements to their ability to pay could also reduce the perceived unfairness of the existing liability scheme. If director liability provisions were more widely perceived as fair (by directors and society in general), directors would be more likely to heed the values commended to them by courts and commentators.

299. The Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.), created most adequate plaintiff requirements for class action securities claims, under which the shareholder with the most money at stake in the claim is presumed to be the most adequate plaintiff. Securities Exchange Act of 1934 § 21(D)(a)(3)(B), 15 U.S.C. § 78u-4(a)(3)(b) (2000). In response to this new law, plaintiffs' firms sought alliances with institutional investors to represent these large shareholders in cases affecting their portfolio securities. In addition to monetary compensation, many institutional investors, acting in their roles as lead plaintiffs, also seek to institute corporate governance reforms that might mitigate the recurrence of fraud in the future. Some scholars recommend that state courts adopt lead plaintiff provisions. *See, e.g.*, Thompson & Thomas, *Litigation Agency Costs*, *supra* note 54, at 7, 64. Such reforms might be helpful in eliminating the so-called "race to the courthouse" and in facilitating institutional shareholder control over plaintiff attorneys.

300. Insurers might also have the power to lead such a reform effort. Insurers have sound business reasons to create incentives for good management practices in accordance with fiduciary duties to minimize payouts required under existing policies. Their expertise can be brought to bear through contract terms allocating deductibles, exclusions, and co-payments.