

Inside the Corporate Veil:
The Character and Consequences of Executives' Duties

By

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I. Introduction

Within medicine, pathology is the study or science of disease. The terminology used by medical practitioners reflects the fact that the work of pathology does not center on happy events and circumstances. A colleague reports that, in the hospital in which her brother practices anesthesiology, weekly pathology meetings are colloquially termed “M&M meetings,” abbreviating “Morbidity and Mortality.” The specialized vocabulary of pathology includes such terms as “atrophy,” “apoptosis,” and “necrosis,” all in the service of lending precision to the specification of what has gone wrong, why, and what the consequences appear to be.¹ Pathology, it is said, forms an intellectual and practical bridge between the basic medical sciences and the practice of medicine.² In more colloquial usage, references

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¹As with many things, the internet makes available to any user a broad range of material concerning pathology, all without intermediation by any medical professional. For example, one may visit “The Pathology Guy” at www.pathguy.com where, according to Google’s description, “[g]eneral topics are discussed as well as articles on autopsies, evidence collection and other forensic issues.”

²See NEVILLE WOOLF, *PATHOLOGY: BASIC AND SYSTEMIC* 3 (1998).

to pathology carry the connotation of abnormality or malfunction.³

By directing our attention to “Corporate Pathology,” this workshop’s organizers invite reflection on the causes of corporate scandals and malfunctions more generally. Much scholarship in corporate law over the last few years has pursued an exercise in pathology with two distinct focal points, which in turn are reflected in recent legal and regulatory reforms. These are (1) malfunctions within boards of directors, in particular the inadequate performance of non-executive directors in relationship to the corporation’s senior management;⁴ and (2) poor service by gatekeepers situated externally to the corporation itself, including auditors, securities underwriters and analysts, and lawyers.⁵

My thesis is that an additional focal point is necessary for fuller understanding of the causes of many forms of corporate malfunction. This distinct target for scholarly engagement with corporations looks, as my title suggests, “inside the corporate veil,” that is, at organizational structures and patterns of interaction below the level of the board within a corporation’s hierarchy. These structures and patterns define a corporation’s culture. Especially significant aspects of corporate culture include how information generated within the corporation is handled internally and disseminated externally, as well as

³And “pathological” is a pejorative way in which to characterize an actor or conduct. For a recent example, see JOEL BAKAN, *THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER* (2004).

⁴For example, the leading academic critique within legal scholarship of managerial compensation practices identifies senior executives’ exercise of dominance over non-executive directors as the mechanism that enables the level of payment to be detached from job performance. *See* LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

⁵The leading example is John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 *BUS. LAW.* 1403 (2002).

the perspective with which individual actors within the corporation perform their work and resolve questions involving compliance with regulation and with the law more generally. By glancing away from actors and activity situated deeper within the corporate hierarchy, corporate law scholarship risks ignoring factors that inevitably shape corporate conduct, while over-emphasizing others. Along these lines, the report of the HIH Royal Commission into the failure of a large Australian insurer observed, “There is a danger in the current emphasis on the roles and responsibilities of boards of directors. It may cause to be overlooked the reality of the necessarily greater part that executives and other employees play in the day-to-day running of many corporate businesses.”⁶

This organizational and operational reality frames this paper’s assessment of the duties that corporate law imposes on executives and other managerial employees who are not members of a corporation’s board and the consequences that should follow when those duties are breached. By imposing mandatory duties in this context, corporate law backstops individual actors’ capacity to distance their conduct from questionable aspects of a corporation’s culture. However, the character and content of these duties is less well settled than might initially be supposed, as is the range of actors who are subject to them.

The paper begins by presenting a basic perspective on managerial work, drawing primarily on the common law of agency but referring at points to insights from the sociology of organizations. The paper turns next to two leading examples of recent corporate malfunctions that stemmed at least in part from the conduct of executives and other employees operating below the level – and it may well be, the

⁶1 HIH ROYAL COMMISSION, THE FAILURE OF HIH INSURANCE 104 (2003).

radar screen – of the board. Both instances – Enron and the collapse of HIH Insurance – generated factually rich narratives that cast light on managerial failures, distinct from the immediate role of the board.

Against this background, the paper focuses on a series of issues in Australia and the United States concerning the duties of executives and other corporate personnel operating below board level. These include the relationships between the statutory and non-statutory law applicable to an organization and general principles of agency and tort law as well as the nature of business judgment and the scope of any “business judgment rule” in contrast to legal standards applicable to the exercise of professional judgment and any agent’s common-law duties of care, skill, and diligence. Typical formulations of the “business judgment rule” apply awkwardly at best within the environment of work done by executives, most pronouncedly so when an executive is a member of a profession. The paper concludes by suggesting more general implications that may be drawn from instances of problematic executive conduct within Enron and HIH.

II. The Context of Executive Work

As a prelude to specific illustrations of the role of non-board-level actors in corporate collapses, some formal characteristics of the structure and operation of organizational management are worth noting. From the perspective of common-law agency, all of an organization’s employees—wherever situated within the organization’s hierarchy—are its agents in connection with their

organizationally-related activities.⁷ Whether or not an employee, a corporate officer is an agent of the corporation, while a single member of a board of directors is not an agent simply by virtue of holding membership on the board.⁸ A corporation or other organization with any degree of size or complexity necessarily stratifies its agents, conferring on some the authority to delegate matters to others.⁹ Like other organizations, corporations develop routines to communicate with those external to the organization as well as practices that determine how information is transmitted within the corporation and disseminated externally. Corporations also develop practices through which agents are furnished with instructions that direct the actions they should take and impose limits on their authority to act on behalf of the corporation, all ultimately derived from authority delegated by the board.

But slippage may occur. Some agents misunderstand the import of their instructions. Others resolve doubts in a way that proves unacceptable to their superiors within the corporation, either because the agent appears to have been dense or recalcitrant or, more cynically, because the outcome of the agent's action is not advantageous to the corporation at the time that outcome becomes known. A corporation may also signal its agents that noncompliance with instructions may be tolerated, for example by rewarding agents whose unauthorized action turns out to have favorable consequences for the corporation. How a corporation compensates its agents and otherwise furnishes incentives to them

⁷See RESTATEMENT (THIRD) OF AGENCY § 1.01, Comment *c*; G.E. DALPONT, THE LAW OF AGENCY 199-205 (2001).

⁸See DALPONT, *supra* note 7, at 119 (2001). A board may of course delegate authority to one of its members to act as an agent on the corporation's behalf. *Id.*

⁹The ability to delegate has been characterized as the essence of management. *See* Schoonejongen v. Curtiss-Wright Corp., 143 F.3d 120, 127 (3d Cir. 1998). On the structure of reporting systems entailed by delegation, see Robert Charles Clark, Corporate Law 801-816 (1986).

may shape how agents understand what the corporation wishes them to do.

Delegated authority to supervise and otherwise direct other actors within an organizational hierarchy creates dynamics of its own. Relationships between senior and subordinate members of management are the mechanisms through which a corporation's objectives are translated into results through measures that require day-to-day action. By demanding or rewarding the accomplishment of what must be done, senior management dominates more subordinate managers, often by communicating a sense of exigency.¹⁰ Subordinate managers occupy a position that, tending to attract blame when things do not go well, creates incentives to generate and document explanatory rationales.¹¹ These strategies often do not protect subordinate managers from the consequences of disaster when it materializes.¹² The same hierarchical relationships that tend to work to insulate more senior managers from sufficiently close association with the makings of the disaster may also insulate them from the knowledge required to take timely action.

III. Glimpses Inside the Veil

A. Enron and the Basics of Financial Management

¹⁰See ROBERT JACKALL, *MORAL MAZES: THE WORLD OF CORPORATE MANAGERS* 117 (1988).

¹¹See *id.* at 89 (describing incentives to “stake out defensible ground against opposition or construct plausible alibis”).

¹²But some thrive because they are able to outrun their mistakes. One of Professor Jackall's subjects characterized the ability to outrun one's mistakes as “the real meaning of ‘being on the fast track’, noting that ‘one way of looking at success patterns in the corporation is that the people who are in high positions have never been in one place long enough for their problems to catch up with them....’” *Id.* at 90.

The collapse of Enron Corporation is often attributed to the inability of systemic gatekeepers—auditors, securities analysts, credit rating agencies—to discern that underlying financial realities were at odds with the company’s financial statements.¹³ Accounts of failure in Enron’s internal governance tend to emphasize its supine and credulous board of directors and its problematic senior management, some of whose members engaged in criminal and self-serving conduct.¹⁴ Less visible are examples of singular ineptness below the level of the board.¹⁵

Consider in this light the following incidents. Enron’s financial condition was worsening in late October 2001 and Greg Whalley, the company’s newly appointed President and Chief Operating Officer, terminated the services of the company’s Chief Financial Officer (CFO), Andy Fastow. To succeed Mr. Fastow as CFO, Mr. Whalley appointed Jeff McMahon, who had previously served as Treasurer. Mr. McMahon asked an assembled group of financial executives to explain why Enron had been excluded from participation in the commercial paper market, the market for short-term debt instruments through which the company generated cash requisite to its energy-market trading and other operations.¹⁶ An underling replied: “We’ve been seeing the changes over the past number of days” At first, Enron was unable to sell notes due in thirty days and could only find buyers for two-week

¹³See Coffee, *supra* note 5.

¹⁴See, e.g., Marleen A. O’Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CINN. L. REV. 1233 (2003).

¹⁵For an account of Enron’s collapse that links managerial attitudes toward business risk to incentives created by, inter alia, the company’s business plan and stock option packages, see William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).

¹⁶This account comes from KURT EICHENWALD, *CONSPIRACY OF FOOLS* 559 (2005).

notes, then over the past week, nothing but overnight paper could be sold, implying that investors in short-term debt doubted the company's ability to do more than repay loans due within twenty-four hours. Then Enron's overnight paper became unmarketable as well. The journalist Kurt Eichenwald reports that "McMahon gaped at the people in the room. 'So you mean to say that over the past week, we've been seeing this train wreck coming, *and nobody did anything about it?*'"¹⁷

Enron's history may explain why responsive action was not taken—or at least attempted—any earlier. Such a funding crisis was unprecedented within Enron, which may have led its financial executives to believe that the company would surmount the crisis without resorting to extraordinary means. And the financial team lacked leadership. Andy Fastow's own crises stemming from his personal stake in partnerships created to deal with Enron had attracted widespread adverse publicity that engulfed him and provoked his termination. Moreover, Enron's organizational culture may have worked to discourage necessary action that would acknowledge the reality of crisis.

From the perspective of its new CFO, even more startling limitations soon emerged. Jeff McMahon next learned that Enron lacked any method with which to track its cash and thereby determine just how much cash the organization had available to it at a particular time. Thus Mr. McMahon could not determine how much to draw down from revolving lines of credit Enron had established with banks. Said McMahon, "That's *impossible!* We're a Fortune 50 company. We *have* to be tracking our cash."¹⁸ A company that did not to track its cash was comparable to an individual who failed to balance his or her checkbook. No one knew, though, how much cash Enron had

¹⁷*Id.*

¹⁸*Id.* at 559-60.

generated through its business operations and how much cash stemmed from collateral posted by trading partners. Again, Enron's history may suggest an explanation: "[a]pparently Fastow had always thought that Enron would have more than enough cash to spare," and, given that assumption, neglected to develop any cash-tracking systems.¹⁹

And then Ray Bowen, a vice president soon to become the Treasurer, learned that Enron, strapped for cash and burdened by a lot of debt, also lacked any day-to-day sense of when its debt matured. Mr. Bowen directed Ben Glisan, the company's incumbent Treasurer, to go get a current schedule of debt maturities. Mr. Glisan replied, "I think I can get someone to pull that together." Mr. Bowen, shocked, replied "Go get it! You *have* to have a maturities schedule." But Enron lacked one. This was because the "workaday, boring details" that constitute the fundamentals of corporate finance did not capture management's attention, given Enron's focus on profits and deals and its use of its finance group to generate reportable profits through the creative use of special-purpose entities.²⁰

To be sure, management's obliviousness to the details of Enron's cash position did not in itself cause the company's collapse. But when confronted with the payment demands made by Enron's outstanding debt, management's ability to respond was inhibited. Moreover, earlier assurances that the company had plenty of cash to withstand crises may have emboldened senior management to take on

¹⁹*Id.* at 560.

²⁰*Id.* at 560-61. An ugly picture emerged when Mr. Glisan finally assembled a maturities schedule. Enron had more than 30 billion dollars in debt outstanding, ten billion of which would come due within the next 12 months. Even this number fell short; Glisan and his team overlooked another 2.6 billion also due within the next 12 months. *Id.* at 561. Whatever Enron's cash position may in fact have been, it lacked the funds to effect repayments of this magnitude. Unless it could generate more cash or renegotiate the terms of its debt with the lending banks, Enron would be insolvent.

yet riskier transactions.²¹

Enron's financial managers did not work in an organizational vacuum that just happened to be unusually congenial to executives unconcerned with the basics of financial management. Prior to his resignation in summer 2001, Enron's CEO, Jeffrey Skilling, tasked the company's chief risk officer and an analyst to assess how well Enron would fare in the event of a global calamity so that he could reassure the board. The response was comforting – only a couple of billion of dollars would be needed to ride out a calamity such as a major nuclear accident – and Mr. Fastow and Mr. Glisan reported that much more cash was available (without, as we've seen, having the benefit of a precise fix on the specifics of Enron's cash position). The risk assessment did not, however, include the consequences of a credit downgrade or mandated disclosure of losses allocated to special purpose vehicles.²² Those assessments, done by others several months before the collapse, projected doom for Enron in short order were its stock price or credit rating to drop. Mr. Glisan ignored them and did not share the bad tidings with his superiors in Enron's hierarchy.²³ It is, of course, unknowable in retrospect how more senior executives might have responded had they learned about the dire consequences of a risk they likely viewed as remote.

²¹*Id.* at 473.

²²*Id.*

²³*Id.* at 429-32. Mr. Glisan's failure to tell Mr. Fastow, his superior as CFO, may have been related to Glisan's profit from his membership in a partnership organized by Fastow. Mr. Glisan may have been reluctant to take any step that might jeopardize the deal. *Id.* at 432. In 2003 Mr. Glisan pleaded guilty to charges of conspiracy to commit fraud by structuring special purpose vehicles in violation of accounting rules. *Id.* at 670.

B. HIH and the Basics of Insurance

Despite the notoriety of its collapse, Enron is not unique as an instance of large-scale executive mishaps. The failure of HIH Insurance illustrates, among other things, how an organizational context may accentuate the cumulative impact of individual failings. Although the insurance industry is intrinsically cyclical, HIH's collapse is attributable to factors specific to it: a sustained pattern of poor business decisions, sloppiness in many forms, plus weak corporate governance typified by "blind faith in a leadership that was ill-equipped for the task."²⁴ Indicative of the relationship between the board and management, HIH's directors recalled no occasion in which the board rejected or materially changed a proposal from management.²⁵ HIH's collapse, unlike Enron's was not preceded by large-scale fraud or insider extractions from the company. However, the financial magnitude of HIH's collapse—a shortfall of potentially \$5.3 billion—may be Australia's largest and thus comparable in relative terms to Enron in the annals of corporate fiascos.

Like Enron, HIH appears to have had an under-involved and under-informed board plus poor internal controls and reporting practices. Unlike Enron, HIH also retained characteristics of a private company dominated by its founder, Raymond Williams, who remained a major shareholder following HIH's public float in 1992.²⁶ Following HIH's merger with a Swiss insurer, Winterthur, in 1995, Mr. Williams pressed ahead to expand HIH's operations in the United Kingdom and the United States, despite (in Winterthur's view) having given assurances HIH would concentrate on Australia. Three

²⁴1 HIH ROYAL COMMISSION, *supra* note 6, at xvii.

²⁵*Id.*, vol. 3, at 262.

²⁶*Id.*, vol. 1, at 52.

years later, Winterthur sold its interest in HHH. Winterthur recognized that it had a predicament: although it was unwilling to bring about changes in the composition of HHH's board, the present board ignored its concerns in connection with major acquisitions and other strategic questions.²⁷

After Winterthur's exit, HHH acquired FAI Insurances, which contributed unexpected losses, and then, shortly before its end, entered into a joint venture relationship with Allianz. Under the joint venture agreement, each insurer was to transfer some insurance lines to the venture and contribute funding to a claims reserve trust. HHH anticipated using the \$200 million it would receive from Allianz to shore up its operations but was obliged to contribute the entire sum to meet its obligation to fund the claims reserve trust. The market became increasingly skeptical, and HHH's end was soon to come.

Some of HHH's operations functioned without adequate controls over underwriting, that is, the decision to insure a particular risk. Its UK branch had no reporting structure that would enable others in the HHH organization to know what risks were being taken.²⁸ In one especially problematic line, film finance insurance,²⁹ business was written initially without the knowledge of branch management. Explicit underwriting guidelines were breached.³⁰ Separately, the UK regulator notified HHH's UK branch that

²⁷*Id.*, vol. 2 at 22.

²⁸*Id.*, vol. 2, at 37.

²⁹This is a form of loss indemnity insurance written to cover the risk to financiers who lend money to film producers that revenues will be insufficient to cover production costs and repay the lenders. *Id.*, vol. 2, at 49.

³⁰*Id.*, vol. 2, at 49-50. In another instance of a breach of an underwriting guideline, HHH's UK branch wrote personal accident coverage for Taiwanese military personnel regardless of whether injuries occurred on military duties or otherwise. *See id.* at 42.

its compliance record for Lloyd's underwriting was “one of the worst....”³¹

More generally, HHH experienced instances of “rogue underwriting” undetected by its control systems. For example, “fronting” occurred without the high-level management approval required by HHH's underwriting guidelines. One insurer “fronts” for another when, in exchange for a fee, it issues policies subject to an agreement that the other insurer will accept all the risk, a practice that may occur when the other insurer is not licensed to write a particular kind of coverage.³²

Systems within HHH to assure that proper information reached its board in a timely fashion did not function well. In basic insurance terms, HHH appears consistently to have under-provisioned, that is, neglected to provide properly for future claims. Its board failed to identify and deal with underprovisioning, to which the Royal Commission attributes HHH's downfall. The board did not grasp the critical nature of assumptions made by HHH's auditors and actuaries³³ in setting reserve figures. Moreover, HHH's management engaged in financial practices that may have misled. HHH, like FAI,

³¹*Id.*, vol. 2, at 61.

³²*Id.*, vol. 1, at xxxiv.

³³HHH's consulting actuary acted subject to instructions received from his client, which directed him to use a specified discount rate and not to incorporate a prudential margin in his calculations. *Id.*, vol. 2, at 299. A prudential margin reflects a cautious approach to calculating an insurer's outstanding claims provision. *Id.*, vol. 1, at 79, 84. Its use has the effect of delaying the recognition of profit and thus the availability of funds for dividends. *Id.* at 84. HHH, instead, reserved to a central estimate, which is the mean of the distribution of possible outcomes in claims experience. The Royal Commission's report does not criticize HHH's actuary for complying with his client's instructions but does criticize HHH's directors for failing to appreciate the significance of the actuary's assumptions. *Id.*, vol. 2, at 302, vol. 3, at 260.

looked to financial reinsurance as a mechanism to improve the appearance of its balance sheet.³⁴

Members of middle management, additionally, engaged in financial manipulation of information provided to the board, HIH's auditors, and its regulator, the Australian Prudential Regulation Authority.³⁵ This led to referrals by the Royal Commission to enforcement authorities.³⁶

Although it's possible that HIH managers who engaged in "rogue underwriting" did so for idiosyncratic reasons, it's more likely that their conduct seemed consistent with practices tolerated, if not encouraged by, executives at higher levels within HIH. Likewise, decisions made by middle managers on the ground that led to financial misstatements had counterparts in conduct of members of senior management.³⁷

IV. Duties Below Board Level

This section examines aspects of duties owed by corporate executives who function below the

³⁴"Financial" reinsurance differs from conventional reinsurance in which an insurer cedes part of the risk it has assumed to another insurer, either wholesale through "treaty" reinsurance or more selectively. The HIH Royal Commission characterized the type of "financial" reinsurance used by HIH and FAI as "more like a deposit arrangement which, whether or not it is accompanied by risk transfer, is primarily directed at the appearance of the balance sheet." *Id.*, vol. 1, at xxx-xxxii.

³⁵*Id.*, vol. 1, at xii.

³⁶On referrals of executives who were not members of HIH's board, *see, e.g., id.*, vol. 3, at 34 (involvement in negotiation of letter of credit arrangements to support operation; secretary's belief assets were subject to a negative pledge would indicate failure to exercise care and diligence reasonably to be expected of person in position); 342 (secretary signed backdated documents to give effect to issue of preference shares). *See also id.* at 342-44 (discussion of whether executives' handling of accounting for preference share issue involved breaches of law).

³⁷Mr. Williams pleaded guilty to three charges arising from his management of HIH, all involving making misleading statements or omitting to disclose material facts in contravention of the Corporations Act. *See* JEAN JACQUES DU PLESSIS ET AL, PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE 287-88 (2005).

level of the corporation's board, including legal sources for these duties and the standard applicable to determining whether an executive has fulfilled a duty of care owed to the corporation. The section then turns to how various statements of the business judgment rule may apply to decisions made by executives. Section V concludes with possible implications that one might draw from the stories of executive mishap within Enron and HIH.

A. Organizational Law and General Law

1. Legal sources of officers' duties. An initial consideration is the relationship between general law and the law—whether or not articulated in a statute—specifically applicable to corporations. The general law of agency imposes duties of loyalty and duties of performance on any agent. An agent's duties of performance include a duty to act with the care, competence, and diligence normally exercised by agents in similar circumstances.³⁸ If an agent claims to possess special skills or knowledge, the agent's duty is to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge. Although a contract between a principal and an agent may set benchmarks for what may be expected of the agent, an agent's breach of the basic duty of care is tortious. General principles of agency law create no presumption that an agent has satisfied the agent's duties, including the duty of care, just as tort law creates no presumption that a professional has satisfied duties owed by the professional to a client.

Corporation statutes vary in whether they articulate the duties owed by a corporation's officers. Jurisdictions within the United States with statutes that follow the current Model Business Corporation

³⁸See RESTATEMENT (THIRD) OF AGENCY § 8.08.

Act prescribe standards with which to determine whether an officer has fulfilled the officer's duties.³⁹

Although statutes in this pattern leave to general law the content of an officer's duty of loyalty, the statutory standard for assessing an officer's conduct—comparable to the standard applicable to directors—requires that the officer act in good faith, with the care that a reasonably prudent person would exercise in like circumstances, and in a manner the officer reasonably believes to be in the corporation's best interests.⁴⁰

In contrast, the Delaware corporation statute does not articulate comparable standards against which to assess the conduct of officers and directors. An actively debated question is whether the extensive body of Delaware caselaw applicable to directors applies to officers as well. Although this debate focuses primarily on the availability of the business judgment rule to officers,⁴¹ a point explored below, it's worth noting that under Delaware cases, the standard of care applicable to directors who make business judgments is gross negligence.⁴² Although what makes negligent conduct “gross” as opposed to “ordinary” does not appear to be precisely defined, “gross negligence” generally connotes

³⁹See Rev. Model Bus. Corp. Act § 8.41 (officer shall perform duties set forth in bylaws or, consistently with bylaws, duties prescribed by board or by officer authorized by board to prescribe duties of other officers)

⁴⁰*Id.* § 8.42.

⁴¹Compare Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005)(rule is and should remain inapplicable to officers) with Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865 (2005)(rule is and should remain applicable to officers).

⁴²See *Smith v. Van Gorkom*, 488 A.2d 873, 873 (Del. 1985).

conduct of an aggravated or extreme character falling short of reckless disregard of a known risk.⁴³ The gross negligence standard is at odds with the standard of ordinary care applicable to employees and agents more generally.⁴⁴

It may seem incongruous that agents situated higher in a corporation's hierarchy would be subject to a lower standard of care (gross negligence) than the standard applicable to ordinary agents and employees. The incongruity stems from two factors. First, the more elevated an agent's position within a hierarchy, the higher the expectations for the quality of the agent's performance. Second (and relatedly), the higher the agent's position, the greater the detrimental impact that may follow from the agent's failure to act with care.

The counterpart Australian doctrines are articulated by statute. In the current Australian Corporations Act, §180(1) states the duty of care and diligence owed by directors and officers, which is to "exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise" as a director or officer holding the same position with the same responsibilities in a corporation with the same circumstances. Section 181(1) states a duty to act in good faith and for a proper purpose, and §§182(1), 183 (1), and 184(1) state duties of loyalty. The

⁴³On the meaning of "gross negligence," see RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL HARM § 2, Comment *a* (Proposed Final Draft No. 1, 2005)("[t]aken at face value, this term simply means negligence that is especially bad."). In contrast, "[a] person acts negligently if the person does not exercise reasonable care under all the circumstances." *Id.* § 3. An actor's conduct is reckless if it creates a known risk of harm that can be reduced by relatively modest precaution and, aware of the risk or facts that would make it obvious to a reasonable person, the actor fails to adopt the precaution. *Id.* § 2, Comment *a*.

⁴⁴See Restatement (Third) of Agency § 8.08.

Act also imposes duties on officers related to other matters of internal management⁴⁵ and financial reporting,⁴⁶ as well as imposing specialized liability regimes in connection with fundraising, continuous disclosure, and takeovers. In contrast with the Delaware standard of gross negligence, the applicable standards of care and diligence are benchmarked against the conduct of a reasonable person in the same position with the same responsibilities and under the same circumstances.

2. *Acting as an officer as opposed to an agent or a professional.* One might wonder under what circumstances an agent of a corporation should be characterized as an “officer,” in particular when legislation attaches specific duties and liabilities to persons determined to be “officers.” Contemporary corporation statutes in the United States prescribe little about officers. Under the Delaware statute, a corporation “shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board” that is consistent with the bylaws and “as may be necessary to enable” the corporation to sign share certificates and other instruments.⁴⁷ One officer must have the assigned

⁴⁵Corporations Act §§ 254L, 256D, 259F, and 260D(share capital), applicable under § 79 to “persons involved in a contravention ” of the Act.

⁴⁶*Id.* §§312 (duty of officer to allow auditor access to company’s books and to give any required information, explanation, or assistance); 295A (duty of person performing (undefined) CEO or CFO function to provide declaration concerning accuracy of financial records); 323B (duty of officer to provide information to auditor of controlling entity and otherwise assist in preparation of consolidated financial statements); 1307(1)(offense to conceal, destroy, mutilate, or falsify books relating to company’s affairs, subject to defense of honest action under § 1307(3)); 1308(2)(offense to knowingly make or authorize the making of a false or misleading statement in any document required by Act or submitted to ASIC); 1308(4) (offense to fail to take reasonable steps to ensure veracity of any relevant statement made or authorized in such document);

⁴⁷Del. Code Ann., tit. 8, § 142(a).

function of recording the proceedings of meetings of directors and shareholders.⁴⁸ The Revised Model Business Corporation, likewise, prescribes little, permitting “every corporation to designate the offices it wants.”⁴⁹

A basic structural difference between U.S. corporation statutes and the Australian Corporations Act is that the Act defines the term “officer” to include directors while also defining in relatively narrow terms the set of other actors who may be “officers”. In the Corporations Act, § 9 defines an “officer” as a director⁵⁰ or secretary of a corporation, or as a person “who makes, or participates in making, decisions that affect the whole, or a substantial part, of” the corporation’s business, or “who has the capacity to affect significantly the corporation’s financial standing”

This definition has the effect of excluding executive managers, regardless of their title or function, whose decisions are more localized in effect or more distanced from business dealings. Within a corporate group, moreover, the definition may not apply to executives who function below the holding-company level, however significant their authority within a particular subsidiary. The definition also excludes persons who may well exercise managerial functions for a corporation who are neither employed nor appointed as officers by it. Thus, the definition would exclude the lead personnel of an

⁴⁸*Id.*

⁴⁹Rev. Model Bus. Corp. Act § 8.40, Official Comment.

⁵⁰Subsection (b)(i) of the definition includes shadow directors, persons “in accordance with whose wishes the directors of the corporation are accustomed to act” other than in connection with the proper functions attached to a person’s professional capacity or business relationship with the corporation or its directors.

external firm of auditors to which a corporation outsources its internal audit function.

This wider cast of corporate characters appears not to be subject to the duties made applicable to officers by the Corporations Act. This gap in statutory coverage, identified by the HIH Royal Commission, would be remedied by the statutory reinstatement of a definition of “executive officer” recently proposed by the Corporations and Markets Advisory Committee (CAMAC).⁵¹ Under CAMAC’s proposed definition of “executive officer,” any person “who takes part in, or is concerned, in the management of” a corporation would be an executive officer of that corporation.⁵² Such persons would be subject to a range of duties articulated in the Act, including the duty of care and diligence stated in § 180(1).

3. *The business judgment rule.* Within U.S. jurisdictions, the business judgment rule remains predominantly a doctrine articulated in cases. Delaware cases characterize the rule as a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.”⁵³ The party challenging the decision has the burden of establishing facts that rebut the presumption.⁵⁴ The functional consequence of the rule’s application is that the court defers to the board’s decision unless it

⁵¹See CORPORATIONS AND MARKETS ADVISORY COMMITTEE, CORPORATE DUTIES BELOW BOARD LEVEL (Discussion Paper 2005). Prior to 2004, the statute included the defined term “executive officer,” which encompassed a broader class than does the present definition of “officer” in § 9.

⁵²*Id.* at 24.

⁵³*Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

⁵⁴*Aronson*, 473 A.2d at 812.

cannot be attributed to any rational business purpose.⁵⁵ As noted above, it's actively disputed whether under Delaware law the rule does or should apply to a corporation's officers.⁵⁶ The Revised Model Business Corporation Act, although articulating circumstances under which a director should not be subject to liability, explicitly notes that it does not "codify the business judgment rule as a whole."⁵⁷ The Act, which recognizes in comment material that officers are subject to agents' duties and the associated standard of care, appears nonetheless to embrace application of the business judgment rule to

⁵⁵*Brehm*, 746 A.2d at 264 nn. 65 & 66. Relatedly, Delaware, like other U.S. jurisdictions, permits a company to include a provision in its charter that exculpates directors against breaches of duty. Under § 102(b)(7), an exculpatory provision is ineffective to limit or eliminate liability that stems from a breach of the duty of loyalty, from acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law, from illegal dividends and other distributions to shareholders, or from a transaction from which a director benefitted personally. The availability of protection under an exculpatory provision operates as an affirmative defense. The court examines conduct on a director-by-director basis. *See In re Emerging Communications, Inc. Shareholders Litig.*, 2004 WL 1305745 (Del. Ch., June 4, 2004). Section 102(b)(7) applies only to directors. It's yet to be resolved whether and to what extent a corporation's directors could exculpate an officer or employee by contract.

Delaware, like other U.S. jurisdictions, also permits corporations to indemnify directors and officers against expenses they incur in connection with litigation stemming from their corporate positions. Although the Delaware statute regulates the process that precedes indemnification and limits its availability in some circumstances, the statute also permits corporations to create additional rights to indemnity by agreement or otherwise. *See Del. Code Ann., tit. 8, § 145 (f)*. Federal courts interpreting Delaware law have held that contractual indemnification is subject to public policy limits that mirror the circumstances in which, under the statute, indemnification is not available in the absence of a right created by agreement, such as liability stemming from conduct in which a director did not act in good faith or did not believe that his or her conduct was in the best interests of the corporation. *See Waltuch v. Conticommodity Services, Inc.*, 88 F.3d 87, 91-93 (2d Cir. 1996).

⁵⁶*See supra* note 41.

⁵⁷Rev. Model Bus. Corp. Act § 8.31, Note ("[b]ecause the elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts, it would not be desirable to freeze the concept in a statute.").

“decisions within an officer’s discretionary authority.”⁵⁸

Within the Australian Corporations Act, the business judgment rule is articulated in a provision that explicitly covers officers as well as directors. Section 180(2) states a business judgment rule: a director or officer who makes a business judgment “is taken to meet” the requirements of § 180(1) if the director or officer makes the judgment in good faith for a proper purpose, has no material personal interest in its subject matter, is informed about the subject matter to the extent the director reasonably believes appropriate, and “rationally believe[s] that the judgment is in the best interests of the corporation.” This is so, under § 180(2), if the judgment “is a rational one unless the belief is one that no reasonable person in their position would hold.”⁵⁹ Section 180(3) defines a “business judgment” as “any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.” CAMAC, in proposing to expand the cast of characters subject to duties under the Act, has also proposed that “as a corollary” of expanding the coverage of duties stated in § 180(1) the business judgment rule articulated in § 180(2) be “extended beyond directors and other officers of a corporation to any other person who takes part, or is concerned, in the management of the corporation.”⁶⁰

As applied to corporate officers, § 180(2) diverges from the common law of agency in two respects. First, an officer “is taken as” having discharged the officer’s duties of care and diligence stated

⁵⁸*Id.* § 8.42, Official Comment.

⁵⁹A Note to this section states that it “operates in relation to duties under this section and their equivalent duties at common law or in equity,” but not under any other provision of the Act or any other law.

⁶⁰CORPORATE DUTIES BELOW BOARD LEVEL, *supra* note 51, at 24-25.

in § 180(1) if the officer meets the requisites stated in § 180(2). In contrast, the common law of agency does not presuppose that an agent has discharged the agent's duties of performance because of other characteristics of the agent's action, such as having acted in good faith. Second, the operative standard of performance for purposes of § 180(2) is not parallel to the standard of common-law agency, which would require that an officer have acted with the care, skill, and diligence ordinarily to be expected of a comparably-situated officer. To be sure, § 180(2) requires that the officer have been informed to the extent the officer reasonably believed appropriate. But § 180(2) does not delve further into how the officer then proceeded to make a particular judgment, looking only whether the officer "rationally believe[d]" the judgment was in the corporation's best interests, a standard satisfied unless no reasonable person in such a position would share the belief.

4. Business judgments and work done by professionals and other business executives.

Defenders of applying to officers the Delaware version of the business judgment rule—and its accompanying standard of gross negligence—emphasize the concern that officers, facing a standard of ordinary negligence, will be deterred from undertaking risky but potentially valuable business opportunities.⁶¹ This defense conflates the applicable standard of care—whether ordinary or gross negligence—with the analytically distinct point that it is desirable that a court not second-guess the substantive merits of business decisions. Moreover, it does not explain why adverse outcomes stemming from work done negligently by corporate officers should be treated differently from adverse outcomes stemming from negligently done work performed by other actors who furnish services. An

⁶¹See Hamermesh & Sparks, *supra* note 41, at 873.

officer may be appointed precisely because the officer is reasonably believed to have relevant skills and experience and in the expectation that the officer will diligently bring those skills and experience to bear in at least an ordinarily careful manner.⁶² To be sure, the undertaking of business risk is a socially desirable activity, but so are the practice of medicine and architecture, professions subject to a regime of ordinary negligence in malpractice litigation.

Formulations of the business judgment rule appear not to take into account the specifics of what executives do—which is highly variable—and what reasonably may be expected of their performance. In simple terms, the rule appears disconnected from the world of work. This may stem from conceptualizing, as the prototypical subject to which the rule applies, a board of directors that makes discrete decisions about particular transactions or other matters. Executives’ work, in contrast, may have fewer discrete points at which decisions are made.

And, in contrast to the original non-delegated power of the board,⁶³ executives have only delegated authority to act, either granted directly by the board or by an executive holding a superior rank. Complications in applying the rule follow as a consequence. Applying any formulation of the business judgment rule to executives, regardless of their rank or function, requires considering whether

⁶²See Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 St. John’s L. Rev. 767, 775 (2002)(arguing that officers’ unique knowledge and expertise underlies distinction between officers and directors and that officers breach their tort-law duty of care if they fail to “use their special knowledge of the corporation”).

⁶³If a corporation’s shareholders authorize action to be taken by directors with limits that the shareholders approve, action by directors outside those limits is a breach of duty. *See Sanders v. Wang*, 1999 WL 1044880(Del. Ch., Nov. 10, 1999)(once shareholders approved stock-grant plan for senior management covering specified number of shares, board increased number of shares awarded to reflect impact of stock splits, although plan approved by shareholders contained no relevant adjustment mechanism; shareholders stated claims of “waste” and breach of duty by board).

the rule protects only authorized action. One might think the answer is yes—how could an executive claim to act in good faith while contravening an instruction from the board or from a superior⁶⁴—but what may appear an unambiguous instruction to the board or a superior, especially in retrospect and in the wake of disastrous consequences, may not seem clear at all to an executive at the point of taking action. Indeed, an executive, having observed that prior contraventions of instructions or policy went unchallenged by superiors within the corporation, may conclude that the operational reality of organizational sanction and approval diverges from what might reasonably be understood based solely on the corporation’s formal rules.

Additionally, the board of a large company may include members who do not have operational expertise relevant to the corporation’s business. But competent work by officers requires such expertise, a distinction that formulations of the business judgment rule do not reflect. As drafted, § 180(2) does not take into account the expectations that an officer possesses the skills ordinarily associated with the officer’s position and that the officer will bring those skills to bear in the officer’s work. By focusing on “judgment,” § 180(2) skews analysis away from the skilled work that officers are expected to perform, focusing instead on an officer’s beliefs and their rationality. Such a focus does not typify professional malpractice litigation or claims asserted against agents more generally.

The fit between formulations of the business judgment rule and the work of officers becomes more awkward if the officer in question is a member of a profession. For example, a corporation’s

⁶⁴See Hamermesh & Sparks, *supra* note 41, at 876 (“an officer should not ordinarily be protected by the business judgment rule with respect to conduct that contravenes policies or directives established by the board of directors or by superior officers implementing board policy.”).

general counsel, as a corporate officer, may give legal advice that has a significant impact on the corporation's business when others within the corporation act on the advice. Is counsel's decision to give the advice a "business decision" for purposes of the business judgment rule? Probably not, as § 180(3) defines "business judgment." Although counsel's decision to give the advice (or the giving of the advice) may well be "relevant to the business operations of the corporation," the definition also requires a decision to take or not to take action "in respect of a matter" with that relevance. A general counsel's legal advice would typically not carry operational consequences until it is translated into action by other executives. This fact may more generally suggest a possible dividing line between managerial conduct and the provision of professional services by a corporate insider. Otherwise, a general counsel, as a corporate officer, would have available protection against liability stemming from negligent advice that would be unavailable to an outside counsel who gave the identical advice.

But suppose general counsel's advice—as well may be the case—mixes strategic business considerations and how they might best be achieved with legal analysis.⁶⁵ Is this more expansive counsel now eligible for the protection of the business judgment rule? Or is part of counsel's advice outside the rule and part within it?⁶⁶ This seems an awkward distinction that unrealistically segments one

⁶⁵For discussion of the contemporary position of general counsel within large corporations, see Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 Fordham L. Rev. 955 (2005).

⁶⁶CAMAC's discussion paper sought advice on whether to define conduct that constitutes "management" of a corporation. The suggested definition is "activities which involve policy and decision making, related to the business affairs of a corporation to the extent that the consequences of those policies or the making of those decisions may have some significant bearing on the financial standing of the corporation or the conduct of its affairs." CORPORATE DUTIES BELOW BOARD LEVEL, *supra* note 51, at 24.

integrated incident into separate compartments.⁶⁷ Or is the business judgment rule stated in § 180 (2) available only to those officers who themselves make ultimate decisions whether or not to take actions with operational effect? If so, decisions made by those officers whose role is advisory or supportive are not within the scope of the rule's protection.

One might also wonder, a bit more broadly, what meaning the rhetoric of "professionalism" carries within the organizational reality of management and within the conception of business decision-making presupposed by the business judgment rule. Perhaps making business judgments does not lend itself to the kinds of established standards of practice that underlie any recognized profession and prove amenable to proof and application when a professional's work is challenged in litigation.

V. Conclusion: Massive Collapses and Executives' Conduct, Duties, and Liabilities

The Enron and HIH stories have implications for the nature and consequences of executives' duties. Of course, it's reasonable to question whether conduct associated with massive collapses should be significant to the legal response to executives' conduct more generally. Two responses come to mind, the first an analogy drawn from the title of this workshop. Just as pathology's study of disease and malfunction is useful to persons who are healthy and wish to remain so, as well as to their medical advisers, corporate fiascos may be instructive more generally. Second, massive corporate collapses engender close scrutiny of conduct that would not otherwise be transparent. Detailed narratives of life

⁶⁷In some circumstances, courts have differentiated among the roles played by the same actor within a corporate context. In *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), a director who also served as the corporation's outside counsel drafted most of the registration statement for an offering of securities. The court's opinion differentiates between the roles, pinning the director's liability on his conduct as a director, not as the corporation's lawyer.

inside the corporate veil emerge as a consequence of the processes requisite to litigation, royal commissions, and investigative journalism. Scrutinizing these narratives provides a basis for at least tentative assessments of practices and types of conduct that may be problematic.

Both Enron and HIH illustrate that corporations, like other organizations, may define their own internal reality in ways that, while not sustainable over time, shape how individual executives perform their work. Thus, within Enron, for at least a while, the nitty-gritty details of basic financial management—cash-tracking systems and debt service and repayment schedules—were beside the point to such an extent that their absence went unnoticed. Financial executives, whose training and prior experience likely touched upon these basics,⁶⁸ ignored them in an organizational environment in which they appeared not to matter. In retrospect, it might even be difficult to specify any particular decision at any particular point made by any one executive to function without adhering to basic financial practices.

By mandating that an executive exercise care and diligence, the law encourages maintaining a healthy distance between how an individual executive chooses to do her work and the more problematic aspects of organizational reality as defined within a corporation. To be sure, the law does not operate alone in this regard; it complements and buttresses the force of an individual’s own sense of proper conduct and concern for reputation in the larger professional and business world external to a particular

⁶⁸Even Mr. Fastow, who came to Enron from doing complex asset securitization deals at Continental Bank, had an educational background that included an MBA. *See* EICHENWALD, *supra* note 16, at 50. Prior to his appointment as CFO, he was perceived within Enron as a “deal guy” who lacked the “chops” requisite for a CFO and who appeared not to understand the basics of debt management. *Id.* at 170, 172. Mr. Fastow became CFO only after a previously-promising external candidate, visiting the company, “seemed subdued; clearly something about Enron was bothering her.” *Id.* at 174. The other external candidate turned down the job. *Id.* at 175.

corporation. The law may, additionally, force the redesign of internal control mechanisms within a corporation, thereby serving as a counterweight to the variety of organizational forces that misshape flows of information within the corporation.⁶⁹

Enron and HIH also illustrate how individual executives may understand and act upon implicit norms defined by their superiors within a corporation. Underwriters at HIH who wrote coverage in clear violation of the company's standards were, in a formal sense, rogue actors who indulged in unauthorized conduct. But they functioned within an organizational structure without adequate internal reporting and other control structures, an organization headed by a CEO unrestrained by either the board of directors or commitments made to a major shareholder. Ongoing interactions and observed patterns of conduct, that is, supplemented or supplanted how HIH's underwriting guidelines would reasonably be understood as statements of conduct authorized by the corporation. HIH's rogue underwriters may have held a personal belief, rational in the circumstances, that their formally unauthorized conduct would further HIH's interests and that the corporation wished them to understand the guidelines as less than mandatory. Were HIH's rogue underwriters making decisions that would be protected by a business judgment rule? While one hopes the answer is no, the fact that this answer is not so evident on the face of typical formulations of the rule suggests the value of reconsidering how best to reformulate the rule if it is to apply to managerial actors, apart from the corporation's board, who hold only delegated authority to act on the corporation's behalf and who perform their work in a complex organizational setting.

⁶⁹For discussion of the mandates concerning internal controls imposed by Sarbanes-Oxley, see Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems,"* available at <<http://ssrn.com/abstract=808084>>.

My final point—which is that much interesting work remains to be done— is an optimistic one for scholars. Engagement with the realities of organizational life within the corporate veil has not typified much of corporate governance scholarship. But, as HIH and Enron illustrate, the work done by executives may contribute as much to corporate malfunctions as failings by boards of directors and external gatekeepers.