

Breaching the Accountability Firewall: Market Norms and the Reasonable Director

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I. INTRODUCTION

The Parliamentary Commission on Banking Standards recently described the lack of public or private enforcement action against bank directors in the United Kingdom in the wake of the financial crisis as “an accountability firewall.”¹ Given that the primary fault of bank boards has been excessive risk taking and incompetence,² one might have expected that these directors would have faced actions for failing to discharge their duty of care. The fact that the directors did not face such actions highlights the difficulty of holding directors accountable for negligent conduct.

Not all would agree that this is problematic.³ The debate over the extent to which the directors’ duty of care should be enforced is longstanding, and different jurisdictions adopt widely divergent approaches. In the United States, corporate law rarely holds directors of public com-

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1. PARLIAMENTARY COMMISSION ON BANKING STANDARDS, CHANGING BANKING FOR GOOD, VOL. 1, 2013–14, H.L. 27-I, H.C. 175-I, at 10 (U.K.), *available at* <http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpebs/27/27.pdf>.

2. As pointed out in a number of public reports: TREASURY COMMITTEE, THE RUN ON THE ROCK, VOL. 1, 2006–7, H.C. 56-I, at 19 (U.K.), *available at* <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>; FIN. SERVS. AUTH., THE FAILURE OF THE ROYAL BANK OF SCOTLAND, 2011, at 179 (U.K.) [hereinafter FSA], *available at* <http://www.fsa.gov.uk/pubs/other/rbs.pdf>; PARLIAMENTARY COMMISSION ON BANKING STANDARDS, ‘AN ACCIDENT WAITING TO HAPPEN’: THE FAILURE OF HBOS, VOL. 1, 2012–13, H.L. 144, H.C. 705, at 51–52 (U.K.) [hereinafter HBOS REPORT], *available at* <http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpebs/144/144.pdf>.

3. See FRANK H. EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 93–100 (1996); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1789–98 (2001). For a detailed review of the arguments for and against greater director accountability, see *infra* Part II.

panies accountable because of the business judgment rule and statutes permit corporations to exempt directors from monetary damages for breaching the duty.⁴ In Australia, in contrast, there have been a number of very high profile decisions in which the director's statutory duty of care⁵ has been enforced through action taken by the Australian Securities and Investment Commission.⁶ Australia also has a common law and equitable duty of care, which is enforced privately.⁷ The United Kingdom, meanwhile, lies somewhere between the two. Under section 174 of the Companies Act of 2006, directors must exercise the care, skill, and diligence of a reasonably diligent person in the director's position.⁸ There is no business judgment rule, and the duty is subject to private enforcement only. Directors of financial institutions also have a regulatory duty to exercise "due skill, care and diligence in managing the business of the firm for which [they are] responsible," which was originally enforceable by the Financial Services Authority (FSA) and now by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).⁹

While Professor Coffee has suggested that enforcement intensity may matter more in promoting the impact of a law than its substantive content,¹⁰ the substantive content and how it is interpreted can affect the viability of enforcement. The financial crisis highlights the issue of whether directors' conduct should be measured against a standard of care

4. Notably under DEL. CODE ANN. tit 8, § 102(b)(7) (West 2011).

5. Actions have been taken under *Corporations Act 2001* (Cth) s 180(1) (Austl.).

6. See ROBERT P. AUSTIN & IAN M. RAMSAY, *FORD'S PRINCIPLES OF CORPORATIONS LAW* ¶¶ 8.305, 8.310 (15th ed. 2012). Australia also has a statutory business judgment rule under § 180(2) of the *Corporations Act 2001*, but it has only been successfully utilized in one case, *Austl. Sec. & Inv. Comm'n v Rich* (2009) 75 ACSR 1; [2009] N.S.W.S.C. 1229 (Austl.).

7. AUSTIN & RAMSAY, *supra* note 6, at para. 8.320.

8. In the United Kingdom, the duty of care is a common law, not a fiduciary, duty. Christopher M. Bruner, *Is the Corporate Director's Duty of Care a 'Fiduciary' Duty? Does It Matter?*, 48 WAKE FOREST L. REV. 1027, 1034–35 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2358616; see also William M. Heath, *The Director's 'Fiduciary' Duty of Care and Skill: A Misnomer*, 25 COMPANY & SEC. L.J. 370 (2007).

9. FIN. CONDUCT AUTH., *HANDBOOK, STATEMENTS OF PRINCIPLE AND CODE OF PRACTICE FOR APPROVED PERSONS*, APER 2.1A.3, STATEMENT OF PRINCIPLE 6 (2013). Individuals regulated by the FSA as approved persons will now be regulated by the PRA, the FCA, or both depending on what functions they perform and whether their firm is regulated by the FCA or both the PRA and the FCA. Some non-executive directors fall under both regimes, and some, perhaps most, executives will fall under both regimes. Fortunately, the provisions of APER can be treated as identical for all regimes. The government has recently indicated that in relation to deposit taking institutions, it will replace APER with a new "Senior Persons Regime" and Banking Standards Rules. HM TREASURY, *GOVERNMENT'S RESPONSE TO THE PARLIAMENTARY COMMISSION ON BANKING STANDARDS*, 2013, Cm. 8661, at 11–12 (U.K.).

10. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 233 (1997) (considering in particular the impact of enforcement on the development and growth of financial markets).

that is norm-setting or norm-reflecting, and if the latter, which norms these should be. The FSA's decision not to take enforcement action against the directors of the Royal Bank of Scotland (RBS) with respect to the takeover of ABN Amro illustrates this point. The largest takeover in banking history, and a key cause of RBS's collapse, proceeded on the basis of a due diligence exercise comprising of two lever arch files and a CD.¹¹ The FSA's report on the collapse of RBS (the RBS Report) criticized the due diligence exercise as wholly inadequate, but also concluded that there had been no contravention of any regulatory rules or principles partly because the exercise had been in line with market practice.¹² In other words, the directors were exonerated because the FSA judged their conduct by a standard that reflected market norms.

This Article examines and evaluates the role of market norms in determining whether directors have acted reasonably and the appropriateness of setting a standard of reasonableness that reflects market norms. It argues that although there are situations in which a standard that reflects market norms may not be appropriate for determining the reasonableness of a director's conduct, it is the best standard more often than not. While this Article focuses on the U.K. director's duty of care, the question of whether compliance with market norms should be exculpatory arises every time legal or regulatory enforcement depends upon establishing that a market actor has acted unreasonably. For example, the Financial Services and Markets Act of 2000 holds bank directors accountable for contraventions of regulatory requirements in their areas of responsibility unless they can demonstrate that they took all such steps as a person in their position could "reasonably be expected to take" to prevent this.¹³

As the financial crisis and subsequent LIBOR scandal demonstrated, market norms can be irrational, short-termist, inefficient, and even criminogenic. If, as a result, directors should be held to higher standards, it again raises a question of broader significance: namely, how one regulates through broad *ex ante* standards—the precise requirements of which can only be clarified *ex post*—in a manner that is fair to the regulated but allows for the promotion of effective accountability.

11. See FSA, *supra* note 2.

12. *Id.* at 33.

13. Financial Services (Banking Reform) Act, 2013 c. 33, § 32(2) (U.K.) (inserting § 66A(5)–(6) and § 66B(5)–(6) into the Financial Services and Markets Act 2000); see also PARLIAMENTARY COMMISSION ON BANKING STANDARDS, *supra* note 1, at 10; HM TREASURY, *supra* note 9, at 11. The new Act also creates a criminal offense under which bank directors and other senior managers can be found guilty of an offense of causing a financial institution to fail where their conduct falls "far below what could *reasonably be expected* of a person in their position." Financial Services (Banking Reform) Act, § 36(1)(c). None of these sections are yet in force.

Part II of this Article addresses arguments for and against enforcing a requirement that directors act with reasonable care and argues that enforcement is important to promote accountability. Part III reviews the role market norms play in the standard of care set by the courts. Next, given that weakness in private enforcement in the United Kingdom has led to calls for public enforcement of directors' duties,¹⁴ Part IV considers the approach of the U.K. financial service regulators to enforcing a regulatory duty of care. Part V argues that in both private and public enforcement, the standard of care should usually be norm-reflecting but then considers under what circumstances it might be permissible to enforce norms *ex post* that are higher than those employed by the market. Finally, Part VI concludes by highlighting other issues raised by this Article.

This Article uses a modified version of Eisenberg's threefold classification to define what is meant by market norms.¹⁵ The first type comprises behavioral patterns, which entail no sense of obligation and are not self-consciously adhered to.¹⁶ The second, like the first type, entails no sense of obligation but are self-consciously adhered to, such as the practice of beginning and ending classes at a particular time.¹⁷ These practices could be changed without criticism. These two categories indicate types of behavior that are considered permissible, though not required,¹⁸ and together will be referred to as "market practices." The third type consists of "obligational market norms"—non-legal rules or practices that actors both self-consciously adhere to and feel obliged to adhere to unless there are good reasons not to.¹⁹ These may be formal obligational norms such as those contained in codes of practice, industry standards, and instruments such as the U.K. Corporate Governance Code. Although non-legal, these will be referred to as "soft law" norms. There may also be "informal obligational norms" that reflect what market actors feel they ought to do. Finally, the term "market norms" refers to both market practices and obligational norms.

14. John Armour, *Enforcement Strategies*, in RATIONALITY IN COMPANY LAW: ESSAYS IN HONOUR OF DD PRENTICE 85 (John Armour & Jennifer Payne eds., 2009) (U.K.) (describing private enforcement as "close to nil" in public companies); *see also* Andrew R. Keay, Public Enforcement of Directors' Duties 26–28 (Jan. 16, 2013) (unpublished manuscript), *available at* <http://ssrn.com/abstract=2201598>.

15. Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1256–57 (1999).

16. *Id.* at 1256.

17. *Id.*

18. *Id.* at 1262.

19. *Id.* at 1256–57.

II. THE IMPORTANCE OF ENFORCEMENT

There are several arguments against more rigorous enforcement of the director's duty of care. Easterbrook and Fischel argue that private enforcement is unnecessary because the market adequately constrains directors' conduct. Careless directors will see a drop in their corporation's share price and will be dismissed or lose their jobs through a hostile takeover.²⁰ The concept of market discipline, however, has been much criticized in the wake of the financial crisis.²¹ Even in normal times, it is unclear that the market can accurately price for careless behavior.²²

There is also an argument that minimal enforcement is supported by the terms of a "hypothetical bargain" between directors and shareholders.²³ The hypothetical bargain theory asks what parties, as rational bargainers, would have bargained for in a given situation had they turned their minds to the issue or if the costs of bargaining for the term were sufficiently low.²⁴ In bargaining for the content of the duty of care, shareholders, as rational bargainers, would take into account that strong enforcement could lead to over-deterrence and so would agree to a less onerous duty and limited enforcement.²⁵ The hypothetical bargain analysis has been criticised for its indeterminacy²⁶ and for assuming that shareholders would contract for minimal performance with minimal accountability. This is by no means self-evident. The rational bargainer might take into account that reducing directors' incentives to take care could increase the probability that unreasonable risks will be taken, which could turn out to be more costly than imposing such incentives.

It is not possible to judge whether fears that enforcement would over-deter risk taking and discourage people from taking up directorial

20. EASTERBROOK & FISCHEL, *supra* note 3, at 95–96.

21. Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 280–81 (2012).

22. Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 120–21 (2006).

23. John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 951 (1988). Some commentators acknowledge that the duty of care is owed to the company rather than shareholders but nevertheless take account only of the implications of the duty for directors and shareholders. *See, e.g.*, Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1166–67 (2006).

24. EASTERBROOK & FISCHEL, *supra* note 3, at 15.

25. *Id.* at 99–100.

26. Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1426–27 (1985); Coffee, *supra* note 23, at 952.

roles (unless they were inefficiently compensated for the risk²⁷) are well founded.²⁸ There is some evidence of a deterrent effect.²⁹ Thus, empirical research indicated that criminal sanctions might have some chilling effect on directors' decision making, but it did not demonstrate that this constituted *over*-deterrence or that civil enforcement would have similar effects.³⁰ In the United States, insurance premiums rose after the decision in *Smith v. Van Gorkom*, and the protection provided by insurance policies was reduced. As a result, some directors resigned.³¹ In the United Kingdom, there is evidence that insurance for directors of financial institutions is becoming narrower in its coverage whilst premiums are rising. This is not, however, due to the unlikely prospect of the director's duty of care being successfully enforced but is rather a response to liability fears consequent on the LIBOR scandal and securities litigation arising out of alleged non-disclosure in rights issues.³² Moreover, arguments that the duty of care cannot be enforced against directors do not deal with the fact that it *is* enforced in Australia—apparently without ill effects. In any event, although concerns about over-deterrence cannot be dismissed, the abject failure of enforcement of the duty of care suggests that there is some way to go before these fears would be realized. As the U.K. government recently commented, the current regime for enforcing directors' duties in the United Kingdom “had an insufficient deterrent effect on bank directors' behavior, and thereby failed to protect the public from harm.”³³

Those who support director immunity, or limited enforcement of the duty of care, often make the orthodox assumption that the corporation

27. Brian R. Cheffins & Bernard S. Black, *Outside Director Liability Across Countries*, 84 TEX. L. REV. 1385, 1389 (2006); Melvin A. Eisenberg, *The Divergence of Standards of Conduct from Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 445–46 (1993); Christopher A. Riley, *The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard*, 62 MOD. L. REV. 697, 712 (1999).

28. For arguments suggesting that they may be overstated, see Keay, *supra* note 14, at 26–28.

29. Coffee, *supra* note 23, at 927; Keay, *supra* note 14, at 27.

30. Robert Baldwin, *The New Punitive Regulation*, 67 MOD. L. REV. 351, 361–63 (2004).

31. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). See Michael Bradley & Cindy Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 32–35 (1989).

32. Jane Croft, *Insurance: Directors Take Action Against Rising Tide of Litigation*, FIN. TIMES (Apr. 29, 2013), <http://www.ft.com/intl/cms/s/0/b6920752-a678-11e2-bc0b-00144feabdc0.html#axzz2u CZniDfh>; Jennifer Thompson & Caroline Binham, *RBS Faces Second Lawsuit on Rights Issue*, FIN. TIMES (Apr. 3, 2013), <http://www.ft.com/cms/s/0/ed1911bc-9c55-11e2-9a4b-00144feabdc0.html#axzz2u CZniDfh>.

33. HM TREASURY, *supra* note 9, at 25.

functions to promote shareholder interests³⁴ and that only shareholders have an interest in whether directors manage corporations carefully and in whether the duty of care should be enforced. Thus, the hypothetical contract account tends to focus on what risks shareholders would have consented to and ignores other groups because it views the duty of care as a term of the corporate contract between only the shareholders and directors.³⁵

Academics such as David Millon have challenged the assumption that corporations should be run in shareholder interests alone.³⁶ But even if this proposition is accepted, it does not follow that only shareholders have an interest in corporations being run competently. Society may require corporations to be run in shareholder interests because that is the best way to create wealth, for example, and there would be a public interest in enforcing the duty of care insofar as this promoted the goal of competently run companies.³⁷ Treating the enforcement of the director's duty of care as a purely private matter between shareholders and directors is particularly problematic in dispersed share-ownership corporations where the costs of negligent conduct are visited on other stakeholders and society. This points to another reason for enforcement, namely the need for accountability.

Accountability is a notoriously slippery concept but refers here to a process with the following core features: that persons (the directors) are obliged to recount, explain, and justify their conduct to a third party who

34. Riley, *supra* note 27, at 706. Although Riley acknowledges that the position alters when the company becomes insolvent. *Id.* at 721–22.; see also Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law Norms and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1658–59 (2001). Others, though, seek to insulate directors from shareholder pressure so that they can make decisions that support the interests of a wider range of constituents. See KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES* ch. 9 (2006); see also Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 428–29 (2001). Blair and Stout argue that the market and internal motivations to “do the right thing” adequately constrain directors. Blair & Stout, *supra*, at 443.

35. EASTERBROOK & FISCHER, *supra* note 3, at 17, 25, 99–100 (also denying any third-party effects).

36. See, e.g., GREENFIELD, *supra* note 34, at ch. 1, 3; David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993); David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, in *PROGRESSIVE CORPORATE LAW 1* (Lawrence E. Mitchell ed., Westview Press 1995).

37. Ross B. Grantham, *The Doctrinal Basis of the Rights of Company Shareholders*, 57 CAMBRIDGE L.J. 554, 577–78, 584–86 (1998). Making the case that there is a public interest in companies being run competently (though not that this requires that they be run in shareholders' interests), see Keay, *supra* note 14, at 35–37. For a critique of the argument that running companies in shareholders' interests serves the public interest, see GREENFIELD, *supra* note 34, at 22–27.

can ask questions, debate the persons' conduct, and pass judgment.³⁸ Although sanctions are not an essential element of accountability, consequences (or the possibility of consequences) being visited on those held to account are required.³⁹

As Justin O'Brien has pointed out, imposing accountability on corporate actors cuts against the facilitative underpinnings of corporate law,⁴⁰ although in the United Kingdom, unlike in the United States, the director's duty of care is a mandatory provision that cannot be contracted out of.⁴¹ Accountability, however, is necessary for two separate though often overlapping reasons. The first is agency.⁴² As directors have been delegated the power to manage the corporations' affairs, they are liable to account to their principals for the manner in which that power is exercised. This would justify private enforcement and accountability to the corporation, and through it to the shareholders, and fits well both with the economic theory that views directors as (non-legal) agents for shareholders⁴³ and with directors' legal position as agents for the corporation.

A second important reason for accountability arises when an actor's conduct has harmed the rights or interests of others.⁴⁴ The more important those interests are—and the more serious the harm—the more pressing the demand for accountability. Directors in dispersed share-ownership corporations make decisions that can harm the interests of a wide range of persons both within and outside the corporation. Holding them to account in such circumstances is important because it gives those

38. Mark Bovens, Thomas Schillemans & Paul 't Hart, *Does Public Accountability Work? An Assessment Tool*, 86 PUB. ADMIN. 225, 225 (2008); Richard Mulgan, "Accountability": *An Ever Expanding Concept?*, 78 PUB. ADMIN. 555, 555 (2000).

39. Carol Harlow & Richard Rawlings, *Promoting Accountability in Multilevel Governance: A Network Approach*, 13 EUR. L.J. 542, 545 (2007).

40. Justin O'Brien, *Snaring Leopards: Tracking the Efficacy of Financial Regulatory Reform in the Aftermath of the Crisis*, 12 OR. REV. INT'L L. 213, 222 (2010); see also Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1989) (in relation to the business judgment rule).

41. Companies Act, 2006, c. 46, § 232 (U.K.).

42. Colin Scott, *Accountability in the Regulatory State*, 27 J.L. & SOC'Y 38, 39 (2000); Amir N. Licht, *Accountability and Corporate Governance* 20 (Sept. 2002) (unpublished manuscript), available at <http://ssrn.com/abstract=328401>.

43. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

44. RICHARD MULGAN, *HOLDING POWER TO ACCOUNT: ACCOUNTABILITY IN MODERN DEMOCRACIES* 12–14 (2003); see also Deirdre Curtin & Linda Senden, *Public Accountability of Transnational Private Regulation: Chimera or Reality?*, 38 J.L. & SOC'Y 163, 169 (2011) (arguing that accountability to wider group is necessary when actors have a "considerable impact" on others and are "choice-determining" for them).

others a voice and demonstrates that their interests count.⁴⁵ The process of being held accountable forces directors to acknowledge the harm that they have caused and accept its impact on others and, in doing so, shows respect for those others as persons and treats them as ends in themselves rather than as means to an end.⁴⁶ The mechanism of accountability through enforcement provides a state-sanctioned channel for the expression of legitimate anger and indignation of those who have been harmed, whilst its absence allows anger to fester and entrenches feelings of injustice and unequal treatment, created by the perception that, in this context, directors are beyond the reach of the law.⁴⁷ Thus, the absence of proceedings to hold directors accountable following the financial crisis breached societal expectations and undermined the legitimacy of, and trust in, the law and regulatory framework.⁴⁸ Private enforcement by shareholders would not necessarily achieve these accountability goals as far as persons other than the shareholders were concerned, which points towards the need for enforcement by a regulator. Moreover, enforcement is more, rather than less, necessary to promote accountability to non-shareholders because, unlike shareholders, they have no means of holding directors directly accountable.

The drive for accountability, however, should not lead to directors being made scapegoats; this would be unjust and could itself undermine the law's legitimacy. Rather, they must be held to an appropriate standard of care, and in determining that standard, it will be argued that market norms must play a part.

III. THE STANDARD OF CARE AND MARKET NORMS

This Part considers what account courts and regulators have taken of market norms in assessing the reasonableness of directors' conduct. The lack of case law on the directors' duty of care means that to obtain an informed overview of the courts' approach, it is necessary to consider case law under other provisions that involve assessments of reasonableness or competence.⁴⁹ The absence of private enforcement renders public

45. Licht, *supra* note 42, at 29–30; Glen Staszewski, *Reason—Giving and Accountability*, 93 MINN. L. REV. 1253, 1286–87 (2009).

46. Jason M. Solomon, *Equal Accountability Through Tort Law*, 103 NW. U. L. REV. 1765, 1793, 1806 (2009).

47. *Id.* at 1785–91, 1808–09.

48. See, for example, criticism in PARLIAMENTARY COMMISSION ON BANKING STANDARDS, CHANGING BANKING FOR GOOD, VOL. II, 2013–14, H.L. 27-II, H.C. 175-II, at 142–48 (U.K.), available at <http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpebs/27/27ii.pdf>.

49. Examples of provisions that involve assessments of reasonableness or competence include the Insolvency Act, 1986, c. 45, § 214 (U.K.), which provides that directors can be ordered to con-

enforcement of the regulatory duty of care more important as an accountability mechanism; thus, the financial services regulators' approach is also considered.

A. The Courts

Courts take little account of market norms, and this may be contributing to under-enforcement of the duty of care. Historically, the standard of care at common law incorporated the low social and market expectations of directors of the time.⁵⁰ Thus, the seminal case of *In Re City Equitable Fire Insurance Co. Ltd.* held that directors would only breach their duty if they failed to exercise the care and skill that they in fact possessed.⁵¹ By 1969, the standards adhered to by the courts were described as "legacies of outmoded economic and social philosophies from another age."⁵² Yet little changed. An Edinburgh solicitor in 1982 observed that although the law only required directors to attend board meetings intermittently whenever they reasonably could, commercial expectations of directors in public corporations were much higher.⁵³

The early-1990s saw the introduction of a more stringent standard, partly as a result of legislative developments and partly as a judicial reaction to a change in public attitudes towards corporate governance in the wake of a spate of corporate scandals in the early part of the decade.⁵⁴ Looking to the standard set by § 214(4) of the Insolvency Act of 1986, the courts held that directors had to show the skill and care of

a reasonably diligent person having both (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has.⁵⁵

tribute to an insolvent company's assets if they knew or ought to have concluded that there was no reasonable prospect that it would avoid going into insolvent liquidation, and the Company Directors Disqualification Act, 1986, c. 46, § 6 (U.K.), which provides that courts must disqualify directors of insolvent companies if satisfied that their conduct as directors of those companies makes them unfit to be concerned in the management of a company.

50. See, for example, the account taken of commercial practice in *In Re Forest of Dean Coal Mining Co.* (1878) 10 Ch.D. 450, 452 (U.K.). For further discussion, see Heath, *supra* note 8, at 391.

51. *In Re City Equitable Fire Insurance Co. Ltd.*, [1925] 1 Ch. 407 (U.K.).

52. M. J. Trebilcock, *The Liability of Company Directors for Negligence*, 32 MOD. L. REV. 499, 509 (1969).

53. Allan MacKenzie, *A Company Director's Obligations of Care and Skill*, J. BUS. L. 460, 462 (1982).

54. See *Bishopsgate Inv. Mgmt. Ltd. v. Maxwell* (No. 2), [1993] B.C.L.C. 1282, 1285 (U.K.).

55. *Norman v. Theodore Goddard*, [1992] B.C.L.C. 14 (U.K.); *In Re D'Jan of London Ltd.*, [1993] B.C.L.C. 646 (U.K.).

This imposed a mixed objective and subjective standard, with the former establishing a minimum standard expected of all directors and the latter raising the standard where the director possessed a special skill. The present § 174 of the Companies Act of 2006 codifies this standard.

While the standard of care has been settled in broad terms, the question of how the courts judge whether a director has displayed the skill and care of “a reasonably diligent person,” and whether this is a norm-setting or norm-reflecting exercise, is unresolved. In addressing it, regard could be had to the approach taken in tort law. There is considerable debate amongst academics over what constitutes the goals of both tort and corporate law,⁵⁶ and the extent to which their goals overlap is contentious.⁵⁷ Nevertheless in tort law, at least when the parties are participants in a market, the standard of care required of market participants should usually reflect what they would have contracted for had they turned their minds to the matter. Arguably, a standard set by reference to market norms reflects the parties’ expectations and embodies the hypothetical term.⁵⁸ Given that contractarians argue that corporate law provides parties with a set of default standard terms that they would have chosen for themselves,⁵⁹ the approach taken in these tort cases may therefore be pertinent when determining how to establish the standard of conduct that should be expected of a reasonable director.⁶⁰ Again, insofar as corporate law is concerned with setting mandatory standards of conduct,⁶¹ this leaves open the question as to how such standards should be set. The tort law approach of setting an objective standard of reasonableness by reference to market norms is potentially instructive.

Yet while the courts in tort cases generally adopt a norm-reflecting approach and admit evidence regarding recognized and established prac-

56. For an overview of the debate in corporate law, see, for example, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989). For a good review of many of the theories of tort law, see Gary T. Schwartz, *Mixed Theories of Tort Law: Affirming Both Deterrence and Corrective Justice*, 75 TEX. L. REV. 1801, 1802–11 (1997). On the important theory of civil recourse in tort law, see John C.P. Goldberg & Benjamin C. Zipursky, *Civil Recourse Defended: A Reply to Posner, Chamallas, and Robinette*, 88 IND. L.J. 569 (2013) and the references cited therein.

57. Kenneth B. Davis Jr., *Once More, The Business Judgment Rule*, 2000 WIS. L. REV. 573, 575–76; Rhee, *supra* note 23, at 1156–57.

58. *Rodi Yachts, Inc. v. Nat’l Marine, Inc.*, 984 F.2d 880 (7th Cir. 1993).

59. EASTERBROOK & FISCHER, *supra* note 3, at 15.

60. Rhee, *supra* note 23, at 1165, 1170.

61. Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1473–74 (1989).

tices within a particular industry when assessing reasonableness,⁶² this is not done in corporate law. Thus, in *Secretary of State v. Baker*, the defendant director argued that expert evidence would assist the court in determining what the notional “reasonably skilled and diligent person” might have done in his situation and that without it, the court lacked the requisite experience or skill to identify the standard against which to measure his behavior.⁶³ Holding that the expert evidence was irrelevant and inadmissible, the court dismissed the assertion that this left it “in the position of attempting to reach a decision on the appropriate and reasonable practice of a manager of a derivatives business within a complex global investment bank without any relevant evidence from a member of that profession.”⁶⁴ On appeal, the court held that “[t]he standard of competence to be shown by a person as a director is . . . [a question] of law. Whether the respondent failed to achieve that standard is a question for the court on which only [in exceptional circumstances] could the evidence of an expert be admissible.”⁶⁵

Secretary of State v. Baker was a disqualification case, and the court drew a distinction between disqualification and professional negligence claims,⁶⁶ which left open the possibility that expert evidence about market practices might be admitted in duty of care cases. This generally has not occurred, although there have been some exceptions. In a recent case, a first instance court did show regard to independent expert evidence on the question of whether there was a relevant market practice indicating how a director should handle a particular commercial situation—there was not. The court also took into account the expert evidence in order to find that the director was not in breach of his duty of care.⁶⁷

62. *Stokes v. Guest, Keen and Nettlefold (Bolts and Nuts) Ltd.*, [1968] 1 W.L.R. 1776, 1783 (Swanwick, J.) (U.K.); *Midland Bank Trust Co. Ltd. v. Hett Stubbs & Kemp*, [1979] 1 Ch. 384, 405 (Oliver, J.) (U.K.); *Baker v. Quantum Clothing Grp. Ltd.*, [2011] UKSC 17; [2011] 1 W.L.R. 1003, [10] (U.K.). The standard of care in tort is not conclusively established by industry practices: it is no defense to a charge of negligence that others are just as negligent. *Thompson v. Smiths Shiprepairers (North Shields) Ltd.*, [1984] Q.B. 405, 416 (U.K.).

63. *Secretary of State v. Baker*, [1999] 1 B.C.L.C. 433, 492 (U.K.).

64. *Id.* at 495.

65. *Secretary of State v. Baker*, [2000] 1 B.C.L.C. 523, [39] (U.K.).

66. *Baker*, [1999] 1 B.C.L.C. at 495; *Baker*, [2000] 1 B.C.L.C. at [39] (U.K.).

67. *ARB International Ltd. v. Baillie*, [2013] EWHC (Comm) 2060, [7]–[8], [32], [57]–[58] (U.K.); see also *Abbey Forwarding Ltd. (In Liquidation) v. Hone*, [2010] EWHC (Ch) 2029, [198], [205] (U.K.) (stating that as no expert evidence regarding commercial practice was adduced, the case was not proven and the directors were exonerated); *Barings PLC (In Liquidation) v. Coopers & Lybrand (A Firm)*, [2002] P.N.L.R. 22, [51]–[52] (U.K.) (expert evidence on the management of investment banks engaging in futures and derivatives trading admitted to assess director’s negligence and bank’s contributory negligence). The *Barings* decision was part of the same group of litigation as *Secretary of State v. Baker*. See *Baker*, [1999] 1 B.C.L.C. at 433.

Meanwhile although some have argued that the courts can take account of soft law norms,⁶⁸ there is little evidence that they do so.⁶⁹ Rather, judges place themselves in the directors' shoes and reach their conclusions about reasonableness using judicial intuition⁷⁰ based on "largely tacit assessments of what is fair and socially valuable."⁷¹ Whether this is in fact a socially valuable approach will be considered shortly.

It is unclear whether this process results in a standard of care that fortuitously reflects market standards or if it varies and how. It seems possible that the courts seek to compensate for their lack of expertise in business matters, for the difficulties of assessing complex business decisions,⁷² and for the risk of hindsight bias, by giving directors the benefit of the doubt, resulting in the enforcement of a lower standard of care and the exoneration of careless directors.⁷³ There is evidence, for example, that the courts are applying a test of irrationality rather than reasonableness in assessing directors' conduct.⁷⁴ The fact that the courts take little account of market norms may therefore be contributing to under-enforcement of the duty of care.

68. PAUL L. DAVIES, *PRINCIPLES OF MODERN COMPANY LAW* 492–93 (8th ed. 2008).

69. On the contrary, in unfair prejudice claims under the Companies Act, 2006, c. 46, § 994 (U.K.), the courts have refused to allow shareholders to rely on breaches of soft law norms to establish unfair prejudice. In *Re Astec (BSR) PLC*, [1999] B.C.C. 59 (U.K.). In *ARB Int'l Ltd. v. Baillie*, [2013] EWHC (Comm) 2060, [9]–[10] (U.K.), the judge refused to apply soft law norms—the London & International Insurance Brokers' Association Best Practice Market Guidelines—to judge a director negligent on the basis that the soft law norms had not become the market standard.

70. See, e.g., In *Re Welfab Eng'rs*, [1990] B.C.C. 600, 602–03 (U.K.); *Brian D. Pierson (Contractors) Ltd.*, [1999] B.C.C. 26, 43 (U.K.); *Roberts v. Frohlich*, [2011] EWHC (Ch) 257; [2012] B.C.C. 407, [101]–[08] (U.K.); In *Re Cont'l Assurance of London Ltd.*, [2007] 2 B.C.L.C. 287, [422] (U.K.).

71. Stephen G. Gilles, *The Emergence of Cost-Benefit Balancing in English Negligence Law*, 77 CHI.-KENT L. REV. 1, 8 (2002).

72. For an account of the complex "real world situations" faced by directors, see Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1481–85, 1490–92 (1984). For a rebuttal of the argument that this process is too arcane for the courts, see Rhee, *supra* note 23, at 1151–52.

73. Blair & Stout, *supra* note 3, at 92.

74. This is not a recent development. Sarah Worthington, *The Duty to Monitor: A Modern View of the Director's Duty of Care*, in *PERSPECTIVES ON COMPANY LAW* 2, 181, 191 (Fiona Patfield ed., 1997). See, e.g., *Roberts v. Frohlich*, [2011] EWHC (Ch) 257; [2012] B.C.C. 407, [108] (U.K.) (court asking whether "no reasonably competent director could have made the judgment"). This echoes the standard of irrationality applied to administrative decisions. *Associated Provincial Picture Houses Ltd. v. Wednesbury Corp.*, [1948] 1 K.B. 223 at 230 (U.K.) (decision will be struck down only if it is "so unreasonable that no reasonable authority could ever have come to it").

B. The Regulators

Directors of financial institutions have a regulatory duty under the Statement of Principles for Approved Persons (APER), Principle 6, to exercise “due skill, care and diligence in managing the business of the firm for which [they are] responsible.”⁷⁵

Regulatory judgments about the reasonableness of a director’s behavior are key to establishing compliance with Principle 6. The FSA took a norm-reflecting approach when assessing the takeover of ABN Amro, stating that because the due diligence conducted by RBS had been in line with market practices, and because there were no relevant general standards or codes of practice, it could not take enforcement action unless “the takeover was not just a bad decision but one which, viewed at the time, was beyond a range of reasonable responses.”⁷⁶ Thus, in the absence of soft law norms, the FSA deferred to market practices.

Subsequently, however, individuals have been unsuccessful in seeking to rely on the RBS Report to argue that the regulator must adduce expert evidence either of market norms or of how other responsible individuals in a similar position might act.⁷⁷ In the action taken against Peter Cummings, the only bank director to face formal FSA sanctions with respect to the conduct that ruined the banks, the FSA’s response to this argument was simply that it had assessed the reasonableness of Cummings’s conduct and decided that his actions were not those of a person in his position acting with due care and diligence.⁷⁸ Again, the CEO of Prudential contended that he should not be disciplined if other credible persons in his position might have acted as he did or considered his conduct to be in compliance with his regulatory obligations.⁷⁹ Nevertheless, the FSA proceeded to find him at fault in the absence of expert evidence on these points.⁸⁰

The proceedings for Prudential’s CEO were administrative in nature, but disciplined persons can refer their cases to the specialist Upper

75. FCA/PRA HANDBOOKS, APER 2.1A.3 (FCA), APER 2.1B.3 (PRA).

76. FSA, *supra* note 2, at 408.

77. *Final Notice: Peter Cummings*, FIN. SERVICES AUTHORITY, ¶ 5.4–7 (Sept. 12, 2012), <http://www.fsa.gov.uk/static/pubs/final/peter-cummings.pdf>. Cummings also argued that the FSA failed to discharge the requisite burden of proof. The more serious the allegations made against a person the higher the standard of proof required. FS & M Tribunal, *Hoodless & Blackwell v. FSA*, ¶ 21 (Oct. 3, 2003), *available at* www.tribunals.gov.uk/financeandtax/Decisions/Financial.htm; FS & M Tribunal, *Legal & Gen. Assurance Soc’y Ltd. v. FSA*, ¶ 19 (Jan. 18, 2005), *available at* www.tribunals.gov.uk/financeandtax/Decisions/Financial.htm.

78. *Final Notice: Peter Cummings*, *supra* note 77, ¶¶ 5.44, 5.68.

79. *Final Notice: Cheick Tidjane Thiam*, FIN. SERVICES AUTHORITY, ¶ 6.4 (Mar. 27, 2013), <http://www.fsa.gov.uk/static/pubs/final/mr-cheick-tidjane-thiam.pdf>.

80. *Id.* ¶ 6.5.

Tribunal (Tax and Chancery)—formerly the Financial Services and Markets Tribunal—a judicial body with the power to rehear cases.⁸¹ The Upper Tribunal (Tax and Chancery) has rejected arguments that expert evidence of market practices needs to be adduced in order to assess whether a person’s conduct falls below regulatory standards.⁸² It has even rejected FSA expert evidence regarding what a reasonable CEO would do in a disciplined director’s position, remarking that this trespassed on the Tribunal’s role.⁸³

The FSA did not and the Upper Tribunal (Tax and Chancery) does not explicitly refer to market practices in making assessments of reasonableness. It is unclear what the FCA’s approach will be.⁸⁴ It is likely that these bodies take account of their own specialized knowledge of market practices in assessing conduct,⁸⁵ but it is unclear whether this leads to the application of market reflecting standards. However, like the courts, they also apply a standard of irrationality when assessing conduct.⁸⁶

In contrast to the lack of clarity surrounding ex post interpretations of reasonableness, the regulators are prepared to articulate norm-reflecting standards ex ante. Market norms feed into this process through “the regulatory conversation”—a dialogue between the regulator and the regulated used to flesh out the meanings of broad standards through guidance and so forth.⁸⁷ The FSA also endorsed guidance drawn up by

81. Financial Services and Markets Act, 2000, c. 8, §§ 55, 133 (U.K.).

82. *FS & M Tribunal, Legal and Gen. Assurance Soc’y Ltd.*, *supra* note 77, ¶ 18; Upper Tribunal (Tax and Chancery), *Thommes v. FSA*, [2012] UKUT B29 (TCC), [27]–[29], *available at* <http://www.tribunals.gov.uk/financeandtax/Decisions.htm>.

83. Upper Tribunal (Tax and Chancery), *Pottage v. FSA*, [2012] UKUT (TCC), [178] (Apr. 20, 2012), *available at* <http://www.tribunals.gov.uk/financeandtax/Decisions.htm>.

84. The FCA has indicated that it will take account of market practices when assessing breaches of the Listings Rules. FCA HANDBOOK, DEPP 6.5B (13)(0). The PRA is silent on the issue. THE PRUDENTIAL REGULATION AUTHORITY’S APPROACH TO ENFORCEMENT: STATUTORY STATEMENTS OF POLICY AND PROCEDURE (2013). In market abuse cases the FSA had indicated that it would usually assess conduct by reference to market standards of behavior, but would not always consider such standards acceptable nor that the person was reasonable in adhering to them. *Final Notice: Darren Morton*, FIN. SERVICES AUTHORITY, ¶ 6.11–12 (Oct. 6, 2009), <http://www.fsa.gov.uk/pubs/final/morton.pdf>; *see also* FCA HANDBOOK, ENFORCEMENT GUIDE ¶ 4.14(2)–(3) (2013) [hereinafter ENFORCEMENT GUIDE] (evidence of industry practices and market standards taken into account during investigations). The FCA has indicated that it would take account of previous FSA decisions when taking disciplinary action, and although its most recent guidance refers only to previous FCA decisions, it seems likely that FSA decisions will remain relevant. ENFORCEMENT GUIDE, *supra*, ¶ 5.22–23.

85. *See, e.g., FS & M Tribunal, Legal and Gen. Assurance Soc’y Ltd.*, *supra* note 77, ¶ 18 (expert evidence admitted but Tribunal disregarded it as its members’ backgrounds in financial services enabled them to assess the relevant issues independently).

86. *Pottage*, *supra* note 83, ¶ 151 (conduct must fall “outside the bounds of reasonableness”).

87. Julia Black, *Talking About Regulation*, 1 PUB. L. 77, 78–79 (1998). The dialogue can take many forms including formal consultations, or informally during firm supervisions.

the industry,⁸⁸ which meant that those who followed the guidance would avoid enforcement action, and the FCA is following suit.⁸⁹ Nevertheless, the FSA was prepared to challenge market norms if they conflicted with its regulatory objectives,⁹⁰ and industry guidance had to specifically address compliance with the FSA's, and now FCA's, own standards in its handbook.⁹¹

IV. THE PROPER ROLE OF MARKET NORMS

A. Respecting Market Norms

Contrary to the position generally taken by the courts and regulators, the standard of reasonableness applied to directors' conduct should, for the most part, explicitly reflect market norms. This position does not go as far as Richard A. Epstein's, which asserts that market practices that amount to customs should be conclusive evidence of reasonable conduct as between the parties to that custom.⁹² Epstein argues that customs arise when parties in equal relationships with identical or parallel roles—such as merchants—must agree on a way to deal with high-frequency, low-cost contingencies.⁹³ As a repeat player, the party who loses out from the custom in the short run will benefit from an optimal rule in the long run. As Epstein states, “a general rule that offers one side benefits today is almost certain to work against the winning party in some future transaction.”⁹⁴ Given this, what counts to market participants is not the gains and losses arising in a particular transaction, but the long-term gains to the market of an efficient custom.⁹⁵ Customs should, therefore, be respected because they optimize the parties' joint welfare.⁹⁶ However, as enforcement of the duty of care is not solely concerned with the aggre-

88. FIN. SERVS. AUTH., CONFIRMATION OF INDUSTRY GUIDANCE: FEEDBACK ON DP06/5 (2007) [hereinafter FEEDBACK ON DP06/5], available at http://www.fsa.gov.uk/pubs/policy/ps07_16.pdf.

89. *Industry Guidance*, FIN. CONDUCT AUTHORITY (Aug. 1, 2014), <http://www.fca.org.uk/firm/s/being-regulated/meeting-your-obligations/guidance/Industry-guidance>; FCA HANDBOOK, DEPP 6.2.1G(4).

90. See the discussion of FSA's Treating Customers Fairly Initiative in David Campbell & Joan Loughrey, *The Regulation of Self-interest in Financial Markets*, in INTEGRITY, RISK AND ACCOUNTABILITY IN CAPITAL MARKETS 65, 70–74 (Justin O'Brien & George Gilligan eds., 2013).

91. FEEDBACK ON DP06/5, *supra* note 88, at 7.

92. Richard A. Epstein, *The Path to The T. J. Hooper: The Theory and History of Custom in the Law of Tort*, 21 J. LEGAL STUD. 1, 4 (1992).

93. *Id.* at 11–14.

94. *Id.* at 12.

95. *Id.*

96. *Id.* at 11–14.

gate welfare of the parties to the corporate contract—namely, directors and shareholders, or corporations—even if their aggregate welfare was promoted by respecting market norms, this cannot conclude the debate about the desirability of respecting those norms.⁹⁷

In any event, it seems unlikely that directors engage in the kinds of transactions in which customs arise—i.e., high-frequency, low-cost transactions. On the contrary, as far as dealing with third parties are concerned, directors are more likely to be involved in low-frequency, high-cost strategic decisions, such as takeover decisions. Epstein's analysis also does not seem apt for describing the dealings between corporations and their directors. It has been suggested that market custom might justify the fact that, in the United States, directors are liable for breaching their duty of care only where they fail to make informed decisions, abdicate their duty, or act in bad faith.⁹⁸ However in English law, custom refers to actual practices that are prevalent in an industry or trade, and there is little evidence of such a market custom. For starters, decisions regarding directors' liability are taken by the courts and not by market actors. Arguably, if legal action was only taken in the circumstances outlined, this might be evidence of custom, but a more likely explanation is that potential claimants would know that only claims on these grounds would be successful, and they would therefore be deterred from litigating in other circumstances.

Nevertheless, there are several arguments for setting a standard of conduct that falls neither below nor above, but rather reflects market practices and obligational norms. Broad standards such as reasonableness have been criticized as so objectionably vague as to offend against the Rule of Law, which requires that those subject to a law should be able “to foresee with fair certainty” how it will be applied and plan their affairs accordingly.⁹⁹ On the other hand:

[W]hilst certainty is highly desirable, it may bring in its train excessive rigidity and the law must be able to keep pace with changing circumstances. Accordingly, many laws are inevitably couched in

97. Because, as Epstein says, custom only registers the preferences of parties to the custom and not those of affected third parties. *Id.* at 5; see also Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1679, 1684 (1996).

98. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); see also Rhee, *supra* note 23, at 1116–67.

99. FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* 75–81 (Univ. of Chi. Press 2007) (1944). This is one reason that Bentham famously excoriated the common law as “dog law.” 5 JEREMY BENTHAM, *THE WORKS OF JEREMY BENTHAM* 235–36 (John Bowring ed., 1843). My thanks to Professor David Campbell for drawing my attention to this.

terms which, to a greater or lesser extent, are vague and whose interpretation and application are questions of practice.¹⁰⁰

Given the range of tasks directors perform, the law could not possibly prescribe in sufficient detail what constitutes desirable conduct in all situations. Attempts to provide detailed prescriptions would, in fact, undermine certainty by creating complexity.¹⁰¹ The use of broad standards is therefore both inevitable and desirable. The problem of unpredictability, however, could be ameliorated if the standard of reasonableness was given content by reference to externally generated *ex ante* norms.¹⁰² The question is whether these should be market norms or other types of norm, and how these should be identified.

A standard that reflects market practices would avoid legislating for a standard of behavior that was higher than common practice and thus the potential unfairness of “punishing” a director for doing what everyone else is doing.¹⁰³ The problem with this consideration is that it applies regardless of whether market practices are otherwise desirable (for example, because they are welfare maximizing).¹⁰⁴

Second, as Judge Learned Hand stated in *T.J. Hooper*, “in most cases reasonable prudence is in fact common prudence.”¹⁰⁵ The fact that a practice is widespread will often, though certainly not always,¹⁰⁶ point to its utility and will usually be a more reliable indicator of efficient conduct than the courts’ or regulators’ intuitive assessments. Evidence of market practices performs an epistemic function, indicating what might be a realistic standard of care and avoiding the dangers of hindsight bias, which causes people to overestimate after the event the extent to which an event could have been predicted beforehand.¹⁰⁷ Hindsight bias could lead to directors being found negligent for consequences they could not have reasonably foreseen, or which seemed remote at the time of the decision.

100. *Sunday Times v. United Kingdom*, (1979) 2 EHRR 245, at para. 49 (Eur. Ct. H.R.).

101. CHARLES SAMPFORD, *RETROSPECTIVITY AND THE RULE OF LAW* 269–72 (2006).

102. As was accepted in *R (Heather Moor & Edgecomb Ltd.) v. Fin. Ombudsman Serv.*, [2008] EWCA (Civ) 642, [2008] Bus. L.R. 1486, [49].

103. Kenneth S. Abraham, *Custom, Noncustomary Practice, and Negligence*, 109 COLUM. L. REV. 1784, 1798 (2009).

104. *Id.* at 1801.

105. *T.J. Hooper*, 60 F.2d 737, 740 (2d Cir. 1932). Though Judge Hand immediately proceeded to make clear that custom was not conclusive.

106. See Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1643, 1711–23 (1996).

107. Hal R. Arkles & Cindy A. Schipani, *Medical Malpractice v. The Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587, 588 (1994).

Third, measuring directors' conduct against market practices and obligational norms will usually meet the expectations of shareholders, creditors, and other corporate stakeholders. As Sealy argued, "What the law has to ensure is that the risks which [the] company elects to embrace fall within the range of legitimate business risks, consistently with the expectations of all those whose interests are at stake" ¹⁰⁸ Legitimate business risks comprise those that are "acceptable . . . by the commercial standards of [the] day." ¹⁰⁹ Corporate constituents are unlikely to want directors to take risks that the market considers unacceptable, and it seems equally unlikely that they would want directors to be more risk averse, given the implications for the corporation's competitiveness. ¹¹⁰

Fourth, setting a standard that is higher than the market's would result in a whole industry being found negligent. ¹¹¹ The consequential disruption of commercial practices and resulting uncertainty is more likely to result in over-deterrence and defensive decision making. Conversely, setting the standard by reference to market practice reduces these risks: successful directors tend to overestimate their abilities and underestimate the likelihood that they will be negligent. ¹¹² They will not tend to see themselves as liable to behave in ways that fall below market norms. If anything they are likely to believe that they will perform better than the market.

Finally, finding directors liable could erode directors' internal commitments to careful behavior, by signaling that others are not behaving carefully. ¹¹³ Setting the standard of reasonableness above market standards would increase the likelihood of directors being found liable, which would exacerbate this risk. Conversely, setting a standard that reflected market practices would signal that the requisite conduct was commonplace, thus ameliorating this problem.

Not only are there problems in setting a standard of reasonableness that is above market norms, there are also problems in setting a lower standard. Duty of care cases promote improved standards of conduct by

108. Leonard S. Sealy, *Directors' "Wider" Responsibilities—Problems Conceptual, Practical and Procedural*, 13 MONASH U. L. REV. 164, 181 (1987) (Austl.). Sealy was arguing against directors having a duty other than to promote shareholder interests.

109. *Id.*

110. For a discussion of shareholders' expectations as a limit on directors' discretion and its implications for the duty of care, see Philip C. Sorenson, *Discretion and its Limits—An Analytical Framework for Understanding and Applying the Duty of Care to Corporate Directors (And Others)*, 66 WASH. U. L.Q. 553, 584–85 (1988).

111. Clarence Morris, *Custom and Negligence*, 42 COLUM. L. REV. 1147, 1147–48 (1942).

112. Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 825 (2001).

113. Blair & Stout, *supra* note 3, at 1772–73, 1796–97.

providing courts or regulators with the opportunity to clarify and reinforce obligational norms of careful behavior.¹¹⁴ The corollary of this is that articulating a standard lower than the markets could introduce and reinforce suboptimal norms. Promoting a low standard (or not enforcing one at all) removes an incentive for those individuals who are motivated by external factors to act more carefully, thus encouraging poor practices.¹¹⁵ Social and internal motivations for compliance may also be weakened as non-enforcement, or enforcement of a low standard, signals that more careful behavior does not really count, which may degrade obligational norms.¹¹⁶

This claim might seem implausible given that, for a substantial period of time, market norms governing the care, skill, and diligence required of U.K. directors were higher than that required by the courts. Recent evidence, however, supports these concerns. For example, the Parliamentary Commission on Banking Standards' Report into HBOS (HBOS Report),¹¹⁷ records a 2004 self-assessment of the HBOS board's performance, which concluded, "The Board made effective but supportive challenges, as necessary, and would not seek to second guess executive management's formulation of strategy."¹¹⁸ Yet the Combined Code of Corporate Governance that applied on a comply-or-explain basis to all U.K.-listed corporations made clear that it was the board that should set the corporation's strategic aims and that non-executive directors should constructively challenge and help develop proposals on strategy.¹¹⁹ It is therefore startling that the HBOS board did not realize that the conclusions in its self-assessment were far from satisfactory.

The law may have contributed to this complacency. Courts have exonerated both non-executive¹²⁰ and executive directors¹²¹ that relied on

114. *Id.* at 1796–98; Eisenberg, *supra* note 15, at 1269–70; Langevoort, *supra* note 112, at 826–28; Rock & Wachter, *supra* note 34, at 1695–96; see also Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997); Alex Geisinger, *Are Norms Efficient? Pluralistic Ignorance, Heuristics, and the Use of Norms As Private Regulation*, 57 ALA. L. REV. 1, 26–27 (2005) (arguing that in addition to altering incentives for action, the law can redress "pluralistic ignorance," i.e., mistaken assumptions regarding what the majority find acceptable).

115. Renee M. Jones & Michelle Welsh, *Towards a Public Enforcement Model for Directors' Duty of Oversight*, 45 VAND. J. TRANSNAT'L L. 343, 369 (2012).

116. *Id.* at 368; see also Jones, *supra* note 22, at 130–31.

117. HBOS REPORT, *supra* note 2, at 8. This bank suffered aggregate pre-tax losses of £30 billion between 2008 and 2011, primarily as a result of bad lending.

118. *Id.* at 30 (emphasis added).

119. FIN. REPORTING COUNCIL, COMBINED CODE 4 (2003), available at <http://www.ucema.edu.ar/cegopp-base/download/TheCombinedCode.pdf>.

120. In *Re Continental Assurance of London PLC*, [2007] 2 B.C.L.C. 287 (U.K.).

121. *Norman v. Theodore Goddard*, [1992] B.C.L.C. 14 (U.K.).

others who are experts in matters lying outside the directors' expertise, provided that the directors exercised judgment in relation to the matters in question¹²² and, in the case of the non-executives, had probed, tested, and discussed the information provided by the experts as intelligent laymen.¹²³ The HBOS Report found that both the non-executive and executive directors lacked banking expertise and so placed their faith in senior executives who had such expertise.¹²⁴ The law could be interpreted as not unambiguously ruling out such reliance provided that, as the self-assessment recorded, the directors made "effective and supportive challenges." Of course, for the law to have influenced the directors, they had to be aware of it, but given that HBOS's company secretary was head of its legal department,¹²⁵ it could be expected that he would have communicated any concerns about its legal position. A further illustration is found in the RBS Report, which records that the RBS directors were legally advised on whether they had given the acquisition of ABN Amro proper consideration. Presumably, despite the minimal due diligence, the advice was positive as the takeover proceeded.¹²⁶ Consequently, assuming directors pay attention to legal advice,¹²⁷ communicating that the law sets a low standard of care may cause them to make less careful decisions than they might otherwise.

None of the above considerations for applying market norms support the FSA's position in relation to RBS. The FSA was wrong to conclude that the RBS directors had acted in accordance with market practices governing due diligence in hostile takeovers. The ABN Amro takeover was not like other takeovers. Hostile takeovers in the banking context are extremely rare and, as the FSA noted, given its size this one was exceptional.¹²⁸ What should be done in "very particular and highly individualistic circumstances . . . is by no means a matter of practice. It is a matter of law to be resolved by judges."¹²⁹ In such circumstances, a finding of negligence would not require an entire industry to change its practices, there are no special reasons for thinking that such conduct pro-

122. *Id.* at 18–21.

123. *In Re Continental Assurance of London PLC*, 2 B.C.L.C. at 402–03, 411.

124. HBOS REPORT, *supra* note 2, at 31.

125. *Conference Report: The European Legal Summit 2004*, LAWYER (Nov. 22, 2004), <http://www.thelawyer.com/conference-report-the-european-legal-summit-2004/113004.article> (records that Harry Baines was company secretary in 2004); *see also* Tim Sharp, *Baines Retires from Legal Role*, HERALD SCOTLAND (Aug. 9, 2012), <http://www.heraldsotland.com/business/people/baines-retires-from-legal-role.18424395>.

126. FSA, *supra* note 2, at 227.

127. *See generally* Rock, *supra* note 114.

128. FSA, *supra* note 2, at 229.

129. *Bown v. Gould & Swayne*, [1996] P.N.L.R. 130 [135] (Simon-Brown L.J.) (U.K.).

motes welfare, and directors could not reasonably believe that their conduct is an accepted practice. Admittedly, exposing those who engage in minority practices to a greater prospect of liability than those who adhere to common practices risks deterring innovation.¹³⁰ Directors may conclude that it is safer to comply with existing practices than to try something new. Again, a useful practice could be held negligent thus preventing it from spreading.

The case law on medical negligence suggests a solution: if an innovative procedure is approved of by a body of responsible opinion, it is less likely to be found negligent.¹³¹ A similar approach could be adopted in corporate law. Nevertheless, stifling innovation is anathema to successful entrepreneurship, and so there needs to be caution in holding even a one-off strategic board decision negligent, though not because of the considerations supporting respect for market norms.

In sum, it would usually be fair, more efficient, less disruptive, and meet the expectations of those affected, for the reasonableness of directors' conduct to be assessed against a standard that reflects market norms and, in particular, market practices. This will not always be appropriate, however, as the next section explains.

B. Departing from Market Norms

The argument that the public and private standard of care should always reflect market norms seems deeply unappealing in light of market participants' conduct, which was irrational prior to the crisis, motivated by unrestrained greed, and even, as the LIBOR scandal showed, corrupt. This section explores in what circumstances it is permissible to depart from market norms and argues that this is allowable when the conduct impugned is irrational or scandalous, and occasionally when the conduct is merely negligent, but then only in limited circumstances such as when it involves a failure to take precautions against predictably serious risks.

The discussion draws on professional negligence decisions in the United Kingdom, which are similar to U.S. medical negligence case law.¹³² These cases are of interest because, just as in the corporate law sphere, the courts' approach may be shaped by concerns over institutional competence and the fear that increased liability could lead to defensive

130. Abraham, *supra* note 103, at 1813.

131. *Waters v. W. Sussex H.A.*, [1995] 6 MED. L. REV. 362, 365 (U.K.).

132. *See, e.g.*, Arkles & Schipani, *supra* note 107, at 595–600 (discussing the accountability of physicians in medical negligence cases); *see also* Rhee, *supra* note 23, at 1166 (citing WARD FARNSWORTH & MARK O'GRADY, TORTS CASES AND QUESTIONS (2d ed. 2009)).

decision making.¹³³ There have also been attempts to rely on this case law to exonerate directors in regulatory proceedings.¹³⁴ However, it is not proposed that the approach taken in these cases should be uncritically adopted because it has been justifiably criticized as placing professionals above the law¹³⁵ and would fail to promote adequate accountability. Rather, the aim is to draw analogies in order to provide a framework for discussing when standard setting that departs from market norms might be permissible.

Turning to case law, courts will find professional practices unreasonable where they are unacceptable to the wider community.¹³⁶ In *A v. Leeds Teaching Hospitals NHS Trust*, medical practitioners removed and retained the organs of deceased children for research purposes without informing their parents or seeking consent.¹³⁷ There was a public outcry when this was discovered.¹³⁸ Although this accorded with universal professional practice at the time,¹³⁹ the courts intervened to sanction behavior that was so serious that it scandalized the public and flouted obligational norms of generalized morality.

Second, courts will examine professional practice and obligational norms to ascertain whether they have a logical basis. If not, then conduct that accords with these will be negligent.¹⁴⁰ For present purposes, this will be treated as a test of irrationality.¹⁴¹

Third, both within and outside the field of professional negligence, courts will hold market practices unreasonable where these fail to take precautions against known or reasonably apparent risks.¹⁴² This includes risks that are rare but where the precaution needed is clear with minimal

133. There are many other similarities between medical negligence cases and directors' duty of care cases. See Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 305–14 (1994).

134. *Thommes v. FSA*, [2012] UKUT (TCC), 27–29 (U.K.); *Final Notice: Cheick Tidjane Thiam*, *supra* note 79, ¶ 6.4; see also *R v. Fin. Ombudsman Serv.*, [2008] EWCA (Civ) 642, [2008] Bus. L.R. 1486 [54]–[56] (U.K.).

135. Rachael Mulheron, *Trumping Bolam: A Critical Legal Analysis of Bolitho's "Gloss,"* 69 CAMBRIDGE L.J. 609, 612 (2010); Harvey Teff, *The Standard of Care in Medical Negligence—Moving on from Bolam?*, 18 OXFORD J. LEGAL STUD. 473, 477 (1998).

136. Mulheron, *supra* note 135, at 629–30.

137. *A v. Leeds Teaching Hosps. NHS Trust*, [2004] EWHC (QB) 644; [2005] Q.B. 506 [533] (U.K.).

138. *Id.* at 509; see also *Bristol Inquiry to Look into Child Organ Removal*, BBC NEWS, (Feb. 11, 1999), http://news.bbc.co.uk/1/hi/health/background_briefings/the_bristol_heart_babies/277120.stm.

139. *Leeds Teaching Hospitals*, EWHC (QB) 644, Q.B. at 561–62.

140. *Bolitho v. City & Hackney Health Auth.*, [1998] A.C. 232 (H.L.) (U.K.).

141. Teff, *supra* note 135, at 480–81.

142. *E.B. Savory v. Lloyds Bank Ltd.*, [1933] 1 A.C. 201 (H.L.) (U.K.); *French v. Thames Valley Strategic Health Auth.*, [2005] EWHC (QB) 459 [112] (U.K.).

costs.¹⁴³ Thus, in *E.B. Savory v. Lloyds Bank Ltd.*, the appeal court did not hesitate to direct the banking industry to change a commercially convenient practice that subverted a bank's safeguards against a risk that had been identified by the bank itself.¹⁴⁴

The question is whether these grounds for departing from market norms can be justified given the previous arguments for adhering to norm-reflecting standards. Taking each of these arguments in turn, holding directors to account for flouting societal standards would not involve retrospective standard setting, contrary to the Rule of Law. Rather, it involves the courts applying standards established *ex ante*, although admittedly different from those that have evolved within the market. Similarly, when the market is dominated by irrational behavior, the values and conduct of market participants will usually diverge from that which is considered acceptable by community standards. Given that directors have, or should have, due notice of what societal standards are, there is no retrospectivity in holding them liable in such circumstances. And as they ought to know what is permissible, they can plan their conduct accordingly.

The *E.B. Savory* situation is more problematic. In this case, banks had recognized that they needed to take precautions against the risk that employees might steal checks from their employers.¹⁴⁵ To guard against this, the bank had to know who employed their customers, who had drawn the checks, and to whom they had been made payable.¹⁴⁶ However, a practice had been introduced whereby customers could pay in checks at a branch (the receiving branch) other than the one where they had their account (the customer branch), and after it had cleared, they could withdraw the funds from the latter. Because the check in *E.B. Savory* was retained centrally at the Clearing House, problems arose because the receiving branch did not know who employed the customer, whilst the customer's branch did not know who had drawn the check and to whom it had been made payable. It happened that two individuals exploited this situation by paying in stolen checks at a receiving branch and withdrawing the funds at their customer branch. This "commercially useful"¹⁴⁷ practice adopted by the bank had been followed for forty years without the banks or fraudsters spotting the problem.¹⁴⁸ Arguably, there-

143. *Hucks v. Cole*, [1993] 1 MED L. REV. 393 (U.K.).

144. *E.B. Savory*, 1 A.C. at 201.

145. *Id.* at 225.

146. *Id.* at 211.

147. *E.B. Savory v. Lloyds Bank Ltd.*, [1932] 2 K.B. 122 at 133 (U.K.).

148. *E.B. Savory*, 1 A.C. at 216.

fore, the risk was only apparent with hindsight, and in imposing liability the court engaged in retrospective standard setting.

On the other hand, it seems likely that the bank did not spot the problem because it had not assessed the risks that the practice posed. Had it done so, it would (or should) have recognized the risk because it had already identified it *ex ante*. Holding market participants liable for failing to guard against risks that they would have recognized had they thought about it does not involve retrospective standard setting: the requirement to take reasonable care signals *ex ante* that persons should at least consider the risks inherent in their conduct.

The law, however, is already more likely to hold directors liable for breaching their duty of care when they fail to exercise judgment about risks.¹⁴⁹ The real difficulty arises when directors argue that even if they had considered the risks, they would still have acted or failed to act in the impugned manner. It may be claimed that directors should not have taken the risk without adopting a particular precaution, or that they should not have taken the risk at all. This is problematic because directors are required to take, rather than avoid, risks and may legitimately choose to run an obvious risk. For these reasons, it has been argued that the duty of care is inconsistent with the director's role.¹⁵⁰ Yet directors are not unique in this respect: medical professionals also regularly choose to deliberately run risks and choose between different treatment options with uncertain outcomes,¹⁵¹ but they are nevertheless subject to a duty of care, albeit that the courts show great deference to their judgment. Again, while these considerations make it particularly problematic for the courts to find directors negligent when their conduct accords with market practice, permitting market practice to determine the requisite standard may be unsatisfactory. It would excuse decisions not to take precautions against serious risks on the grounds of costs, for example, despite predictably serious consequences for others.

In professional negligence cases, the courts deal with analogous issues by asking whether the need for a precaution, and the nature of the precaution required, would be obvious as a matter of lay common sense.¹⁵² This appeals to societal norms in preference to professional norms. The problem is that given the nature of business decisions, it is not clear that there would be many circumstances in which lay common

149. Worthington, *supra* note 74, at 192; Rhee, *supra* note 23, at 1166–67.

150. Vanessa Finch, *Company Directors: Who Cares About Skill and Care?*, 55 MOD. L. REV. 179, 205 (1992).

151. Gevurtz, *supra* note 133, at 309–12.

152. Mulheron, *supra* note 135, at 620.

sense would be sufficiently informed to be able to make an accurate judgment about these matters.¹⁵³ In such cases, the courts could look to relevant codes of conduct, industry standards, and other soft law instruments, on the one hand, and use these to assess, on the other hand, both market practices and informal obligational market norms.¹⁵⁴ In cases of conflict, the former should usually prevail, on the grounds that soft law norms reflect the considered views of market actors of acceptable conduct and are also more likely to incorporate community expectations. For example, in the United Kingdom, soft law norms emphasize that it is the board's responsibility to ensure that there are regular and systematic assessments of the risks facing their businesses and that internal control systems are instituted to manage risk.¹⁵⁵ Yet, such systems were woefully lacking in banks in the run up to the financial crisis. Again, as David Millon recently argued, short-termism may be a prevalent market norm "that leads actors to assume uncritically that focus on current share prices at the expense of long-term fundamental value is appropriate."¹⁵⁶ In contrast, the U.K. Corporate Governance Code states that boards are collectively responsible for the *long-term* success of their companies.¹⁵⁷ This provision was introduced in 2010 to address the short-termism highlighted by the financial crisis and in response to formal reform proposals.¹⁵⁸ The debate surrounding "enlightened shareholder value"¹⁵⁹ and section 172 of the Companies Act 2006,¹⁶⁰ which requires directors to have re-

153. Manning, *supra* note 72, at 1493–94 (arguing that there is no community understanding about what a director should do and how.).

154. See Dimity Kingsford-Smith, *Governing the Corporation: The Role of Soft Regulation*, 35 U.N.S.W. L.J. 376, 390–92, 396–401 (2012) (Austl.) (discussing the use of soft law norms by Australian courts to give content to directors' duties).

155. FIN. REPORTING COUNCIL, INTERNAL CONTROL: REVISED GUIDANCE FOR DIRECTORS ON THE COMBINED CODE 1 (2005). However, the stipulation that boards are responsible for determining the nature and extent of the significant risks the company takes was only introduced in the Corporate Governance Code post-crisis: see FIN. REP. REPORTING COUNCIL, UK CODE OF CORPORATE GOVERNANCE, Principle C.2 (2012).

156. David Millon, *Shareholder Social Responsibility*, 36 SEATTLE U. L. REV. 911, 916 (2013).

157. It is the first Principle. FIN. REP. REPORTING COUNCIL, UK CODE OF CORPORATE GOVERNANCE, PRINCIPLE A.1 (2012).

158. DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS, ¶¶ 1.13, 1.26, 5.27 (2009), available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

159. See Andrew Keay, *Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective*, 2006 L.M.C.L.Q. 335 (U.K.); see also Sarah Kiarie, *At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?*, 17 INT'L. COMPANY & COM. L. REV. 329 (2006).

160. Companies Act, 2006, c. 46, § 172(1)(a) (U.K.).

gard for the long-term consequences of their decisions, may also have played a part. Therefore, the provision can be viewed as incorporating the law's, the community's, and informed market actors' views of appropriate behavior as an attempt to alter market practices and, consequently, should be the preferred standard against which to measure directors' conduct.

Nevertheless, there needs to be some discretion over whether to apply soft law, as it often sets out best practice, and negligence lies in failing to comply with satisfactory practices, rather than best practice. Furthermore, it may not be appropriate for all directors at all times; thus, the U.K. Code of Corporate Governance only applies to listed corporations, and even then, it can be departed from in appropriate circumstances.¹⁶¹

In the absence of relevant soft law, a final option is to admit expert evidence about whether market participants considered the practice in question to be reasonable.¹⁶² This would involve measuring market practices against informal obligational market norms applicable at the relevant time. It recognizes that what market participants do is not necessarily what they think ought to be done. This is similar to the approach in medical negligence cases where the courts have held that a doctor was not negligent when he acted in accordance with a practice accepted at the time as proper by a responsible body of medical opinion skilled in the treatment in question.¹⁶³ The reference to "proper" practice was thought to import a normative rather than a descriptive element.¹⁶⁴ In other words, a doctor would not be exonerated simply because he complied with professional practice if the professional practice was not accepted as proper by professional experts. Retrospectivity would not be an issue where the courts chose between evidence regarding two preexisting sets of professional practices. The professional negligence cases, however, also established that even if just one body of responsible medical opinion supported the doctor's practices, the doctor would be exonerated. It was irrelevant that another body of professional opinion considered her practices improper: the court could not prefer the latter opinion to the former and would not examine the relative merits of the two bodies of opinion. Expert evidence became conclusive of reasonable conduct and was criticized as placing professionals above the law, and deferring to a director's

161. FCA HANDBOOK, LR 9.8.6(5).

162. See, e.g., *ARB Int'l Ltd. v. Baillie*, [2013] EWHC 2060 (Comm), [7]–[11] (though there the court preferred expert evidence, as the soft law norms had not become the market standard).

163. *Bolam v. Friern Hosp. Mgmt. Comm.*, [1957] 1 W.L.R. 582 (U.K.).

164. J. L. Montrose, *Is Negligence an Ethical or a Sociological Concept?*, 21 MOD. L. REV. 259, 262 (1958).

expert in this manner would undermine accountability.¹⁶⁵ However, even if retrospective standard setting is avoided, it is unclear on what basis the courts could choose one set of market or societal norms in preference to another, and this creates a risk of arbitrariness. If such a choice is to be made, its legitimacy must be assessed against other arguments for adhering to market norms.

Turning then to whether it is unfair to find directors liable when they are simply doing what others are doing, when societal expectations about what counts as appropriate conduct diverges sharply from market conduct, enforcement of a standard of care that reflects societal values rather than the market's seems warranted, particularly if the conduct has given rise to accountability claims from the wider community. Holding market participants accountable to the law signals that they are not exempt from the demands of community morality. Markets are, after all, embedded in society and exist to serve society's aims. This is not necessarily to advocate a stakeholder model of the corporation, that is, that judgments about the legitimacy of directors' conduct should turn on how directors balance conflicting stakeholder interests.¹⁶⁶ Rather, even if it is accepted that directors must promote shareholder interests (as U.K. law requires them to do),¹⁶⁷ they should do so in a manner that does not violate the mores of the wider community.

Holding market actors accountable for egregious conduct does not necessarily involve prioritizing community values over market values. The behavior of market participants prior to the financial crisis, which was so destructive of the market, typically featured unrestrained greed that showed no respect for the interests of others. One explanation for this conduct was that market actors wrongly believed that unrestrained selfishness constituted the legitimate pursuit of self-interest and thus justified market behavior. However, the self-interest that is essential to the operation of the market respects the autonomy of other parties to the market exchange.¹⁶⁸ Insofar as the pursuit of greed became not only a market practice but also an informal obligational norm, penalizing such conduct would not only deter such conduct but also erode the normative

165. Mulheron, *supra* note 135, at 612.

166. On stakeholderism, see, for example, EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* (1984).

167. Companies Act, 2006, c. 46, § 172 (U.K.). While some argue that this section does not enshrine shareholder primacy, the weight of academic commentary supports the view that it does. See e.g., ANDREW KEAY, *ENLIGHTENED SHAREHOLDER VALUE AND CORPORATE GOVERNANCE* (2013); Brenda Hannigan, *Board Failures in the Financial Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms: Part 2*, *COMPANY LAW.*, Feb. 2012, at 35, 39–40.

168. Campbell & Loughrey, *supra* note 90, at 76, 86–87.

effect of this “false” market value, to the benefit of the market and society.

Conduct that egregiously flouts community expectations, such as the conduct of the LIBOR traders, would usually be dealt with more appropriately through rules governing fraud rather than the duty of care. It is also typically extremely difficult to link egregious conduct to directors. Directors’ ignorance about what is going on in their corporations is a common feature of corporate scandals and has contributed to the “accountability firewall.”¹⁶⁹ However, examples of actions that might be caught include decisions to award high levels of executive pay, though in the United Kingdom this has now been addressed through legislation,¹⁷⁰ or decisions to cause corporations to engage in reputation-damaging conduct, such as authorizing aggressive tax avoidance schemes that cause the corporation to cross the line of legality. This final example highlights the difficulties in ascertaining what the community’s shared values are. While these difficulties must not be minimized, this issue lies outside the scope of a discussion that focuses on market norms. For present purposes, it is sufficient to note that certain types of conduct clearly evoke community condemnation and are captured by the exception.

As for irrational conduct, the Rule of Law only requires the protection of rational and legitimate expectations about the law.¹⁷¹ However in the context of the financial crisis, while market conduct as whole was irrational, the conduct of market actors in continuing to take high risks may have been individually rational because it allowed them to maintain market share.¹⁷² Thus, when asked, “Aren’t you getting in over your head with all of these CDO investments and their problems of illiquidity?,” Charles Prince, then-CEO of Citigroup famously replied, “When the music stops in terms of liquidity things will get complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”¹⁷³ As Coffee pointed out, the directors saw problems on the hori-

169. See PARLIAMENTARY COMMISSION ON BANKING STANDARDS, *supra* note 1.

170. Enterprise and Regulatory Reform Act, 2013, c. 24, §§ 70, 80 (U.K.).

171. SAMPFORD, *supra* note 101, at 57, 89.

172. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF ‘08 AND THE DESCENT INTO DEPRESSION 75–116, 235 (2009); Robert T. Miller, *Morals in a Market Bubble*, 35 U. DAYTON L. REV. 113, 133–37 (2010) (arguing the conduct was rational). *But see* GEORGE A. AKERLOF & ROBERT J. SHILLER, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM (2009); *see also* Dallas, *supra* note 21, at 311–12; Donald C. Langevoort, *Chasing the Greased Pig down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209 (2011).

173. Michiyo Nakamoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-Outs*, FIN. TIMES (July 9, 2007), <http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz2tw6xZknR>.

zon, but their fear of falling behind the competition was ever more compelling.¹⁷⁴ But even if this conduct was rational—which is challengeable given its implications for the long term interests of the participants¹⁷⁵—it is not legitimate to expect the law to disregard reckless risk-taking simply because it is widespread or turn a blind eye to exploitative greed. Neither the Rule of Law nor considerations of fairness require this.

The *E.B. Savory* category is again more difficult. On one hand, assuming that directors have not simply failed to consider the risks of a particular decision but reviewed them and acted in accordance with market norms, fairness points away from liability. On the other hand, in cases where conflicting bodies of expert evidence reveal a division of market opinion regarding the propriety of directors' conduct, directors cannot be taken completely by surprise if a court rules that their conduct was unreasonable. There is also less unfairness when a court's judgment of reasonableness is informed by those conflicting market norms, rather than by an arbitrary judicial assessment of desirable market conduct. Nevertheless, the potential for unfairness remains, thus liability should only be imposed where there are countervailing considerations in its favor. For example, the need to be fair to directors might be overridden by the need to be fair to others. It may also be legitimate to impose liability when "in the light of common sense or newer knowledge, market practices were 'clearly bad'"¹⁷⁶—that is, where the practices were unreasonable by community standards.

Adhering to market practices was also justified on the basis that it would reflect the expectations of corporate constituents. Shareholders seemed happy when bank directors took excessive risks. Thus, RBS shareholders, who received dividends of 22% in 2006 and 23% in 2007,¹⁷⁷ were happy to acquiesce in the takeover of ABN Amro, later described as a gamble.¹⁷⁸ This demonstrates that determining whether directors have taken acceptable risks cannot be left to shareholders when the decision imposes material externalities on other persons. For example, the ABN Amro takeover led to the collapse of RBS, which adversely

174. John C. Coffee, Jr., *What Went Wrong? A Tragedy in Three Acts*, 6 ST. THOMAS L. REV. 403, 416–17 (2009).

175. Dallas, *supra* note 21, at 311.

176. *Stokes v. Guest, Keen & Nettlefold (Bolts and Nuts) Ltd.*, [1968] 1 W.L.R. 1776, 1783 (U.K.).

177. *Ordinary Share Dividends*, RBS, <http://www.investors.rbs.com/dividends> (last visited Apr. 1, 2014).

178. TREASURY COMMITTEE, THE FSA'S REPORT INTO THE FAILURE OF RBS, 2012–13, H.C. 640, ¶ 27 (U.K.), available at <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/640/640.pdf> (noting that 94.5% shareholders voted in favor of the acquisition).

impacted employees, borrowers, and taxpayers. Considerations of accountability require that the expectations of the creditors and the wider community regarding acceptable conduct should count in such circumstances.

Finally, irrational market behavior cannot be defended as efficient or welfare maximizing. Behavior that flouts societal values might meet these criteria,¹⁷⁹ but efficiency and welfare maximization should not override community norms in guiding the law's response to such conduct. Conversely, the law must reflect and accommodate other important values such as fairness, justice, and respect for others as ends in themselves.¹⁸⁰ Behavior is egregious often, if not always, because it offends some or all of these values, and this in turn is what renders the need for accountability.

But yet again, courts and regulators must be cautious about impugning conduct that only reaches the level of negligence like that in *E.B. Savory*. In that case, the appeal court noted that the precautions needed to remove the risk were very straightforward, which suggests that the court weighed the costs of the precautions against the benefits and found that this pointed in favor of taking precautions.¹⁸¹ It is unclear whether this influenced the court's assessment of reasonableness,¹⁸² but in the absence of a cost-benefit analysis, there is a risk that efficient practices could be found negligent. Even if the courts did undertake such an analysis, it is far from certain that it would be accurate. There will, though, be times when the outcome of a cost-benefit calculation is clear and when a finding of unreasonableness will not disrupt an efficient practice, but this is likely to be rare given the complexity of business decisions.

179. The question of whether and when norms are efficient has been much debated. *See, e.g.*, ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 167–83 (1991) (efficient norms emerge in close-knit groups); Cooter, *supra* note 97, at 1655 (efficiency of norms depends on whether they are produced by efficient incentive structures); Eisenberg, *supra* note 15, at 1281 (identifying low levels of directorial care to have been the result of inefficient norms); Posner, *supra* note 106, at 1711–23 (explaining why inefficient norms arise).

180. The arguments on this point have been canvassed thoroughly elsewhere. *See* Julius L. Coleman, *The Grounds of Welfare*, 112 YALE L.J. 1511 (2003); David Dolinko, *The Perils of Welfare Economics*, 97 NW. U. L. REV. 351 (2002); Michael B. Dorff, *Why Welfare Depends on Fairness: A Reply to Kaplow and Shavell*, 75 S. CAL. L. REV. 847 (2002); Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961 (2001) (contending that welfare maximization should be the sole value guiding law); Riwaan Mokai, *On Fairness and Efficiency*, 66 MOD. L. REV. 452 (2003) (arguing contrary to the position of Kaplow & Shavell, *supra*); *see also* David Campbell, *Welfare Economics for Capitalists: The Economic Consequences of Judge Posner*, 33 CARDOZO L. REV. 2233, 2234–35, 2246–47 (2012).

181. *E.B. Savory v. Lloyds Bank Ltd.*, [1932] 2 K.B. 122 at 134, 142 (U.K.).

182. *Id.*

In sum, arguments against departing from market norms do not prevail where the conduct in question is irrational or contrary to social mores. It is more difficult to defend finding directors' negligent in an *E.B. Savory* type case. Although many of the impugned decisions made by directors would fall within this category, such a conclusion does not render the "accountability firewall" unassailable. First, irrational and scandalous conduct could not be excused even if it was widespread market conduct. Second, the examination of the U.K. legal position suggests that using market norms to judge directors' behavior could increase instances of directors' liability and thus promote accountability. Third, even in an *E.B. Savory*-type case, it will be possible to find directors liable, albeit in limited circumstances.

V. CONCLUSION

This Article concludes by highlighting issues of wider importance raised by the discussion. The first is who is best placed to make judgments that depart from market norms, the courts or regulators. Regulators can set higher standards than the market *ex ante*, but they are less well-placed to do so *ex post*. Unlike the courts, they can be, or perceived to be, influenced by political concerns and self-interest.¹⁸³ This perception is likely to be strong where the regulator enforces norms that diverge from those of the market and will pose risks to the regulator's legitimacy. Legitimacy with the regulated is critical as it reduces challenges to the regulator's authority, thus enhancing the effectiveness of the regulatory framework. While these concerns apply even when the regulator articulates standards that depart from the market's *ex ante*, they would be greatly exacerbated when it does so *ex post*. To strive for legitimacy, the regulator must not only promote Rule of Law values that law should be certain, stable, and prospective, but also the regulatory values of transparency, openness, and participation.¹⁸⁴ A standard of reasonableness that is given content *ex post* could flout these requirements. On the other hand, penalizing conduct that offends against shared community values would not offend against the principle of retrospectivity, and it is a regulator's public interest role to give expression to community values within the parameters of its regulatory objectives. Furthermore, legitimacy with

183. See, for example, the response to the FSA's report into the collapse of the Royal Bank of Scotland in Richard Partington, *FSA Given Frosty Reception on Hostile Bank M&A Call*, FIN. NEWS (Dec. 13, 2011), <http://www.efinancialnews.com/story/2011-12-13/reaction-fsa-ban-on-hostile-bank-m-and-a?ea9c8a2de0ee111045601ab04d673622>; see also *Final Notice: Peter Cummings*, *supra* note 77, ¶ 5.3 (Cummings's submissions).

184. Black, *supra* note 87, at 95.

the regulated cannot be a conclusive factor governing the content of the regulatory standard of care: society may wish some kinds of behavior to be controlled regardless of the perception of the regulated about those controls. If the regulator fails to respond to these expectations, it risks losing legitimacy with the public, a situation that Black has referred to as a regulatory “legitimacy paradox,”¹⁸⁵ because the steps regulators may need to take to satisfy one constituency will deprive them of legitimacy in the eyes of another. One response to this paradox is for broad regulatory standards such as reasonableness to be enforced by the regulator through the courts. In the United Kingdom, in context of financial services, the Upper Tribunal (Tax and Chancery) can perform this legitimising judicial role, but not many cases are referred to it because of incentives to settle with the regulator.¹⁸⁶ Moreover, the Upper Tribunal (Tax and Chancery) will not become involved where the regulator decides not to take action at all. The FSA’s inertia following the financial crisis highlights the problems of a regulator enforcing a broad standard of reasonableness where it believes that the conduct in question either reflects market practices or has not been ruled out by formal *ex ante* norms. The risk of inertia is heightened since respecting market norms will safeguard the regulator’s legitimacy with the regulated. This raises issues of regulatory accountability.

Meanwhile, leaving the directors’ duty of care under section 174 of the Companies Act of 2006 to private enforcement means, as far as public corporations are concerned, that there will be no enforcement at all, particularly in those cases where the accountability deficit is most acute—where directors’ conduct imposes material costs on persons other than the shareholders. It has been argued that the duty of care owed by all directors to their corporations should be subject to a greater degree of enforcement, and others have argued that this could be achieved through public enforcement through the courts.¹⁸⁷ This raises the question of what the relationship should be between a director’s regulatory duty of care and a director’s duty of care under the Companies Act of 2006. There seems little reason for the role of market norms to be different under either regime. It is, however, unclear to what extent judicial decisions under a regulatory regime should take account of decisions applying section 174 and vice versa, or to what extent formal regulatory standards would

185. *Id.*

186. There are discounts for early settlement, FCA HANDBOOK DEPP 6.7, and costs will be less.

187. Keay, *supra* note 14, at 13. For similar calls in the U.S. context, see Jones & Welsh, *supra* note 115.

influence judgments of reasonableness under section 174. These issues require further exploration.¹⁸⁸

Unless judges, however, are prepared to take greater account of market norms, they are likely to give directors the benefit of the doubt and set a low standard of care. Public enforcement will not resolve this issue. Regulatory failure in financial services suggests that public enforcement of directors' duty of care will fail unless the regulator can be more confident about when behavior that accords with market practices will be held culpable by the courts: in the absence of greater certainty, the regulator will be reluctant to even instigate proceedings. This Article suggests how market norms should be treated. There may be disagreement about whether its conclusions are over- or under-protective of market norms, but the role they play in identifying a reasonable director is a critical factor in the wider debate over directors' accountability.

188. See Jennifer Hamilton, *Negligence in the Corridor? The Interaction Between "Separate Rooms" of Regulation and the Common Law in Financial Services*, 23 J. PROF. NEGL. 134 (2007).