

Reintroducing Releases of Officer Liability into Australian Corporate Law

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Recent debate about the legal treatment of officer liability for negligence has suffered from inadequate evaluation of non-legal incentives to act carefully, including norms and markets; imprecision in delineating and differentiating types of negligence cases; and a failure to consider a full range of appropriate options for limitation of officer liability. In particular, reform bodies should have considered waiving the statutory prohibition against releases of officer liability for negligence. This paper provides a taxonomy of negligence cases, and evaluates the problems and limitations of legal rules in each type. It then evaluates empirical evidence from Australia's early corporate history during which time liability releases were permitted. Despite significant standardisation there is little evidence of systematic unfairness or of terms unsuited to governance. After reviewing recent experience with liability releases in the United States, the paper then analyses the appropriate path for reform in Australia.

INTRODUCTION

Lawyers often see legal rules in binary terms. A legal rule either exists, or it does not exist. If it exists, the subject of that rule is 'regulated'; if it does not exist, that subject is 'unregulated'. If it is unregulated, current thinking all too frequently begins with the question 'why not?'. I suspect that the positivist doctrinal tradition in the teaching of lawyers is the principal culprit. Austinian and even Holmesian views of the law separate what is possible, from what is forbidden.¹ Despite the overwhelming inadequacies of legal analysis for prescriptive purposes, it seems a short step for traditional legal minds to seek to enact laws that permit the things we like or want or tolerate, and to prohibit the rest. The proposition that legal rules have costs, substitutes and limits does not fit into either the positivist tradition or the natural law tradition – despite the fact that these attributes influence both what the 'bad man'² might do, and what the good legislator should do.³

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¹ 'The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law': O W Holmes Jr, 'The Path of the Law' (1897) 10 *Harvard Law Review* 457, 461. '[E]very positive law ... is a direct or circuitous command of a monarch or a sovereign number to a person or persons in a state of subjection to its author.': J Austin, *The Province of Jurisprudence Determined* (first published 1832, 1954 ed) 134.

² Holmes used the concept of the hypothetical 'bad man' as a means of understanding what behaviour the law would punish: Holmes, above n 1.

³ Holmes was well aware of this point, and his recognition of consequential considerations was historic. Unfortunately, his comment that 'if the training of lawyers led them habitually to consider more definitely ... the social advantage on which the rule they lay down must be justified, they sometimes would hesitate where now they are confident' remains as true today as when it was written: Holmes, above n 1, 468.

Take an example.⁴ Over three quarters of a century ago, an insurance company collapsed into insolvency. Investors and other claimants on the firm sustained major losses. The principal culprit was a fraudulent executive director. The articles of the company released its directors from various forms of liability, including ‘loss, damage or misfortune’ unless the conduct giving rise to the liability was a consequence of the directors’ own wilful default. Because the directors other than the fraud had acted honestly, they were absolved from liability, even though a judge of a court of superior jurisdiction concluded that they had acted negligently in the management of the corporation. In the midst of the ensuing hue and cry,⁵ a committee chaired by a silk was formed and given a brief to investigate a range of matters including the appropriateness of articles releasing or indemnifying directors against liability.

The relevant section of the report is about 1000 words long (rather shorter than the headnote of the case that inspired the analysis).⁶ Two conclusions were formed. First, it is impossible to attempt to define directors’ duties.⁷ Second, it is inappropriate for articles to permit the release of directors from liability for breaches of duty.⁸ We are not told — nor has anyone ever thought to ask — how frequent these releases were or what terms were agreed.⁹ It does not occur to anyone that the uncertainties which motivate the committee’s first conclusion might be a persuasive reason to use contracts to shift risks and limit liability. A number of other questions also go begging. The only clear conclusion is that negligent directors must be made to pay, and that contracts which diminish the force of this quasi-retributive impulse should be prohibited. The ‘bad man’ is to be left in no doubt.

I am sorry to say that the debate has not really advanced that much since then. The Corporate Law Economic Reform Program (‘CLERP’) most recently raked over these same coals.¹⁰ It deserves credit for restating these issues in language with (potentially) more precise meanings, such as ‘risk’ and ‘efficiency’. But the focus has not really changed. Problems with legal rules are to be fixed by legal rules — by adding a business judgment rule here, by changing the formulation of the duty of care there.¹¹ The analysis remains as bare of empirical evidence as the Greene Committee’s report before it, despite the need and opportunity to examine jurisdictions in which liability releases are permitted, to evaluate the efficiency of the directors’ and officers’ insurance market, and so on. Theoretical analysis is also thin. One looks in vain for

⁴ The reported case is *Re City Equitable Fire Insurance Corp* [1925] Ch 407.

⁵ J Asif, ‘The Effect of Section 310 of the Companies Act 1985 on Directors’ and Officers’ Insurance and on Auditors’ Professional Indemnity Policies’ (1989) *Professional Negligence* 209, 210 (referring to public scandal).

⁶ Company Law Amendment Committee 1925–26, Report [1926] Cmd 2657 §§ 46–7.

⁷ *Ibid.*, 20.

⁸ *Ibid.*

⁹ The report describes particular forms of the release as ‘common’: *ibid.*, 19.

¹⁰ Corporate Law Economic Reform Program, *Directors’ Duties and Corporate Governance: Proposals for Reform Paper No 3* (1997). The *Corporate Law Economic Reform Act 1999* (Cth) has now been enacted and embodies the program’s principal recommendation.

¹¹ The report asks: ‘Can Government legislation ensure good corporate governance?’ (*ibid.*, 21). Unfortunately, the question is rhetorical. Everything that follows assumes the answer is yes.

discussion of cognitive biases of judges in negligence cases, differences in the capacity of ex ante contracts and insurance to address moral hazard problems, and so on.

In this paper, I want to broaden both the debate and the mode of analysis. Rather than the latest of many reviews of the law on duties of care or business judgment rules, I want to address the case for reclaiming the law as it stood in Australia prior to the states' enactment of legislation first passed in England in response to the Greene Committee in 1928.¹² Specifically, I address the case for reintroducing liability releases. In part I, I analyse theoretically the demand for liability releases.¹³ Part II fills some of the gap in our knowledge of the regulated phenomena by providing empirical evidence of the use in Australia of releases and indemnities in the period prior to regulation. Part III addresses the manner in which a legislature might go about introducing officer releases, having regard to both comparative experience and *realpolitik*, and the form that legislation should take.

I. THE ECONOMIC CASES FOR AND AGAINST LIABILITY RELEASES

In order to understand why liability releases might be justified, one must first understand the justifications for subjecting officers to liability. In evaluating these issues, I want to focus on liability which arises in primarily 'corporate' contexts — liability for negligence qua director and for breaches of the fiduciary duty of loyalty.¹⁴ Thus, I do not consider the officer's role as a gatekeeper for the purposes of corporate compliance with social or broader economic regulatory regimes, although the seal between the two is hardly hermetic.¹⁵ The distinction is nonetheless appropriate because my primary subject is the use of contracts to release liability, which can only have effect between parties in privity of contract.¹⁶

¹² *Companies Act 1931* (Qld) s 160; *Companies Act 1934–5* (SA) s 170; *Companies Act 1936* (NSW) s 132; *Companies Act 1938* (Vic) s 157; *Companies Act 1943* (WA); *Companies Act 1959* (Tas) s 97.

¹³ The CLERP report specifically indicates its desire that the introduction of a business judgment rule (now embodied in the *Corporations Law* in s 180(2)) will prevent the need for liability releases: above n 10, 26. It ignores the obvious point that, in the United States, the business judgment rule has a longer history than legislation enabling liability releases. The business judgment rule was adopted in its modern form no later than *Graham v Allis Chalmers*, 188 A 2d 125 (Del, 1963). The first legislation was enacted almost a quarter of a century later in 1986, as a result of a case held to fall outside the protection of a business judgment rule: *Smith v Van Gorkom*, 488 A 2d 858 (Del, 1985). This case would probably be decided in the same way under s 180(2).

¹⁴ The duty of loyalty is an Americanism, but a useful one, as the various manifestations of fiduciary obligations that do not relate to care lack a single rubric of convenience in English law.

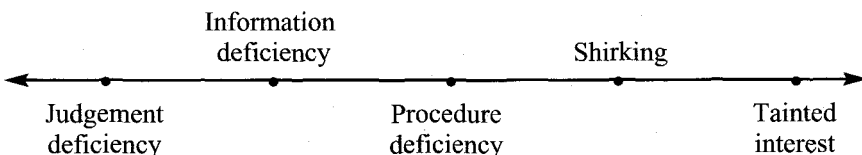
¹⁵ See generally Reinier Kraakman, 'Corporate Liability Strategies and the Costs of Legal Controls' (1984) 93 *Yale Law Journal* 857.

¹⁶ Indemnities are another matter, however — *Corporations Law* s 199A.

Rationales for Officer Liability

The circumstances in which liability for negligence might be asserted can be described in terms of an original taxonomy consisting of five case types. I introduce this taxonomy as a classificatory regime for negligence cases, and as a basis for analysis of the effects of liability. This is illustrated graphically in Figure 1. The continuum reflects the heterogeneity of cases within each category.

Figure 1 A Taxonomy of Director Negligence Cases



The first case type, judgment deficiency, is characterised by a claim that a decision was based on flawed judgment. Few, if any, cases assert flawed judgment alone. The common law biased itself against such findings.¹⁷ CLERP's business judgment rule is aimed at excluding most judgment deficiency cases from the scope of liability.¹⁸

Information deficiency cases posit some form of duty to be informed generally or to seek information in particular cases. Such a duty to be informed is in issue in several recent cases, such as *Daniels v Anderson*¹⁹ and *Permanent Building Society (in liq) v Wheeler*.²⁰ The greatest difficulty with these cases is causation. A failure to acquire information does not necessarily mean that the decision which caused the loss would not have been taken. To conclude otherwise requires a court to make the sorts of findings it traditionally eschews in judgment deficiency cases.²¹

Procedure deficiency cases do not require courts to balance the costs and benefits of either managerial action or information acquisition.²² Instead, these cases posit procedural aberrations, wherein a director fails to comply with a general procedure, or with some more specific injunction. My intuition is that this is the real basis of the historic finding of negligence against a chief executive in *Daniels v Anderson*.²³ That director had failed to implement a policy laid on him by the non-executives, and had concealed that failure and related

¹⁷ See, eg, *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480, 487; *Re City Equitable Fire Insurance Corp* [1925] Ch 407, 427–9.

¹⁸ CLERP, above n 10, 23.

¹⁹ (1995) 16 ACSR 607 *sub nom AWA Ltd v Daniels* (1992) 7 ACSR 759.

²⁰ (1994) 14 ACSR 109.

²¹ This is graphically shown in *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109, 161–2. There, the judge refused to award damages against a director failing to discharge his duty to be informed.

²² Ian M Ramsay, 'Liability of Directors for Breach of Duty and the Scope of Indemnification and Insurance' (1987) 5 *Company and Securities Law Journal* 129, 146–8 (emphasising procedural focus of modern company law).

²³ (1995) 16 ACSR 607.

information from them. Nonetheless, these cases are not free of complications either. Not every procedure is mandatory, those that are mandatory may be subject to exceptions, and there is in every case a difficulty of reconciling procedural dictates with the highly discretionary nature of directorship. An important subset of procedure deficiency cases, in which affirmative findings of liability are fraught with most peril, are 'structural' deficiency cases. These typically involve issues such as the division and delegation of responsibilities between directors and between the board and employees.²⁴ These cases proceed on the basis that the corporation's governance structure is dysfunctional, not that there has been a departure from it.

Shirking cases impugn the conscientiousness of the director's application of his energies to his or her functions. This area of law is often caricatured by reference to the law's undemanding requirements regarding attendance of board meetings.²⁵ Information structural deficiency cases are often portrayed in terms of shirking. The line between the two is elusive (not much turns on it) but the typical shirking case involves the passive director archetype.

The fifth case type involves tainted interests. In principle there are clear differences between negligence and disloyalty cases.²⁶ However, the duty of care may operate elastically to become more onerous when applied to directors who are personally interested in transactions, and to other directors who, apparently lacking such interests, nonetheless aid and abet directors who do have such interests.²⁷ This intensification functions not only to apprehend directors who are capable of suppressing facts relating to their own interests (for instance, a side payment by the culpable officer to other directors to quell dissent), but to induce information-forcing.²⁸ That is, a higher standard forces directors to provide more information about what actually happened, which increases the apprehension of the guilty. Several cases fit into this category.²⁹

Before we can understand the merits of using liability in these case types, it is important to reflect on the circumstances in which suits alleging negligence are normally brought. In general, most suits are brought either by liquidators in relation to insolvent companies (insolvent trading and misfeasance

²⁴ A number of recent cases have argued in favour of limiting the director's entitlement to delegate certain functions and to rely on employees to act honestly: see *Metal Manufacturers Ltd v Lewis* (1986) 11 ACLR 122, 129–31; *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405, 431–2 (affirmed on appeal (1992) 10 ACLC 1233, 1245–7); *Daniels v Anderson* (1995) 16 ACSR 607, 664.

²⁵ *Re Cardiff Savings Bank; Marquis of Bute's Case* [1892] Ch 100; *Turquand v Marshall* (1869) LR 4 Ch App 379; *Re Denham & Company* (1884) 25 Ch D 752.

²⁶ Especially doctrinal ones: see *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109, 160–7.

²⁷ Douglas Branson, 'Intracorporate Process and the Avoidance of Director Liability' (1989) 24 *Wake Forest Law Review* 97; Michael J Whincop, 'A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care' (1996) 6 *Australian Journal of Corporate Law* 72, 88–9.

²⁸ See generally Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87; Robert E Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597.

²⁹ See, eg, *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109; *State of South Australia v Marcus Clark* (1996) 19 ACSR 606.

summons cases) or by public prosecutors in similar situations which are marked by apparent impropriety. Shareholders have been infrequent litigators, because of collective action problems and standing dilemmas. They are most likely to assert claims after the revelation of major losses.³⁰ This 'disaster' profile is a result of the difficulties of observing the actions of directors and senior managers, and of conducting litigation while those in charge of the company at the relevant time remain the dominant coalition in the board. Experimental psychology has revealed potential biases in making decisions regarding the quantum of ex ante risk on an ex post facto basis.³¹ The over-representation of cases involving disaster situations and the fact that something has in fact gone wrong are likely to lead to overestimation of ex ante risks by courts.³²

Liability for negligence may have two efficiency justifications, following the usual justifications for tort liability.³³ One is to provide an economic incentive to take actions (making judgments and acquiring information) and institute practices (procedures and divisions of responsibilities) which are expected to increase shareholder wealth. The incentive can only operate by deterring failures to take these actions or institute these practices. The other is to provide a form of disaster insurance for shareholders. Liability can only serve the latter purpose if judges impose it in circumstances where the loss is 'care-unpreventable'.³⁴

The insurance function is easy to analyse. First, directors are poor insurers. Shareholders have greater capacity to reduce company-specific disaster-like risks either by diversification or by buying put options. Executives make sunk cost investments of human capital in their corporations. Thus, directors have far more attenuated capacities to diversify, so requiring them to bear risk compounds their risk aversion.³⁵ This point is virtually canonical in the economic literature, and is especially true for executive directors — the most likely to be held liable in all but shirking cases. More importantly, negligence is a very poor basis for insurance since it only provides a benefit where negligence is found to exist. Thus, the legal principles on negligence create contingent entitlements to insurance, which is quite inconsistent with the purpose of insurance. Strict liability for loss is more effective if insurance is the objective,

³⁰ See, eg, *State of South Australia v Marcus Clark* (1996) 19 ACSR 606.

³¹ Ed Bukszar and Terry Connolly, 'Hindsight Bias and Strategic Choice: Some Problems in Learning from Experience' (1988) 31 *Academy of Management Journal* 628.

³² Amos Tversky and Daniel Kahneman, 'Judgment Under Uncertainty: Heuristics and Biases' in Daniel Kahneman, Paul Slovic and Amos Tversky (eds), *Judgment Under Uncertainty* (1982) 3, 11; D C Langevoort, 'Beliefs, Biases and Organizational Behaviour: The Epistemology of Corporate-Securities Lawyering' (1998) 63 *Brooklyn Law Review* 629.

³³ G L Priest, 'The Current Insurance Crisis and Modern Tort Law' (1987) 96 *Yale Law Journal* 1521, 1537. In making this point, I do not want to deny that liability might operate to do corrective justice between the parties. But that purpose has never explicitly been articulated — or justified.

³⁴ That is, the expected value of care is less than its cost. The phraseology belongs to Steven P Croley and Jon D Hanson, 'What Liability Crisis? An Alternative Explanation for Recent Events in Products Liability' (1990) 8 *Yale Journal on Regulation* 1, 15.

³⁵ See, eg, Kraakman, above n 15, 858–67; John Coffee, 'Shareholders Versus Managers: The Strain in the Corporate Web' (1986) 85 *Michigan Law Review* 1.

but is fundamentally inconsistent with the residual claim status of equity investment.³⁶

If insurance is an unsuitable objective for legal liability, what can we say of the use of liability rules to deter failures to take care? I have noted that legal liability has rarely been perceived as a source of correction for judgment deficiencies.³⁷ For reasons already described, judicial error is highly likely in reconstructing the incremental costs and benefits of particular judgments. If so, liability cannot be used to target, or therefore deter, poor judgments — at least without deterring decisions that are risky but justifiable at the time they are made. The new business judgment rule is consistent with this claim.³⁸

Issues concerning the acquisition of information in information deficiency cases are related to those raised by substantive decisions in judgment deficiency cases. It is technically possible to evaluate these issues in a 'rational', unbiased way. An adjudicator can use Bayes' Theorem to model the updating of beliefs based on new information.³⁹ For instance, a comment from a third party to the effect that a particular employee is engaging in unauthorised transactions may cause a chief executive to update his or her beliefs about the probability of this fact being true.⁴⁰ This forms a potential basis for further action, which may often include the acquisition of further information. Bayes' Theorem prescribes a formula for determining revised probabilities.⁴¹ The revised belief may support particular action. But Bayes' Theorem does not constrain the form of initial beliefs.⁴² Rational managers with the same risk aversions may rationally act differently with respect to the same information if their initial beliefs diverge. If that is so, a judge, reconstructing the sequence

³⁶ If managers were the optimal risk-bearers, contracting with agents would be straightforward: all risks would be allocated to agents: Kenneth Arrow, 'The Economics of Agency' in John Pratt and Richard Zeckhauser (eds), *Principals and Agents: The Structure of Business* (1991) 37, 44–45.

³⁷ See above text accompanying n 17, 18.

³⁸ See *Corporate Law Economic Reform Act 1999* (Cth) s 180(2).

³⁹ For an overview of Bayes' Theorem, see Eric Rasmusen, *Games and Information: An Introduction to Game Theory* (2nd ed, 1994) 52–7.

⁴⁰ To put this in context, consider this in the context of *Daniels v Anderson*, when the chief executive, Hooke received information from Lloyds regarding unauthorised transactions by Koval, the foreign exchange manager.

⁴¹ Bayes' Theorem determines the probability of some fact, B_i , being true, given the occurrence of a signal, A :

$$P(B_i|A) = \frac{P(A|B_i)}{\sum_{k=1}^K P(A|B_k)P(B_k)}$$

In other words, the conditional probability of some fact B_i being true, given the occurrence of the signal, A , is the probability that A would occur if B_i held, divided by the sum of the products of the probabilities that A would occur under each of k possible and mutually exclusive states and the probability of each state holding. Thus, assume there are two states: K is in control and \bar{K} is out of control. H may think that the probability of the first is 0.9, and thus the other is 0.1. The probability of getting a report from a merchant banker that \bar{K} is out of control when that is not true is 0.4; the probability of getting the report when it is true is 0.6. Bayes' Theorem indicates that the revised probability that \bar{K} is in control is 0.86.

⁴² In other words, the values of $P(A|B_k)$ are not endogenous to the theorem.

of events in order to judge the existence of negligence, would need to be able to verify the form of the initial beliefs, every piece of information acquired relevant to the subject, and the implications of that information for the relevant subject.⁴³ If judges cannot do that, or defendants cannot do it for them, hindsight biases may overwhelm the analysis. In practice, information deficiency cases are likely to be evaluated in the more limited terms of procedural (and especially structural) deficiencies, or, in passive director cases, of shirking.⁴⁴ These cases circumvent the need to make these difficult cost-benefit judgments regarding the acquisition of particular information by evaluating processes in general. Active attempts by courts to make these judgments may impel directors to avoid risky decisions or to make unnecessary, costly investments in information systems in order to construct the basis of a negligence defence.⁴⁵

Procedural deficiencies raise similar issues, although they depend less on reconstructing the inferences about particular information. Functionally, they resemble the judicial review of corporate governance. For a court to impose liability because of the absence of particular procedures or the presence of others is equivalent to mandating or prohibiting the use of those arrangements.⁴⁶ Courts have rarely gone so far as to impose this kind of liability explicitly, although issues of delegation have recently been much discussed.⁴⁷ Mandatory governance is unlikely to be welfare-increasing.⁴⁸ Economic theory indicates that the governance needs of firms differ substantially, having regard to differences in their assets, the markets in which they compete, the concentration of shareholdings, capital structure and so on.⁴⁹ The need and optimal form for governance is a consequence of these factors — it is not logically prior to them. Adversarial and legislative processes are not well qualified to understand these relationships between governance mechanisms compared to markets.⁵⁰

I have noted that the procedural deficiency involved in *Daniels v Anderson* — ignoring directives — is in some ways an easy case for liability.⁵¹ But in at least some cases, directors will defend their conduct with various excuses, as

⁴³ The capacity to verify undisclosed beliefs is obviously very difficult.

⁴⁴ See above text accompanying n 22–25.

⁴⁵ Alfred Conard, 'A Behavioral Analysis of Directors' Liability for Negligence' [1972] *Duke Law Journal* 895, 903–4.

⁴⁶ Recently, there have been strong impulses towards a monitoring board made up of non-executive directors: see eg Committee on the Financial Aspects and Code of Best Practice of Corporate Governance, Sir Adrian Cadbury (Chairman), Report (1992). As to the doubtful case for non-executive directors, see Laura Lin, 'The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence' (1996) 90 *Northwestern University Law Review* 898.

⁴⁷ See the discussion in CLERP, above n 10, 43–4.

⁴⁸ See generally Larry E Ribstein, 'The Mandatory Nature of the ALI Code' (1993) 61 *George Washington Law Review* 984.

⁴⁹ The *discriminating* alignment between governance and transaction attributes is fundamental to the transaction cost economics paradigm: O E Williamson, *The Mechanisms of Governance* (1996).

⁵⁰ This is implicit in the ASX's refusal to mandate best practice in corporate governance but to require disclosure of the practices adopted: Australian Stock Exchange, Listing Rule 4.10.3.

⁵¹ See above text accompanying n 23.

Hooke did in *Daniels v Anderson*,⁵² in which case one returns to issues of judgment. On the other hand, concealing information, as Hooke concealed data from the other board members, makes the case for liability rather stronger.

But there is a deeper issue here, which bears on the value of using legal rules in these cases. The discharge of directorship takes place in a context strongly embedded in a social context.⁵³ Board behaviour, although affected by laws and markets, is likely to be heavily characterised by norms. Norms evolve as a means of fostering coordination and cooperation in team production situations.⁵⁴ As a result of multiple directorships, these norms are likely to have broad currency across many boards, and information about compliance with them is similarly diffused.⁵⁵ Outside contexts in which boardroom warfare rages, or in 'endgame' situations where a director's term is set to end (insolvency and takeovers are examples),⁵⁶ the vast majority of directors are likely to internalise norms of obedience to board decisions and procedural compliance. These are necessary not just for the board to function effectively, but also to preserve the 'social' element of the relation.⁵⁷ Directors infringing these

⁵² (1996) 16 ACSR 607, 677–83.

⁵³ See generally Mark Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness' (1985) 91 *American Journal of Sociology* 481. Most of the following comments are directed to the boards of public corporations, or other boards to which external directors are appointed. Small boards or one-person boards stand in a different position, since these institutions are typically characterised by common ownership and control, which economises on the agency costs of directorship: Eugene Fama and Michael Jensen, 'Separation of Ownership and Control' (1983) 26 *Journal of Law & Economics* 301.

⁵⁴ There is a burgeoning literature on norms in law and economics. References of particular value include Lisa Bernstein, 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms' (1996) 144 *University of Pennsylvania Law Review* 1765 [hereinafter *Merchant Law*]; Lisa Bernstein, 'Social Norms and Default Rules Analysis' (1993) 3 *Southern California Interdisciplinary Law Journal* 59 [hereinafter *Default Rules Analysis*]; Robert Cooter, 'Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant' (1996) 144 *University of Pennsylvania Law Review* 1643 [hereinafter *Decentralized Law*]; Robert Cooter, 'The Theory of Market Modernization of Law' (1996) 16 *International Review of Law and Economics* 141 [hereinafter *Market Modernisation*]; Robert Ellickson, 'Law and Economics Discovers Social Norms' (1998) 27 *Journal of Legal Studies* 537. As to the special problems of team production and its relation to the board, see Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247.

⁵⁵ Robert Burt, 'The Social Structure of Competition' in Robert Eccles and Nitin Nohria (eds), *Networks and Organizations: Structure, Form, and Action* (1992) 57; Mark Granovetter, 'The Strength of Weak Ties' (1973) 78 *American Journal of Sociology* 1360.

⁵⁶ The significance of 'endgames' is best understood from an informal game theoretic perspective. Many situations involving interaction between parties can be modelled as a 'prisoner's dilemma', in which each has a self-interest in acting opportunistically, notwithstanding the joint gains from cooperation. Robert Axelrod's work demonstrates that norms of cooperation may emerge where games repeat or iterate indefinitely — longer term gains from cooperation may exceed short term gains of opportunism, given the capacity to punish defectors: Robert Axelrod, *The Evolution of Cooperation* (1984) 169–91. The incentive to act opportunistically will dominate the incentive to cooperate in 'endgames', in which parties know that they are, for some reason, playing the final round, or when they know when that final round will arrive. For informal analysis, see Avinash Dixit and Barry Nalebuff, *Thinking Strategically* (1991) 98–113.

⁵⁷ See Granovetter, above n 53.

norms can be punished, either by the board of the corporation in question (second-party enforcement), by other boards informally connected by common directors, or by other social networks (third-party enforcement).⁵⁸ These punishments may include social ostracism, censure, refusal to recommend the director to other companies as a non-executive director or consultant, cancellation of powers or offices (eg chairing committees) dependent on board grants, disendorsement at future elections, termination of contracts with the corporation the director is (lawfully) interested in, and so on. If that is the case, one would expect that, apart from endgame situations in which legal rules may be valuable, boards will enforce their own procedure against directors with far greater effectiveness than a court, and will have a greater capacity to differentiate their procedure according to their circumstances.⁵⁹

I have observed that passive director situations are most likely to be involved in shirking cases.⁶⁰ Undoubtedly, the law has sharpened its claws for the pursuit of this quarry since the 1980s.⁶¹ In some senses, the do-nothing director is an easy catch. Even if courts cannot ascertain the optimal level of effort by directors, zero effort seems to comfortably lie below it on most analyses. But this assumes that passive directors are *meant* to be active, and that they were appointed to serve the same sorts of functions as watchdog non-executives. There are three reasons to doubt this. First, passive directors may be legally contingent. Until 1995, companies were required to have two directors, even if there was but one shareholder with beneficial interests.⁶² To require a second director, who was appointed for compliance purposes, to take a diligent interest in the company imposes unnecessary deadweight costs. The fact that only one director need be appointed *now* is not a sufficient answer to this point, as companies and directors may experience real costs in changing over. Second, passive directors may be appointed to expedite procedures in emergencies, when the principal director is incapable or unavailable. Third, directors may be appointed for business networking. Management studies indicate the profound importance of networks for modern business.⁶³ Directorship may be a valuable conduit for networked relations because of the access to information and high level deliberation.

That is not to say that shirking is not a problem. On the contrary — shirking in team production plays a prominent role in economic theories of organisation.⁶⁴ But again, the utility of legal rules as a means of addressing it is

⁵⁸ For analysis of the conditions for second- and third-party enforcement, see Jason Scott Johnston, 'The Statute of Frauds and Business Norms: A Testable Game Theoretic Model' (1996) 144 *University of Pennsylvania Law Review* 1859.

⁵⁹ As to the value of private enforcement of norms, see Bernstein, *Merchant Law*, above n 54.

⁶⁰ See above text accompanying n 25.

⁶¹ See generally Jennifer Hill, 'The Liability of Passive Directors: *Morley v Statewide Tobacco Services Ltd*' (1992) 14 *Sydney Law Review* 504; Sally Sievers, 'Farewell to the Sleeping Director — the Modern Judicial and Legislative Approach to Directors' Duties of Care, Skill and Diligence' (1993) 21 *Australian Business Law Review* 111.

⁶² Formerly, *Corporations Law* s 221.

⁶³ See generally Nohria and Eccles, above n 55); Hakan Håkansson and Ivan Snehota (eds), *Developing Relationships in Business Networks* (1995).

⁶⁴ Armen Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62 *American Economic Review* 777.

doubtful. Shirking is a problem because it is usually unobservable. But if it is unobservable then a legal rule penalising shirking will be ineffective or dysfunctional.⁶⁵ Other forms of control are more likely to be important. Norms and bonding are the most likely ones.⁶⁶ The parties most likely to become directors and chief executives are likely to internalise strong work ethics. Even scholars who have adopted strong pro-regulatory positions have often agreed that shirking is a problem on a lower order of magnitude.⁶⁷ If negligence is asserted mostly in disaster situations, legal rules are unlikely to have much effect on shirking. At least in established public corporations (where shirking is likely because of ownership and control separation), shirking is unlikely to culminate in disaster. The consequent improbability of liability being invoked results in very low deterrence of shirking, but may cause directors to consciously adopt less risky policies.

Tainted interest cases raise problems that differ from the other case types. They raise serious moral hazard problems in which the director's incentives are self-consciously antagonistic to shareholders' interests.⁶⁸ Moral hazard problems are not present in the first three case types, and are only present in a predictably 'residual' manner with shirking.⁶⁹ Tainted interests by contrast raise instances of normative failure, in which the norms internalised by directors do not prevent, or do not extend to, substantial overreaching or disloyalty. This may be because of the proximity of an endgame situation, where opportunism is likely. For reasons I have already described, legal rules — both fiduciary and the heightened form of negligence — are useful in these situations, especially in endgames, where market discipline is weak.⁷⁰

Cases For and Against Releases of Liability

If the analysis in section A is accepted, there is a strong case for mechanisms that limit negligence liability. In judgment, information and procedural deficiency cases, liability can rarely be used to operate as an effective deterrent to 'care-preventable' failures in judgment, information acquisition, and governance procedure. This is a consequence of various difficulties, pre-eminent

⁶⁵ Alan Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *Journal of Legal Studies* 271.

⁶⁶ As to norms, see above text accompanying n 53–9. Bonding is a term that describes contracting processes which create property rights that make pledges to act in another's interests self-enforcing: Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

⁶⁷ Melvin Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1472–3 ('Most top managers will probably refrain from shirking simply because their self-esteem is tied to hard work and accomplishment.').

⁶⁸ Moral hazard problems arise because the post-contractual actions of a contracting party are difficult to observe, and thus to control. That party is therefore more likely to choose actions in self-interest: D H Baird, R Gertner & R J Picker, *Game Theory and the Law* (1994) 309.

⁶⁹ That is, bonding and normative processes are imperfect — some shirking remains. Economists claim that this is anticipated and reflected in securities prices: Jensen and Meckling, above n 66.

⁷⁰ As to endgames, see above text accompanying n 56. As to the value of liability rules, see above text accompanying n 25–29.

⁷¹ See above text accompanying n 31–32.

amongst which is the distortion of hindsight, selection, and salience biases.⁷¹ The paradigm disaster situation suggests the liability minimising strategy is to minimise risks and lay a paper trail, in anticipation of litigation, rather than due care or value maximisation.⁷² Liability in shirking cases needs limitation because shirking is, by definition, difficult to measure even for contracting parties, and because its effect is most likely to be reduced by non-legal means, such as property rights allocations and norm internalisation. By contrast, the intense moral hazard problems associated with tainted interest cases deprives the argument for limitation of liability in these cases of its force.

The issue, however, is the means by which limitations should be effected.⁷³ There are three possible means. One might be thought of as a legal limitation; the other two involve contracts. A legal limitation can be built into substantive negligence principles. This can be done by defining the substantive duty to exclude some or all of the first four case types. It can also be done by entitling the director to assert a defence such as a business judgment rule. Anglo-Australian law historically followed the first route by adopting broadly phrased tests of negligence;⁷⁴ US law adopted the business judgment rule as a principal defence.⁷⁵ Contractual means take the legal rule as given but reallocate liability by exchange either to insurers, under a directors' and officers' ('D & O') insurance policy, or shareholders, under a contract releasing the director from liability. Legal limitations and D & O insurance are sanctioned options in Australian law; contractual releases have been unlawful since state legislation was enacted in Australia between 1931 and 1943.⁷⁶

What are their respective merits?⁷⁷ Legal rules have one advantage — they are less affected by major environmental changes that cause contracts to be insufficiently state contingent.⁷⁸ At the time contracts are entered, parties may not foresee the occurrence of certain types of eventualities; had they done so, they might have cut different deals. Insufficiently state contingent contracts create incentives for breach or renegotiation. Because they can operate *ex post* in an adjudicatory context, legal rules can be adjusted to address new developments or remote events. Revolutions in capital markets, such as the

⁷² See Conard, above n 45, 903–4.

⁷³ See generally Rani John, 'Relieving Directors from the Liabilities of Office: The Case for Reform of Section 241, Corporations Law' (1992) 10 *Company and Securities Law Journal* 6.

⁷⁴ See above text accompanying n 17; *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Corporations Law* s 1318.

⁷⁵ *Graham v Allis Chalmers*, 188 A 2d 125 (1963); *Sinclair Oil Co v Levien*, 280 A 2d 717 (1971); *Aronson v Lewis*, 473 A 2d 805 (1984); *Cede & Co v Technicolor*, 634 A 2d 345 (1994).

⁷⁶ *Corporations Law* s 199A; as to predecessor legislation, see above n 12.

⁷⁷ In analysing liability releases, I assume the liability release has been defined to include judgment, information, and procedural deficiency cases and shirking, but excludes tainted interests.

⁷⁸ A contract that is insufficiently state contingent (or contingently incomplete) fails to realise potential gains from trade in certain future states of the world. This condition creates an incentive to breach or renegotiate the contract: Ian Ayres and Robert Gertner, 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules' (1992) 101 *Yale Law Journal* 729, 730.

emergence of a market for junk bond debt, aspects of globalisation, or substantial revisions of certain legal rules may constitute contingencies of this character. D & O insurance markets are affected by insufficient state contingency, but less than contractual releases, because insurance contracts are renegotiated periodically by renewal. However, renewal may not be a sufficient control on this problem if claims have a long liability 'tail', that is, claims arise long after the relevant events occur.⁷⁹ Insurance crises have often been most pronounced in industries with long-tailed liability, such as chemical and pharmaceutical industries.⁸⁰ But I have my doubts how significant insufficient state contingency really is. First, the basic categories of negligence cases are relatively stable. If exclusions in liability releases are defined by reference to more general language such as the presence of personal interests, many of these problems could be addressed.⁸¹ Second, if contracts are affected by contingent incompleteness, the optimal response is to provide rules filling gaps that are directed to the unforeseen event — not to prohibit entering contracts in the first place.⁸²

The limitations also differ in the moral hazard they create.⁸³ Limitations change the incentives of parties to take certain actions — such as shirking or taking excessive risks — they would not take in the absence of the limitation. D & O insurance is vulnerable — like any insurance policy — but insurance policies are designed to mitigate these risks.⁸⁴ Moreover, regular re-contracting provides the scope to insist on changes limiting moral hazard potential. Insurers may be better placed to monitor behaviour by the insured, given the absence of collective action problems, especially compared to shareholders.⁸⁵

As with insufficient state contingency, legal limitations can address moral hazard by denying protection *ex post* where such behaviour is present. However, this depends on moral hazard being verifiable — which, by the nature of the problem, it often is not.⁸⁶ Contractual releases are vulnerable to moral hazard, unless there is some form of limitation which allows a court to withhold the benefit of the release.⁸⁷ The significance of this form of moral

⁷⁹ Priest, above n 33, 1574–6.

⁸⁰ *Ibid.*

⁸¹ See below text accompanying n 113–114.

⁸² See, eg, Ayres and Gertner, above n 28.

⁸³ Care should be taken not to confuse this discussion with the earlier analysis of moral hazards. I referred earlier to the tainted interest moral hazard problem which arises from the general 'contract' referring imperfectly observable managerial power on directors. Here, I am talking about the moral hazard arising from the limitation of liability.

⁸⁴ The usual devices are coinsurance (the insured bears some proportion of the risk) and deductibles (the insured bears the risk up to a certain dollar amount): see Priest, above n 33, 1553–6.

⁸⁵ Cf Michael Whincop, 'Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law' (1997) 21 *Melbourne University Law Review* 187, 231.

⁸⁶ Information is verifiable if a contracting party (eg shareholders) can prove it to a third-party adjudicator. Information may be observable by a contracting party, but may not be verifiable: see Schwartz, above n 65.

⁸⁷ Nonetheless, if moral hazard conduct is unverifiable, legal limitations will be just as flawed as contractual releases. Neither contracts nor legal rules can predicate on unverifiable information: Schwartz, *ibid.* If it is verifiable, the contracts entered in low transaction cost markets would be expected to address it.

hazard is, however, open to question. For reasons mentioned above, excessive risk taking is rarely a failing of managers, and it is doubtful whether shareholders would be worse off in any event.⁸⁸ Excessive risk taking may also be kept under control by other contracts such as those with banks or other lenders.⁸⁹ I have also referred to reasons which suggest shirking is a moral hazard problem of lower order of magnitude. The other principal moral hazard, overreaching, is also controllable by predicating the release on the absence of personal interests.

By contrast, both legal limitations and D & O insurance suffer from legal 'drift'. There is always a risk that the business judgment rule may function as a 'dangerous supplement' to liability for negligence, by redefining itself in a way that provides a wider scope for negligence.⁹⁰ The key issue lies in the scope and conditions for the business judgment rule. CLERP's proposed rule could provide a backdoor entrance for the claims it should ideally be vanquishing, such as reconsidering substantive merits, information acquisition and governance.⁹¹ Changes to the law are also problematic for D & O insurance. Insurance depends on the existence of uncorrelated, independent risks. If legal rules change to increase generally the obligations of directors, risks become increasingly correlated, which diminishes the scope for insurance markets to function.⁹² Relatedly, D & O insurance is vulnerable to result-oriented policy construction. A court may limit exclusions where the judgment's satisfaction depends on the availability of insurance.⁹³ This creates similar problems because most exclusions relate to correlated risks. Liability releases are the least vulnerable to expanded liability and operate with the greatest certainty.

Wealth effects favour contractual releases. Some firms, especially entrepreneurial SMEs, may not have sufficient wealth to afford D & O insurance.⁹⁴ Likewise, even where a business judgment defence is technically available, the expected litigation cost of asserting it may be high.⁹⁵ If contractual releases are not available to these firms, two consequences may follow. One is reduced investment in entrepreneurial firms of this character. The other is 'judgment proofing'. That is, directors will place assets beyond the reach of a sequestration order.⁹⁶ Because it nullifies liability rule deterrents, judgment proofing may have external effects on various third parties such as tort creditors. Of

⁸⁸ See above text accompanying n 15.

⁸⁹ C Smith and J Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 6 *Journal of Financial Economics* 117.

⁹⁰ Peter Drahos and Stephen Parker, 'Critical Contract Law in Australia' (1990) 3 *JCL* 30, 35 (reviewing post-structural literature).

⁹¹ See *Corporate Law Economic Reform Act 1999* (Cth) s 180(2).

⁹² Priest, above n 33, 1562–3.

⁹³ For example, where the director is judgment-proof. Manipulation of exclusions increases the variance of risk pools and decreases the supply (and thus increases the cost) of insurance: Priest, *ibid* 1536.

⁹⁴ See, eg, Stephen Hoyle, 'Directors Rocked by Insurance Increases', *Australian Financial Review*, 18 August 1993, 1.

⁹⁵ If litigation costs are high enough for directors, an equilibrium is possible in which they agree to settle claims without merit despite the presence of a business judgment rule: Robert Cooter and Daniel Rubinfeld, 'Economic Analysis of Legal Disputes and Their Resolution' (1989) 27 *Journal of Economic Literature* 1067, 1083–4.

⁹⁶ See generally Lynn LoPucki, 'The Death of Liability' (1996) 106 *Yale Law Journal* 1.

course, judgment proofing may happen any way, but at the margin some firms that would not otherwise engage in the practice may do so as a consequence of the expected costs of legal liability under negligence standards.

Limitations differ in the process by which they are 'priced', as between shareholders and managers. D & O insurance is only available on payment of an insurance premium, which in one way or another, will usually be borne by the shareholders.⁹⁷ Renewing insurance permits changes the risk to be reflected in exclusions and the premium. Liability releases will normally be specified *ex ante* in the corporate constitution. As such, they will form part of the corporate contract, the terms of which are decided at the time the firm's securities are offered to investors.⁹⁸ In an efficient capital market, inefficiently wide releases which exacerbate moral hazard will be reflected in lower priced securities. Over time, with the release of information and changes in risk, management, and environment, the discount may turn out to be too low. Prices will fall. However, any loss will not be suffered by the directors, but the owners of securities for the time being. There may also be an attempt to include a release *after* the offering. This procedure is not the subject of a market exchange, but the subject of a shareholder vote to amend the constitution.⁹⁹ Although some amendments may be Pareto superior — benefiting both shareholders and directors — wealth may be transferred from shareholders to directors if the former lack sufficient information to make decisions.¹⁰⁰ A similar process is at work with legal liability. The net expected effects of liability rules and substantive defences on investment and agency costs will be reflected in securities prices at the time of offerings. The greater uncertainty in future changes makes pricing more complex. Changes in the law after the initial offering operate in much the same way as midstream amendments, except that their allocative implications may be harder to estimate.¹⁰¹

To conclude, the case for distinguishing the treatment of contractual releases from D & O insurance and substantive defences, by prohibiting the first, and permitting the others is not soundly based in theory. D & O insurance has superior capacity to control moral hazard (if it is significant), and being renegotiated regularly rather than arranged in one-off corporate contracts, has superior pricing properties. Wealth effects may limit the availability of D & O insurance for highly risky companies, and one would anticipate lower

⁹⁷ Either through direct payment or because the cost is reflected in the supply curve for director services.

⁹⁸ Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1991) 15–22.

⁹⁹ If a liability release is included in the constitution, a special resolution would be required: see *Corporations Law* ss 136–7.

¹⁰⁰ Eisenberg, above n 67, 1474–80; Jeffrey N Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 *Columbia Law Review* 1549, 1575–6. Cf Roberta Romano, 'Answering the Wrong Question: the Tenuous Case for Mandatory Corporate Laws' (1989) 89 *Columbia Law Review* 1599.

¹⁰¹ In some ways, corporate law rules introducing a business judgment rule may make shareholders worse off than enacting a provision enabling liability releases to be adopted, other things being equal. The business judgment rule may be mandatory, and, even if it is only a default, shareholders would have to opt out of it, which is far harder than managers attempting to opt into a liability release.

expected litigation costs under liability releases than the alternatives because they reduce the expected stakes from litigation against directors. Substantive defences and liability releases have similar capacity to control moral hazard, and function identically in their role in corporate exchanges, except that substantive defences are probably more uncertain. A possible argument against contractual releases may lie in contexts where they are not offered at the time of initial investment, but as part of a midstream amendment, because of the possibility of impoverished choice by shareholders at these times. Before one can conclude that prohibiting liability releases is allocatively inefficient, it is necessary first to consider arguments rooted in fact. The next part addresses this need.

II. SOME EMPIRICAL EVIDENCE

The Characteristics of Relevant Evidence

An unfortunate aspect of much legal policy is its failure to make adequate empirical examinations of the subject in question. The prohibition of liability releases recommended by the Greene Committee is just such an example. There are two principal questions which need to be considered to shed some light on the theory considered in the last part. The first concerns the capacity of the stock market to reflect the net agency costs associated with liability releases in security prices.¹⁰² If stock markets cannot do that, there may be a case for restricting certain forms of contracts, on the basis that shareholders may be worse off if they are included.¹⁰³ Of course, the capacity of stock markets in the 1920s and 1930s to price information about agency costs has no necessary implications for that issue in 2000 and beyond. I do not purport to offer a capital market study of the pre-Greene era for this reason, and the more general analysis of the pricing of governance terms is sufficiently studied in the legal literature on the capital markets.¹⁰⁴

The second question concerns the form of liability releases entered prior to prohibition. If there is evidence that liability releases are systematically unfair, the capital market issue is most important. There might be a tentative conclusion that an inefficient market is encouraging inefficient contracting. If on the other hand liability releases are not systematically unfair and seem adapted to their purposes, the case against their prohibition is strong even in the absence of capital market evidence. It is this evidence I offer below.¹⁰⁵

¹⁰² See generally Frank H Easterbrook, 'Managers' Discretion and Investors' Welfare: Theory and Evidence' (1984) 9 *Delaware Journal of Corporate Law* 540.

¹⁰³ The case is not absolute, as it depends on one's efficiency criterion. If officers' gains exceed shareholders losses, the Kaldor-Hicks efficiency concept would sanction the choice, but considerations of distributive justice may not.

¹⁰⁴ See generally Marcel Kahan, 'Securities Laws and the Social Costs of "Inaccurate" Stock Prices' (1992) 41 *Duke Law Journal* 977; Roberta Romano, 'Corporate Law and Corporate Governance' (1996) 5 *Corporate and Industrial Change* 277.

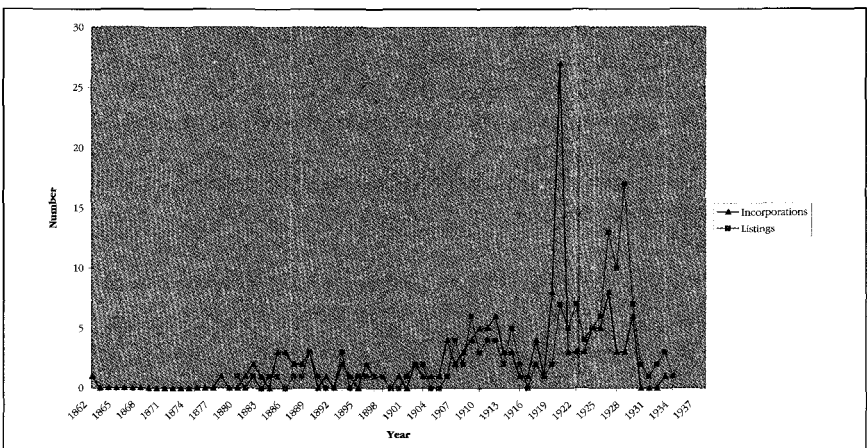
¹⁰⁵ This section draws selected relevant results from my article, 'Empirical Analysis of Corporate Charters and Mandatory Rules: An Australian Study', unpublished paper (1999) [hereinafter *Empirical Analysis*].

Nature of the Study

My study is of the articles of companies whose securities were publicly quoted at a time before the introduction of mandatory rules contained in the adoption of the provisions of the 1928 English companies legislation by Australian states. The principal problem one faces in research of this kind is incomplete and fragmentary data. The data gathering involved the following steps. First, I ascertained the companies whose securities were listed on the Sydney Stock Exchange (SSE) on the last trading day of 1935. The SSE was selected as the oldest and best archived stock exchange in the country.¹⁰⁶ A complete set of records as to the SSE's Official Listing Requirements was locatable, whereas gaps emerged in those of other exchanges. Over two-thirds of the company in my final sample were incorporated in New South Wales. For those companies, the mandatory rules became effective on 22 July 1936. The last trading day in 1935 is therefore a useful borderline for pre- and post-mandatory rules. Four hundred and fourteen companies fitted these criteria.

The second step was to locate copies of the corporations' charters and information concerning the company, such as its listing date and date of incorporation. The only source of data as to charters is the microfiche records of the old state Corporate Affairs Commissions, which were taken over by the Australian Securities & Investments Commission ('ASIC') in the transition to national corporate law in 1990. As a result of gaps and inconsistencies in ASIC records, the effect of name changes, and the like, records were sought for 213 companies. ASIC was able to supply complete information for 150 companies. The 150 companies in the sample are incorporated in a range of jurisdictions. One hundred and six were incorporated in New South Wales; 36 in Victoria; six in Queensland; and two in South Australia. Figure 2 summarises dates of incorporation and listing.

Figure 2 Summary Statistics For Sample



¹⁰⁶ See generally Stephen Salsbury and Kay Sweeney, *The Bull, the Bear and the Kangaroo: The History of the Sydney Stock Exchange* (1988) 65–241.

To gather evidence on contract terms, I examined the articles as they stood at the earlier of 31 December 1935 (the cutoff date for the sample) or the last day of the year preceding the enactment of the mandatory rules by the jurisdiction of incorporation.¹⁰⁷

Results

As a general comment, a large majority of companies provided for either liability releases or indemnification. The indemnities are sometimes wide enough to include liability for negligence. Because these wider indemnities were also prohibited post-Greene they form an important object of study. The subjects of indemnity fall into these principal categories – actions, costs, charges, losses, damages and expenses. The patterns of usage are analysed in Table 1:

Table 1 Terms Used in Charter Indemnities

<i>Indemnity against —</i>	<i>% adopting</i>
Costs	89.3%
Losses	88.0%
Expenses	87.3%
Charges	26.7%
Damages	25.3%
Actions	16.7%
Liabilities	2.7%

The combination of these terms sheds light on standardisation in corporate documentation, a matter I shall have more to say about in part III. Just three mutually exclusive combinations account for five-sixths of the charters with indemnity subjects. These are illustrated in Table 2:

Table 2 Principal Indemnity Subjects

<i>Indemnity combinations —</i>	<i>% adopting</i>
Indemnity against costs, losses, expenses (only)	60.0%
Indemnity against actions, costs, charges, losses, damages, expenses	14.0%
No indemnity provision	9.3%

Thus, a majority of companies opted for a limited indemnity which does not extend to indemnity against, say, damages for negligence. However, there are more extreme positions on the indemnity subject — no indemnity, or a much wider indemnity, which extends to actions, charges, and damages.¹⁰⁸

¹⁰⁷ This applies only to the Queensland and the South Australian companies, since Victoria adopted the mandatory rules after New South Wales: see above text accompanying n 12.

¹⁰⁸ It has been suggested that the intermediate indemnity goes no further than a directors' common law right to indemnity: Alfred Topham, Albert Llewellyn-Taylor & Alexander Topham, 1 *Palmer's Company Precedents* (13th ed, 1927) 771.

Literally, an indemnity against, say, damages or actions would entitle the director to indemnity for damages for breach of negligence, even in a tainted interest case. This would be a serious moral hazard problem. However, we find that indemnities are sometimes subject to qualifications, which disentitles the director to assert rights under the provision. Twenty three per cent of contracts cancel the right to indemnity where the conduct in respect of which indemnity is sought involved the director's 'wilful default'.¹⁰⁹ Moreover, there is a highly significant correlation between the appearance of the 'wilful' constraint and the use of the more extensive indemnity subjects, particularly the 'damages' subject.¹¹⁰ This is not accidental. The qualification limits the greater potential moral hazard problems associated with the wider indemnity, although the verification of 'wilful' conduct may be difficult, given its subjectivity. Four contracts imposed a qualification that the provision indemnified the director against acts 'done in or about the execution of duties', which is a logical means of limiting indemnity to areas where moral hazard problems are lower. Interestingly, one charter drafted in 1889 customised its own term to limit indemnity to cases 'where a judgement is given in [the director's] favour or in which he is acquitted' — the only indemnity which would be permitted by legislation almost fifty years later.¹¹¹

The liability release provisions range across varying subjects. Some subjects arise from the directors' own conduct; others arise from acts of other persons such as officers or employees. In the latter case, a release functions to deny any agency or vicarious liability operating between the director and the other. It also mitigates mutual monitoring. The majority of companies — 88.7% — had a release of liability relating to other officers. Here, too, standardisation is notable, as 70.7% of the sample referred to the 'acts, receipts, neglects and defaults' of other officers. The bulk of the others use combinations of these terms, or similar words such as 'deeds' or 'omissions'. Of the 10.3% of the sample that did not provide for any such release, over two-thirds had also not provided for an indemnity, which is strongly correlated at any level.¹¹² This demonstrates that some companies did not use the contractual freedom afforded by pre-Greene law. A mandatory business judgment rule may be welfare-decreasing for these companies.¹¹³

¹⁰⁹ One further contract (not counted with the 'wilful' group) imposes a customised limitation referring to 'culpable negligence'. It indemnified the officer against costs, charges, damages, and expenses.

¹¹⁰ This can be seen in the following table:

	"Wilful"	Not "Wilful"	Totals
Damages Indemnity	30	8	38
No Damages Indemnity	5	107	112
Totals	35	115	150

The χ^2 statistic is 87.99 ($df=1$, $p<0.0001$), which is statistically significant at any meaningful level. The eight contracts which indemnify against damages and which do not provide for a dishonesty qualification do not indemnify against actions.

¹¹¹ But see now *Corporate Law Economic Reform Act* (Cth) s 199A(3).

¹¹² The χ^2 statistic is 98.35 ($df=1$, $p<0.0001$).

¹¹³ That is, because some firms would opt out of it. Whether the same provisions would be adopted under a different default is, however, uncertain: cf Russell Korobkin, 'The Status Quo Bias and Contract Default Rules' (1998) 83 *Cornell Law Review* 608.

Related to these releases of vicarious liability for the acts of other directors are releases from damage associated with other persons employed by or contracting with the firm. Releases of liability for the acts or omissions of employees as such are rare — only one such provision was observed. However, releases of liability associated with the acts or defaults of the corporation's bankers or depositaries are common — 84.7% of the charters included this term. This term is closely associated with terms releasing the director from liability arising from defects of title on property purchased by the company or taken as security.

Releases relating to the directors' own responsibilities cluster into different formulations. Table 3 describes the principal ways these releases are formulated:

Table 3 Formulation of Director Liability Releases

<i>Release formulations —</i>	<i>% adopting</i>
Loss, damage or misfortune	86.0%
Damage flowing from insufficiencies of funds deposited	82.7%
Damage flowing from defects of title to property	82.0%
Director's error of judgment or oversight	48.7%
Director's acts, receipts, neglects, defaults, or omissions	3.3%
No release of any form	9.3%

Thus, releases were typically *not* drafted in the widest terms. Two of these releases are confined to a limited fact situation addressing deficiencies in receipts and title defects, none of which are typically in the director's field of comparative advantage. The 'error of judgment or oversight' release is notably phrased alike the typical language of a business judgment rule. 'Loss, damage, or misfortune' is comparatively restricted, connoting cases involving non-feasance by the released directors, compared to a release which refers simply to 'acts', 'neglects' or 'defaults'.

Like the indemnities, releases are often qualified. These qualifications are highly standardised. Except for just one charter that explicitly excluded cases of 'gross negligence', the only observed qualifications refer to cases of 'wilful' default or 'dishonesty'. These include: 43.3% of the charters are qualified by reference to wilful default; 39.3% refer to 'dishonesty'; 6% refer (probably redundantly) to both in the alternative. Of the charters remaining which were unqualified by either, only 2% of the sample — three charters — actually contained a liability release, and none included the broadest release.

From a theoretical economics perspective, the form of these qualifications is puzzling. Both dishonesty and wilful default refer to subjective mental states. A lay person would call them difficult to prove; an economist would call them unverifiable. Theory holds that parties will not predicate payoffs on information that is unverifiable.¹¹⁴ There are two possibilities here. One is that parties emulate provisions in common use or in authoritative precedents even

¹¹⁴ Schwartz, above n 65.

if these embody dysfunctional terms.¹¹⁵ The second possibility is that these terms provide scope for ex post analysis by a court. The parties are stipulating the use of a discretionary standard to evaluate possible moral hazard, because of the likelihood that more specific provisions would be underinclusive.

When we look at both indemnities and releases, an interesting pattern emerges. Most articles cluster into networks which are individually homogeneous. Almost 45% of the sample is characterised by the limited indemnity against costs, losses and expenses, and the expansive release of personal and vicarious liability qualified by dishonesty. In fact, these articles are practically the same as the article used in one of the two reported English cases on liability releases, *Re Brazilian Rubber*.¹¹⁶ 28.7% of the sample splits into two further networks. One uses minimalist terms — no ‘personal’ releases or no indemnity apart from the minimalist ‘costs, losses and expenses’ provision. The other provides for a wide indemnity, the vicarious liability releases, and a release against personal liability for loss, damage or misfortune (but not against errors of judgment or oversight), the releases and indemnity being qualified for wilful default. The remaining 40 articles do not fall into clear networks, but mostly tend to pick and choose between the terms used in the other networks. There are very few customised terms, and the few that do exist are reported above.

As I document in more detail elsewhere, network usage is not constant over time.¹¹⁷ Although there are no significant differences between the mean adoption times for the two smaller networks, both are significantly older (in the sense that the average time of adopting these terms is longer) than the timing of the ‘*Brazilian Rubber*’ network.¹¹⁸ The adoption time for the miscellaneous group of contracts is significantly greater than for the *Brazilian Rubber* network, but significantly shorter than for the other two. The recent adoption age of the *Brazilian Rubber* network may itself be attributable to the outcome in *Brazilian Rubber* which accepted the validity of these clauses.¹¹⁹ In part III, I will argue that this evidence is consistent with the presence of learning and network effects.

What are the policy implications of this evidence? Most companies adopted provisions that were inconsistent with the mandatory rules imposed post-Greene. A majority of companies adopted wide releases or indemnities, but ones which seem consistent with the sorts of cases where I have indicated limits on liability are appropriate. The vast majority provide a qualification on the release which could, at a pinch, be used to deny release in cases of moral hazard. The mandatory rules introduced seem inefficient, because they preclude terms likely to be needed for optimal contracting. There is little or no

¹¹⁵ See above text accompanying n 144–151.

¹¹⁶ [1911] 1 Ch 425.

¹¹⁷ *Empirical Analysis*, above n 105.

¹¹⁸ Use of the term “significantly” implies a difference in means in the direction indicated which is statistically significant at conventional levels for hypothesis testing (ie $p < 0.05$).

¹¹⁹ Consider that of the 67 members of the network, 64 adopted the terms after the decision in *Brazilian Rubber*. The resulting chi-square statistic is statistically significant at any meaningful level.

evidence of systematic unfairness. No term explicitly seeks to exclude liability for overreaching or breach of the duty of loyalty, and courts would be most unlikely to enforce any such term. The apparent suitability of these widely adopted provisions suggests the inefficiency of the prohibition.

III. THE PATH FOR LEGISLATIVE REFORM

American Parallels

Many American states have enacted laws entitling a certificate of incorporation to include liability releases. These were first enacted in 1986 shortly after the decision of the Delaware Supreme Court in *Smith v Van Gorkom*,¹²⁰ in which directors were held liable, apparently for information deficiencies during the pendency of a merger, and in the face of soaring premia in the market for D & O insurance. Delaware differed from some other states, in particular Virginia and Indiana, both of which virtually eliminated liability for duty of care violations.¹²¹ Section 102(b)(7) of Delaware's *General Corporation Law* enables the corporation's certificate of incorporation to include:

- (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director:
 - (i) For any breach of the director's duty of loyalty to the corporation or its stockholders;
 - (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
 - (iii) [for unlawful dividend payments or stock purchases]; or
 - (iv) for any transaction from which the director derived an improper personal benefit.¹²²

These provisions enable a corporation to seek the approval of a majority of its shareholders to amend its certificate of incorporation, or to include the provision at the time it seeks investment. Whether or not the term transfers wealth from shareholders to managers depends on the capacity of shareholders to vote on a midstream amendment in a manner that is consistent with their best interests, or the efficiency of the primary securities market, as the case may be.¹²³

The legislation is broadly consistent with my analysis of the cases in which limitations of liability are appropriate. The cases excluded from the provision are those in which moral hazard problems and conflicts of interest are greatest. They are also broadly similar to the qualifications we observed in the charters in Part II, although the generality of those qualifications implies that similarity turns on their construction. A small number of cases have been decided

¹²⁰ 488 A2d 858 (Del. 1985).

¹²¹ *Ind Code Ann* § 23-1-35-1(e) (eliminating duty of care liability, excepting wilful misconduct or recklessness); *Va Code Ann* § 13.1-690.

¹²² *General Corporation Law*, Del. Code Ann. tit. 8, § 102(b)(7) (1999).

¹²³ See above text accompanying n 100.

under the provision. The courts have indicated that releases apply only to duty of care liability, not to liability for breach of the duty of loyalty or for equitable fraud,¹²⁴ or for failures to disclose.¹²⁵ These suggest that judges are conscious of potential moral hazard problems created by liability releases, and reclassify cases as breaches of the duty of loyalty to address the problem, as early commentators predicted they would.¹²⁶ Nonetheless, if the release becomes excessively dependent on judicial interpretation little advance is actually made by reducing the release to contractual terms, compared to the use of the business judgment rule.¹²⁷

The Durability of the Prohibition

So far my analysis favours the reintroduction of liability releases. An initial question we might ask is why we haven't seen the law changed in the past?¹²⁸ Between the 1930s and the early 1980s, the number of cases in which negligence was asserted against directors in Australia was very small.¹²⁹ Thus, the demand for changes in the law was low. Only with the renaissance of the law in this area in the 1980s might one have expected that to change. However, the political climate at this time was not germane for introducing rights to limit contractually directors' liability. Directors and entrepreneurs were being portrayed as cowboys; the backlash would be too great for any political party who would paint directors as a wronged constituency in need of protection immunising them against liability.¹³⁰ Some of those factors may still be influential. Negative payoffs for politicians are likely to be greatest at the time of corporate collapses, as in *City Equitable*. Because the timing of these collapses is uncertain, politicians would like to minimise this risk.¹³¹ In the absence of competition between jurisdictions in the formulation of corporate law (as in the US), politicians will have a strong personal interest in minimising the

¹²⁴ *Zirn v VLI Corp*, 621 A.2d 773 (Del SC, 1993).

¹²⁵ *Arnold v Society for Savings Bancorp, Inc*, 650 A2d 1270 (Del SC, 1994).

¹²⁶ *AC Acquisitions Corp v Anderson, Clayton & Co*, 519 A.2d 103 (Del Ch 1986); Comment, 'Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule' (1987) 24 *Harvard Journal on Legislation* 527.

¹²⁷ For an argument that attempts to define rights precisely often leads to discretionary, standard-based adjudication, see Carol Rose, 'Crystals and Mud in Property Law' (1988) 40 *Stanford Law Review* 577.

¹²⁸ The analysis in this section draws on economic theories of regulation, which hold that laws and regulation are the products of a process in which interest groups make self-interested bids for the services of regulators and politicians. The interest groups most likely to be successful are those with the lowest costs of organisation, which, in general, are small groups in which per capita stakes are high, vis-à-vis large diffuse groups. See generally Sam Peltzman, 'Toward a More General Theory of Economic Regulation' (1976) 19 *Journal of Law and Economics* 211; Richard Posner, 'Theories of Economic Regulation' (1974) 5 *Bell Journal of Economics* 335; G Stigler, 'The Theory of Economic Regulation' (1971) 2 *Bell Journal of Economics* 3. For contemporary references, see Jerry L Mashaw, *Greed, Chaos, & Governance: Using Public Choice to Improve Public Law* (1997); Maxwell Stearns, *Public Choice and Public Law: Readings and Commentary* (1997).

¹²⁹ One exception is *Re Australasian Venezolana Pty Ltd* (1962) 4 FLR 60.

¹³⁰ See generally Trevor Sykes, *The Bold Riders* (1994).

¹³¹ See generally Mark Roe, 'Backlash' (1998) 98 *Columbia Law Review* 217.

expected future risks associated with legislation.¹³² The position of bureaucracies responsible for corporate regulation will be very similar.

One might expect directors to lobby for such legislation, as they did in the US. However, directors are not a homogeneous group. The sorts of 'professional' directors who act for large, publicly listed corporations may have weaker incentives to seek the legislation. For them, D & O insurance is usually available, and non-executive directors — a majority of most boards, these days — can decline to act for risky corporations more likely to court insolvency and thus litigation. The capacity of large corporations to invest in paper-trail-generating information systems, at these directors' behest, is also considerable.¹³³ These directors may even be able to use the absence of contractual limitations in an anti-competitive manner. Their broad experience of practice gives them skills which make it highly unlikely they will be sued in an adversarial context in which procedural issues are the dominant concerns.¹³⁴ If those skills are costly for first-time directors to acquire, the mandatory application of a negligence standard predicated on these skills may function as a barrier to entry alike a mandatory quality standard.¹³⁵ By contrast, directors of smaller, riskier, entrepreneurial firms will have a higher demand for limitations. They are more likely to be a subject of litigation, but the cash flow pressures on their firms will reduce the capacity to pay high D & O premiums will be greater than in less risky firms. The question is: which directors will be more influential in the lobbying process. It seems likely the smaller pool of highly experienced directors will be. They are the repeat players, for whom lobbying investments are most economic, and they are a smaller group with lower costs of political organisation. Their preferences should prevail.

Self-interested lawyers prefer a regime in which the expected value of legal services is maximised. That is undoubtedly higher under a system in which limitations on liability are administered through the courts, rather than a system in which litigation is much less likely.¹³⁶ In addition, there is a legal demand for complexity which maximises the expected value of future instructions and decreases the likelihood of pre-trial settlement.¹³⁷ Permitting limitations on liability may transfer wealth away from lawyers to corporate secretarial firms and underwriters advising on the terms (including liability releases) which a firm should take to primary securities markets.

¹³² This argument is made in Michael Whincop, 'The Political Economy of Corporate Law Reform in Australia' (1999) 27 *Federal Law Review* 77 and 'Rules, Standards, and Intransitive Statutes: What the Economic Reform of Corporate Law Might Have Looked Like' (1999) 17 *Companies and Securities Law Journal* 11.

¹³³ See above text accompanying n 45, and n 72.

¹³⁴ See above text accompanying n 22.

¹³⁵ The complex question here is whether mandatory quality terms (as opposed to price terms) will function anti-competitively: see Michael Spence, 'Monopoly, Quality, and Regulation' (1975) 6 *Bell Journal of Economics* 407.

¹³⁶ See above text accompanying n 95.

¹³⁷ Isaac Ehrlich and Richard Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *Journal of Legal Studies* 257, 271, 274; Louis Kaplow, 'Rules Versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557, 620; Jonathan Macey and Geoffrey Miller, 'Toward an Interest-Group Theory of Delaware Corporate Law' (1987) 65 *Tex Law Review* 469, 504–505; Michelle White, 'Legal Complexity and Lawyers' Benefit from Litigation' (1992) 12 *International Review of Law and Economics* 381.

What do shareholders prefer? I have argued that shareholders may often be better off if liability limitations are included. The returns to them are the sum of the expected value flowing from reduced risk borne by the director, savings in expected litigation costs, and savings in D & O insurance premia. This is offset by the expected value of damages recoverable under negligence awards. The fact that these terms were adopted in the articles of a majority of corporations in the past suggests (although it does not prove) that the differential should on average be positive. Nonetheless, a large and diffuse group such as shareholders will be ineffective in lobbying for changes.

These considerations suggest that the prescriptions that follow must be read subject to the proviso that they may not be political-support-maximising regulations. The interests of lawyers, politicians, and regulators will be opposed; the strongest advocates — the directors of risky and entrepreneurial firms and shareholders — may often be ineffective interest groups in the political process.

Prescriptive Analysis

What Should the Default Rule Be?

My analysis has concentrated on provisions for contracting out of the default legal rule regarding director negligence. However, the form of the default itself matters, because contracts entered in equilibrium often depend on the default, except under zero transaction cost assumptions.¹³⁸ First, it is inappropriate to follow the minority approach of the American states and write director negligence substantially out of existence. My analysis indicated that some firms did not contract out of it. Arguably, some firms may wish not to do so as a means of signalling the quality of their corporate governance and their lower risk. They could conceivably contract *into* higher standards, if the default is diluted, but the costs and uncertainties of doing so would be high, *vis-à-vis* the low cost adoption of an established term opting out of the default by those wishing to do so.¹³⁹ In other words, the high transaction costs of a minority who would be forced to opt into a complex legal provision are likely to outweigh the lower transaction costs of a majority adopting a simple precedent.¹⁴⁰ This is one example where 'majoritarian' defaults are inferior.

Thus, the default should stay as it is now. Likewise, the economic argument for a subjectively defined standard of care — a fixture of post-*City Equitable* jurisprudence — is much weaker if liability limitations are permitted.¹⁴¹ Subjectivity resembles contractual 'tailoring' to reflect the sort of rule an individual director might agree to.¹⁴² It represents the only means open to courts of simulating an efficient exchange if contracts are not permitted. However, tailoring probably decreases the incentives for firms (or directors) to signal their superiority by remaining with a more onerous default.

¹³⁸ See Ayres & Gertner, above n 28.

¹³⁹ Ian Ayres, 'Making a Difference: The Contractual Contributions of Easterbrook and Fischel' (1992) 59 *University of Chicago Law Review* 1391.

¹⁴⁰ See Ayres & Gertner, above n 28, 113–6.

¹⁴¹ Whincop, above n 85, 228–9.

¹⁴² See generally Ian Ayres, 'Preliminary Thoughts on Optimal Tailoring of Contractual Rules' (1993) 3 *Southern California Interdisciplinary Law Journal* 1.

What Limitations Should Be Permitted?

Recent research in law and economics argues that the contractual equilibria that obtain in corporations may be path dependent.¹⁴³ That is, they are shaped and constrained by earlier developments, even though some of these developments may quickly become irrelevant. For example, a particular term might have theoretical appeal because it does a better job at constraining moral hazard problems, but the prevalence of other terms chosen in the existing equilibrium may effectively lock-out innovations and customisation. Why would this be so?

Marcel Kahan and Michael Klausner use two related concepts, learning and network externalities, to explain why returns to users of standardised terms increase with selection of these terms in other contracts.¹⁴⁴ Learning externalities arise from the use of a term commonly used in past contracts. Relying on a term used substantially in the past rather than developing a customised term has several advantages. The term is almost costless to draft, its operation and validity are more certain, and it is better known to professionals who deal with the firm and analyse its securities. These benefits are conferred by early adopters of the term on subsequent adopters.¹⁴⁵

Network externalities inhere in the use of a term that is simultaneously used in other contracts.¹⁴⁶ By analogy to products such as operating systems or e-mail, the value of a contract term may depend on the number of people expected to use it in the future. For example, adopting a term in common use may reduce the cost of professional advice, based on the higher degree of familiarity professionals have with the term, and increases the likelihood of capturing benefits from future judicial interpretation.¹⁴⁷ If learning or network externalities apply to contract terms, contracts may display substantial standardisation and future innovation in contract terms may be constrained. If a term becomes standardised, there is nothing to say that the term is in any respect optimal. The standardisation that occurs may be excessive — but also possibly insufficient.¹⁴⁸

¹⁴³ On path dependency, see Mark J Roe, 'Chaos and Evolution in Law and Economics' (1996) 109 *Harvard Law Review* 641.

¹⁴⁴ Michael Klausner, 'Corporations, Corporate Law and Networks of Contracts' (1995) 81 *Virginia Law Review* 757 [hereinafter, *Networks*]; Marcel Kahan & Michael Klausner, 'Standardization and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")' (1997) 83 *Virginia Law Review* 713 [hereinafter, *Standardization*]; Marcel Kahan & Michael Klausner, 'Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases' (1996) 74 *Washington University Law Quarterly* 347 [hereinafter, *Path Dependence*]. Critiques of Kahan and Klausner's work are assayed in Russell B Korobkin, 'Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms' (1998) 51 *Vanderbilt Law Review* 1583, 1593–9; Mark A Lemley and David McGowan, 'Legal Implications of Network Economic Effects' (1998) 86 *California Law Review* 479, 488–99.

Kahan & Klausner, *Standardization*, above n 144, 719–25.

¹⁴⁶ On network economics, see generally Joseph Farrell & Garth Saloner, 'Standardization, Compatibility and Innovation' (1985) 16 *Rand Journal of Economics* 70; Michael L Katz & Carl Shapiro, 'Network Externalities, Competition, and Compatibility' (1985) 75 *American Economic Review* 424.

¹⁴⁷ Klausner, *Networks*, above n 144, 774–89.

¹⁴⁸ Kahan & Klausner, *Standardization*, above n 144, 760–1.

The analysis in Part II indicates that there is a high degree of standardisation in the adoption of contractual releases. Learning and network externalities might be expected in the context of liability releases. There will always be uncertainty in the form of conduct that will invoke expressed qualifications; since the rule may function in the manner of a discretionary standard.¹⁴⁹ Precedents will help to clarify the scope of the term — a fact possibly reflected in the intense concentration of the *Brazilian Rubber* term's adoption after that case was decided¹⁵⁰ — and may become *focal points* for contracting.

The potential for suboptimal equilibria suggests that much depends on how the entitlement to opt into a liability release is formulated.¹⁵¹ This raises two issues incidental to determining the optimal formulation of the legal rule. First, should any mandatory rules be used to constrain the scope of liability releases that may lawfully be adopted? Second, can lawmakers encourage the development of optimal focal points for standardisation?

One's views on mandatory rules inevitably turn on perceptions of market efficiency or shareholder rationality.¹⁵² Rational shareholders and efficient markets do not need the protection of, say, mandatory constraints on liability releases. Mandatory rules would, at best, be market mimicking.¹⁵³ However, if we are unsure of market efficiency or shareholder rationality, this conclusion could usefully be turned around, to advocate mandatory rules that prohibit terms that rational shareholders would not adopt. These would correspond to categories where moral hazard problems are likely to be greatest.

To turn to the second issue, there may be various ways of encouraging the formation of optimal focal points which encourage the emergence of efficient terms and an appropriate level of both standardisation and diversity. One is simply for lawmakers and appropriate industry bodies to work together to develop a series of boilerplate provisions thought to be conducive to the formation of contract networks whose positive externalities are welfare maximising.

Michael Klausner has persuasively argued against drafting corporate statutes that take the form of a stated rule subject to an 'unless provided otherwise' qualification.¹⁵⁴ These may lead to excessive lock-in of the default, or to suboptimal networks. Instead, corporate laws could take menu format, by specifying alternative provisions that firms can opt into.¹⁵⁵ I wish to harness

¹⁴⁹ Klausner, *Networks*, above n 144, 775–6.

¹⁵⁰ See above text accompanying n 118–9.

¹⁵¹ Klausner, *Networks*, above n 144, 764–5, 837–41 (arguing that the presence of network externalities, law may serve a beneficial coordinating role analogous to technical standards).

¹⁵² Corporate lawyer-economists have lavished much energy on the denunciation of mandatory rules: see, eg, Easterbrook and Fischel, above n 98; Henry N Butler and Larry E Ribstein, 'Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians' (1990) 65 *Washington Law Review* 1. Cf Gordon, above n 100 (arguing that mandatory rules may be efficiency enhancing and may serve distributive purposes) and Bernard S Black, 'Is Corporate Law Trivial?: A Political and Economic Analysis' (1990) 84 *Northwestern University Law Review* 542 (arguing that mandatory rules are trivial in the US legal system).

¹⁵³ That is, they would prohibit terms no one would agree to: Black above n153, 552–3.

¹⁵⁴ Klausner, *Networks*, above n 144, 829–34.

¹⁵⁵ *Ibid* 837–41.

this idea in a slightly modified way, by using a notional 'tick-a-box' approach to enabling provisions. This provision would enumerate a series of specific types of liabilities that firms could opt out of, followed by relevant mandatory rules to specify market-mimicking limits on liability releases.

Before specifying my thoughts on what that provision looks like, I want to address one further idea. My theoretical analysis is consistent with a notion that the governance properties of legal rules are substitutable at the margin for alternative mechanisms — administrative forms of monitoring, property rights, and so on. There is a sound argument that at least those firms opting out of certain forms of liability should be obliged to specify clearly the other components of governance on which shareholders are supposed to be able to rely. If that is the case, the specified governance 'plan' can be used as a self-regulatory document, when directors are sued for negligence.¹⁵⁶ For example, a firm might make much of its use of a number of sophisticated non-executive directors with expertise in the monitoring and management of firms of its type. If it turns out that those directors are not given, and do not seek information to enable them to monitor, the case for invoking a duty of care penalising failures by directors to be informed is much stronger than it would otherwise be. Thus, firms opting out of forms of personal liability should be obliged to report on the governance measures they have taken and plan to take in the future. Substantially misleading information in this report or protracted failures to adopt these measures would form potential bases for suspending the entitlement to release. This is not the same as saying noncompliance is the basis of a cause of action. This measure is consistent with the ASX's current philosophy on governance disclosure,¹⁵⁷ and it permits firms to have an important part in defining the liability rule standards applied to them.

My proposed draft enabling provision is set out below:

- (1) The constitution of the corporation may include a provision which eliminates or reduces the liability of a director or directors to damages to the corporation or its shareholders in relation to such of the following matters as may be specified in the constitution:
 - (a) Loss or damage resulting from the acts, omissions or defaults of employees, agents, contractors or other persons with whom the firm has business dealings.
 - (b) Loss or damage resulting from the acts, omissions or defaults of other directors of the corporation.
 - (c) Loss or damage resulting from want of care, skill, judgment, attention, or information by the director, or by the board in matters involving collective decisions.

¹⁵⁶ See generally Alan Dignam, 'A Principled Approach to Self-regulation? The Report of the Hampel Committee on Corporate Governance' (1998) 19 *Company Lawyer* 140; Neil Gunningham and Joseph Rees, 'Industry Self-regulation: an Institutional Perspective' (1997) 19 *Law and Policy* 363; Alice Belcher, 'The Invention, Innovation and Diffusion of Self-regulation in Corporate Governance' (1996) 47 *Northern Ireland Legal Quarterly* 322; John Holland, 'Self Regulation and the Financial Aspects of Corporate Governance' [1996] *Journal of Business Law* 127.

¹⁵⁷ See above text accompanying n 50.

- (d) Loss or damage resulting from deficiencies in the firm's governance or internal controls.
- (2) Where the provision releases a director from liability of the sort mentioned in (3) or (4), the constitution must also include a provision which obliges the directors to supply to each shareholder, at the same time as annual financial statements are provided, a report on the measures it adopted in the financial year for which financial statements are supplied, and the measures it expects to adopt in the following year, which are directed to:
- (a) the frequency of board meetings, and director attendance;
 - (b) the form and nature of information supplied to directors, and the frequency with which it is supplied;
 - (c) the nature of any delegations, whether to an employee, another director, or any other person, of directors' personal responsibilities, including obligations of monitoring;
 - (d) the employees and officers who attend board meetings;
 - (e) the principal sub-committees of the board, their membership, and the frequency with which they meet;
 - (f) board resolutions that address the governance of the corporation or substantial parts of its business;
 - (g) the procedures adopted by the board for addressing contracts, transactions, and matters in which directors are interested;
 - (h) the extent and material terms of directors' and officers' insurance coverage, and significant dealings with insurers during the period under consideration;
 - (i) the nature, significant terms and extent of any auditing of governance procedures;
 - (j) other principal mechanisms of governance protecting shareholders' interests, and arrangements for the board's monitoring of these mechanisms; and
 - (k) any other matters specified by the article.
- (3) The release will not operate to exclude a director's liability in any of the following circumstances:
- (a) Where the liability arises in circumstances where the director has acted disloyally, dishonestly, or in bad faith.
 - (b) Where the liability arises from illegal conduct.
 - (c) Where the liability arises in circumstances where the director has a material personal interest that may substantially conflict with the interests of shareholders which has not been disclosed to the board, and submitted to the disclosure and approval processes required by the *Corporations Law*, the common law, and the articles.
 - (d) Where —
 - (i) the liability arises in circumstances where another director has a material personal interest that may substantially conflict with the interests of shareholders which has not been submitted to the disclosure and approval processes required by the *Corporations Law* and the articles; and

- (ii) the director who seeks the release knew or was in possession of information concerning the existence of that interest, and has failed to take reasonable steps consistent with the interests of shareholders to address that interest.
- (e) Where a report was supplied to shareholders in pursuance of (2), and that report will lead to material misapprehension of governance in the corporation, or there is an unreasonable failure to adopt the measures specified in that report.

Sub-section (1) is the liability releases menu. It enables firms to choose which of these releases they want. By defining menu choices in this specific way, the reliance on markets to develop optimal terms is diminished, as the phrasing could often be substantially borrowed from the statute itself.

Sub-sections (1) and (2) interact by requiring that if the liability release opts out of liability for negligence or insufficiency of governance, the firm has a specific obligation to report on governance processes within the firm. This serves two purposes — one is to provide increased information about the quality of the governance of the firm; the other is to operate in the self-regulatory manner described above. The former purpose may assist the pricing of securities in secondary markets, and may assist institutional investors and other shareholders in lobbying management for changes to governance. The latter purpose comes into play when a plaintiff asserts that a director is not entitled to rely on the release, as provided in sub-section (3)(e). It may also be generally relevant when there are allegations of other breaches of duty to which the liability release is not applicable, as the regularity of the director's conduct can be compared with these benchmarks.¹⁵⁸ The matters enumerated in sub-section (2) are doubtless susceptible to refinement or improvement, but are a useful first approximation of the matters relevant to shareholders. Sub-section (2) also enables the article to add issues in respect of which the firm chooses to report, so bonding itself to report on its governance processes.

By embedding in the constitution the obligation to provide the governance report, shareholders have power to enforce the obligation to provide the report. The article functions as a contract, which is capable of being enforced specifically by injunction, at the suit of any shareholder, although not by an order for damages.¹⁵⁹

Sub-section (3) is broadly similar to the provisos to s 102(b)(7). It adds a provision to serve the self-regulatory purpose described. Of particular note are paragraphs (c) and (d). Rather than speak in general terms of 'improper' personal benefits, the article attempts greater specificity. First, it specifically implicates the procedures for addressing transactions involving conflicts of interest. If these have been followed, moral hazard problems are likely to have been substantially addressed. Second, it takes a broader definition of tainted interest cases by providing for a mutual monitoring obligation when directors

¹⁵⁸ This could be in the context of an application for a banning order or an injunction.

¹⁵⁹ *Bailey v NSW Medical Defence Union Ltd* (1995) 18 ACSR 521, 546.

are aware that their colleagues have interests. I noted above that negligence often intensifies in tainted interest cases, and directors are often expected to function at a higher level even when they are not technically interested in a personal sense.¹⁶⁰ Sub-section (4)(d) requires these directors to take reasonable steps when they know, or possess information indicating, that another director has an interest which has not been submitted to the formal procedures for transactions involving conflicts of interest. There is some elasticity and uncertainty in the nature of 'reasonable' steps, but it is appropriate that the requirement depend on the transaction in question and the firm's governance processes. Paragraphs (c) and (d) have also been drafted to oblige any director to disclose his interest, not just as a matter of form, but to decrease the opportunity for *other* directors to avoid the operation of the qualifications by denying knowledge. This intensifies the mutual monitoring obligation and increases the likelihood that transactions will be submitted to formal procedures.

How Should Limitations Become Effective?

Like the Delaware model, firms could adopt a liability release from the outset, or seek to include the provision by amendment. I have referred to some of the difficulties that might arise in this context, if the market does not price governance terms or shareholders' choice on amendment proposals is impoverished.¹⁶¹ Two amendments of the *Corporations Law* may assist in this regard. First, a firm that includes a liability release from the outset must do two things — first, note the liability release in the profile statement for the prospectus;¹⁶² and second, the prospectus must provide a report on the governance processes of the firm that addresses, at the least, all of the matters referred to in sub-section (2). Both procedures should increase the information available to the primary market in general and to individual shareholders.

Firms could include a liability releases by amending the constitution by way of a special resolution of the general meeting.¹⁶³ It is appropriate to preclude directors from voting their own shares in relation to that resolution, to ensure the resolution is adopted by disinterested shareholders.¹⁶⁴ One possible problem is that primary markets may function efficiently, but shareholders do not make informed choices in relation to constitutional amendment proposals because of high information costs and collective action problems. A special resolution, however, requires a supermajority of 75%. If directors cannot vote their shares, the likelihood of a suboptimal change is quite low.

The limitation would only relate to conduct occurring after the provision becomes effective. To obtain release of liability for earlier conduct, directors would have to seek ratification from shareholders after full disclosure.¹⁶⁵ The *Corporations Law* should preclude the use of a joint resolution for the constitutional amendment and ratification.

¹⁶⁰ See above text accompanying n 27–30.

¹⁶¹ See above text accompanying n 97–101.

¹⁶² A profile statement is required to be included in the prospectus under the amendments contained in the *Corporate Law Economic Reform Act 1999* (Cth) s 714.

¹⁶³ *Corporations Law* ss 136, 137.

¹⁶⁴ Similar provisions are made under the related parties provisions (s 243ZF).

¹⁶⁵ *Miller v Miller* (1995) 16 ACSR 73.

Application to Takeovers

I see no particular difficulties in applying these provisions to most negligence cases decided under Australian law. However, there is one area in which the provisions throw up difficulties. That is in relation to takeover law. Directors may be sued for negligence if shareholders are capable of proving loss in relation to actions taken by directors. *Smith v Van Gorkom*¹⁶⁶ involved the decision of the board to approve a merger offer. Suits are also conceivable in relation to defensive tactics, attempts to auction the firm or solicit other bids, disclosures made during the takeover's pendency, and so on.

Much depends on how one characterises these cases. One could evaluate them as cases asserting judgment or information deficiencies, and thus an unsuitable subject for judicial review. On the other hand, directors have a self-evident interest in the result of the takeover. Thus, these cases implicate serious tainted interests, in which judicial review is, as we have seen, a corrective to moral hazard problems.

Most of the economic literature condemns defensive tactics designed to entrench management and to make hostile takeovers difficult.¹⁶⁷ On the other hand, the cases for and against other forms of behaviour, such as requirements for equal treatment and the facilitation of control auctions, is evenly divided.¹⁶⁸ Thus, benchmarks for shareholders' best interests are not always clear, except for self-entrenchment.

The tentative position I wish to assert here is that although negligence and liability limitations are by no means irrelevant to takeovers and may occupy a useful residual function, more detailed rules regarding the obligations of management and other parties involved in the takeover are likely to be a superior regulatory device.¹⁶⁹ The stakes and importance of takeovers are sufficiently high to warrant the use of more precisely specified obligations, such as the matters that must be disclosed and requirements for expert opinion as to valuations. Lawyer-economists have noted that some aspects of Delaware law make excessive use of fuzzy tests, and that these redistribute rents from shareholders to managers of potential target companies and to lawyers.¹⁷⁰ Greater clarity may encourage bidders with some degree of risk aversion to make

¹⁶⁶ 488 A 2d 858 (Del. 1985).

¹⁶⁷ See generally Frank H Easterbrook and Daniel R Fischel, 'The Proper Role of a Target's Management in Responding to a Tender Offer' (1981) 94 *Harvard Law Review* 1161.

¹⁶⁸ See, eg, Lucian A Bebchuk, 'Toward Undistorted Choice and Equal Treatment in Corporate Takeovers' (1985) 98 *Harvard Law Review* 1695 (favouring equal opportunity); Lucian A Bebchuk, 'The Sole Owner Standard for Takeover Policy' (1988) 17 *Journal of Legal Studies* 197 (favouring equal opportunity); Ronald J Gilson, 'Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense' (1982) 35 *Stanford Law Review* 51 (favouring auctions); Frank H Easterbrook and Daniel R Fischel, 'Auctions and Sunk Costs in Tender Offers' (1982) 35 *Stanford Law Review* 1 (opposing auctions); Alan Schwartz, 'The Fairness of Tender Offer Prices in Utilitarian Theory' (1988) 17 *Journal of Legal Studies* 165 (opposing auctions and the single owner standard).

¹⁶⁹ See generally Kaplow, above n 137; Lucian A Bebchuk and Allan Ferrell, 'Federalism and Takeover Law: The Race to Protect Managers from Takeovers' (1999) 99 *Columbia Law Review* forthcoming.

¹⁷⁰ Bebchuk and Ferrell, above n 168.

offers they may not otherwise make. If these obligations are specified as default rules, their clarity may affect the likelihood that firms explicitly contract for the rules against the background of which takeovers are conducted.¹⁷¹ Easterbrook and Fischel have pointed out that firms typically go public with few or no restrictions, but too often seek to hide behind the political process or discretionary standards in the courts to be protected when a takeover arises.¹⁷² Thus, the provision outlined above and any liability release adopted should be rendered subject to more specific rules on takeovers.

CONCLUSION

In Part I of this paper, I reviewed the role for liability rules that predicate on negligence by the director. I noted that the imposition of liability by a court can rarely operate precisely, and cannot easily be insulated against cognitive biases. That likelihood of judicial error may deter risk-taking decisions rather than any relevant form of negligence, and may also engender other forms of socially undesirable behaviour. At least in publicly listed companies, in which agency problems are likely to be most intense, social norms may evolve to discourage shirking and encourage compliance with the procedure and decisions of the board. These factors combine to favour limitations of liability in most negligence cases, except for cases involving tainted interests. In these cases, liability, amongst other forms of legal sanctions, may have a proper function, both to deter self-dealing, disloyalty and overreaching, and to encourage those who know of this behaviour to ensure that due process is followed. I analysed three alternatives which might be applicable to reduce liability. I argued that legal principles were no more likely to reduce moral hazard problems than liability releases were. Comparative statics indicate that, unless the ban on liability releases serves some purpose not connected with efficiency (such as corrective justice), that ban cannot be justified.

Part II analysed empirical evidence of the use of liability releases in Australian companies before they were banned by legislative mandatory rules. Although displaying substantial standardisation, the contracts observed demonstrate prima facie suitability to the needs of governance. Prohibiting these contracts is likely to be welfare-decreasing, although a welfare conclusion really needs stock market evidence to be conclusive.

Part III reviewed a path for legislative reintroduction of liability releases. Liability releases are unlikely to emerge in Australian law. Their principal advocates are likely to be relatively ineffective as political lobby groups, compared to those who would prefer other means for limiting liability. I outlined a possible provision which could be introduced. It lists a series of provisions a release may include. This may better respond to problems of suboptimal standardisation attributable to learning and network externalities. The rules I

¹⁷¹ See generally Michael Klausner and Robert Daines, 'Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs', unpublished paper, 1999.

¹⁷² Easterbrook and Fischel, above n 98, 169–70.

outlined were accompanied by several mandatory rules, directed, first, to standard moral hazard and conflict of interest situations, and second, to requiring reports regarding corporate governance to be provided to shareholders at the time the corporation goes public or seeks to amend its constitution, and on an annual basis thereafter.

This work has foreshadowed a number of original questions for further research. Perhaps the most significant is research into the role for social norms in the operation of the board. Important empirical research regarding the form of these norms, and their role in resolving disputes is long overdue. Interesting theoretical questions remain in extending the recent law and economics research on this subject to the board context. That research indicates that these norms, even if desirable in form, are not necessarily a sound basis for giving content to legal rules. This work may reveal the hopelessness of using legal rules to attempt to influence governance beneficially, except in straightforward endgame situations. The result of this work will be a richer understanding of director behaviour and the stimuli directors respond to. That the law has operated without this understanding in the past is no licence for it to continue to do so.