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THE DETERRENCE THEORY: A CASE FOR ENHANCED ENFORCEMENT OF DIRECTORS' DUTIES

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Abstract

This article is concerned with providing a justification for effective enforcement of directors' duties. It aims to consider whether enforcement of directors' duties is necessary. It argues that enforcement of directors' duties is crucial to effective corporate governance. Drawing on the deterrence theory, it argues that there is a clear link between increased enforcement and increased compliance. Enhanced enforcement of directors' duties is essential for securing compliance; countries therefore ought to put in significant effort to develop effective enforcement mechanisms.

Key words: Directors' duties, Enforcement, Corporate Governance, deterrence theory.

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I. Introduction

Directors play an important role in corporations. Their activities have significant effects on their companies' wealth, the wealth of their shareholders and the interests of other stakeholders in those companies (Keay, 2009). The law therefore regards them as fiduciaries. A key aspect of corporate law and governance is therefore concerned with providing rules which constrain potential abuses of power by directors (Davies & Worthington, 2016). These rules govern board structure, shareholders' governance rights and directors' duties. The third of these, directors' duties, are intended to provide boundaries within which directors may exercise their powers (Davies & Worthington, 2016). These duties are however not 'self-enforcing' (Black and Kraakman, 1996) consequently, breach may occur in different forms. Directors may divert the company's assets for their own personal use through self-dealing. This could be by exploiting potential business opportunities intended for the company or by selling assets to the company at a value which is higher than the current market price. Directors could also fail to give the company sufficient attention, preferring to spend their time on other leisure activities (Kershaw, 2012, p. 177-178). Similarly, they may seek many perquisites such as holidays charged on the company, private jets, classy cars, and unnecessary office equipment thereby reducing shareholder value (Solomon, 2013, p. 10). Directors may therefore generally act in their own interests, to the detriment of the shareholders, thereby reducing value to shareholders and the society (Parkinson 1993, p 51). There is therefore a crucial need for effective enforcement mechanisms in corporate law. This is the central concern in this article.

This article argues that in order to secure compliance with directors' duties', there is need for enhanced and effective enforcement. This argument is based on the *deterrence theory*. It is therefore argued that in order to ensure compliance with directors' duties, based on the deterrence theory, the severity, certainty and celerity of punishment for breach should be increased.

This article is structured as follows. The first section conceptualises enforcement. The next section then provides a brief overview of enforcement mechanisms. The third section goes on to highlight the importance of enforcement in corporate governance drawing from the view of various scholars. The fourth section examines the deterrence theory and responds to potential criticisms of its validity. The fifth section then moves on to examine some empirical evidence of deterrence in the corporate context. Following that, the applicability of the deterrence theory to directors' compliance is examined. Finally, some concluding remarks are offered.

Two notes on the scope of this article. First, legal systems differ in their provision of mechanisms for enforcing directors' duties. Similarly, socio - cultural differences between countries may dictate the extent of compliance with directors' duties. Consequently, this article's arguments may apply to varying degrees among countries with different corporate governance models. This article however uses a *theoretical* approach in justifying the need for enforcement of directors' duties. It therefore does not focus on any particular jurisdiction. Its arguments however provide a *theoretical* foundation for further research into the mechanisms for enforcing directors' duties in various jurisdictions.

Secondly, in corporate governance, a familiar distinction is often made between executive and non-executive directors (Tricker, 2015, p. 92). The company law of most jurisdictions however generally refers to ‘directors’ without differentiating between the types of director. Hence, in common law countries such as the UK, Australia, Canada, and Nigeria, all the directors on the board have the same legal duties and responsibilities. This is the concept of directors adopted in this article. Hence, the term ‘directors’ in this article refers to all directors generally without distinguishing between executive and non-executive directors.

II. Conceptualising Enforcement

The term *enforce* generally means ‘to make sure that a law, rule or duty is obeyed or fulfilled’ (Soanes & Hawker, 2006). According to Ehrlich, law enforcement may be described as the ‘apprehension and punishment of law breakers’ (Ehrlich, 1972, p. 259). Posner, similarly, describes enforcement of law as the ‘process by which violations are investigated and a legal sanction applied to the violator’ (Posner, 2014, p. 859). Enforcement, then, generally comprises of two basic elements; the first is the *investigative* element, which involves examining and getting informed about a violation or breach. The second element, which is *sanction*, connotes imposing some sort of penalty on the violator. Enforcement may therefore be defined as the process of ensuring compliance through investigation and imposition of proper sanctions in case of breach.

III. Brief Overview of Enforcement Mechanisms

Enforcement mechanisms for breach of directors’ duties may be broadly classified into two: private enforcement and public enforcement. Private enforcement mechanisms include derivative proceedings, shareholders’ personal actions, actions by administrators and liquidators, representative actions, and corporate actions. Public enforcement mechanisms include disqualification proceedings, civil judicial proceedings by regulators, criminal proceedings, warnings and threat of sanctions by public regulators, and administrative

sanctions by regulators. Different legal systems determine which enforcement mechanism would apply to breach of directors' duties in their jurisdiction. The UK, for example, relies significantly on private enforcement, in the form of derivative claims, for breach of directors' duties (Keay, 2014, p. 84). These have however been mostly ineffective in securing enforcement as evidenced by the fact that derivative claims are rarely initiated (Keay, 2014, p. 91). Nigeria, similarly, makes use of private enforcement mechanisms for breach of directors' duties (Companies and Allied Matters Act 1990, Pt. X). Australia however substantially relies on public enforcement, the civil penalty regime, for enforcement of director's duties (Corporations Act 2001, Pt. 9.4B; Welsh, 2014, p. 237).

The various enforcement mechanisms for directors' duties have their unique strengths and weaknesses. Their individual effectiveness therefore depends on a range of different factors. For example, private enforcement mechanisms suffer from weaknesses such as lack of incentive, the funding problem, and information asymmetries (Keay 2014). Similarly, private enforcement may be ineffective in the absence of an independent and efficient judiciary. On the other hand, public enforcers often have mixed and weak incentives to enforce effectively. They may also suffer from corruption and lack of information of the market and specific firms (Jackson and Roe, 2009, p. 208-210). Public enforcement therefore has its own weaknesses. An exploration of the strengths and weaknesses of the various enforcement mechanisms necessitates a detailed analysis of each one. This is however beyond the scope of this article which aims to provide a *theoretical* argument in support of enforcement of directors' duties.

IV. The Importance of Enforcement of Corporate Governance

The importance of enforcement of corporate governance has been identified by various notable scholars. La Porta et al (1998) in their studies on investor protection considered both the content of the law and the quality of its enforcement in protection of shareholder rights.

They noted that shareholder protection encourages the growth of equity markets. Shareholder protection here includes shareholder rights contained in laws and regulations as well as effective enforcement of those rights (La Porta et al, 2000). They also opined that a sound system of legal enforcement could compensate for weak rules as active and efficient courts could step in to redress wrongs done to investors by management (La Porta et al, 1998). Furthermore, in their study showing the impact of investor protection on financial markets, they found that effective investor protection, which includes both law and effective enforcement, contributed to the growth of the financial market in countries that had them. According to them, any corporate governance reform needs to focus on certain principles and part of these principles is that legal rules are important, and ‘good legal rules are the ones that a country can enforce’ (La porta et al, 2000).

Similarly, Coffee (2007) in his analysis on the impact and importance of enforcement argued that the level of enforcement intensity might explain the differences in financial development between jurisdictions. He argued that the main difference between the financial development of common law and civil law countries is the level of enforcement. Hence, enforcement plays a major role in a country’s financial development. It is therefore insufficient to have rules alone without effective enforcement.

The importance of effective enforcement has also been noted by Goldschmid who opined that ‘there is no issue so integral to market confidence as effective enforcement’ (Goldschmid 2005, p. viii). Economies require private investments in order to grow and as noted by Millstein ‘capital does not flow to dangerous neighbourhoods’ (Millstein, 2005, p. 1). This statement is consistent with the results of an empirical study carried out by Bhattacharya and Daouk (2002). In their study, they found that enforcement of insider trading laws was generally associated with a reduction in the cost of equity. Thus, investors are more likely to invest in a market that has effective investor protection. Hence, while it is important to have

strong securities and companies law to reassure investors that their assets are protected, this is simply not enough. In the absence of proper enforcement, most corporate governance mechanisms will be ineffective. It is therefore important to devise effective enforcement mechanisms to ensure compliance.

In spite of the many arguments in favour of enforcement of corporate governance as highlighted above, some scholars are more sceptical about the innate need for enforcement. Blair and Stout (2001), for example, have argued that the internalised norms of trust and trustworthiness play more important roles in discouraging misconduct by directors. They assert that individuals may sometimes have a preference for behaving in a trustworthy manner even if untrustworthy behaviour will not lead to any external sanction – legal or market. They therefore argued that external incentives such as sanctions, which aim at ensuring compliance, could be counterproductive. The next section will however rebuff such scepticism, using the deterrence theory, and seek to justify the inherent need for enforcement of directors' duties.

V. The Deterrence Theory

The issue of enforcement has concerned economists, philosophers, legal practitioners, and criminologists over the years who have tried to study the relationship between enforcement and compliance (Ehrlich 1972, Stigler 1974). A basic economic hypothesis is that an increase in the cost of a desirable activity relative to other competing activities results in a shift away from that activity towards activities that are now cheaper (Ehrlich 1972). This hypothesis forms the basis for the validity of the '*deterrence theory*' of law enforcement.

Deterrence generally means refraining oneself from an act or omission due to the fear of penalty. It is more formally defined as 'the omission of an act as a response to the perceived risk and fear of punishment of contrary behaviour' (Gibbs, 1975, p. 2). Deterrence can be

either general or specific; it is specific where it deters previous violators who have been punished from committing further violations and it is general where it aims to deter persons who have not yet violated from doing so (Paternoster, 2010).

The concept of deterrence has a long history and has been evident through the ages. Indeed many of the torturous punishments used in ancient times were intended to serve as a warning and deterrence to others (Ball, 1955). The formal deterrence theory itself can however be traced to the early works of two philosophers, Cesare Beccaria and Jeremy Bentham. Cesare Beccaria's essay '*on crimes and punishment*' written in 1764 formed the basis for the deterrence theory. He argued that all human beings have a self-interest in committing crimes and that crimes could be prevented by punishment, which is certain, proportional and swiftly applied (Beccaria, 1996). Similarly, Bentham identified the principle of utility in his work published in 1789 where he stated that 'Nature has placed mankind under the governance of two sovereign masters, pain and pleasure'. Utility is the difference between the benefits and costs of one's actions; an individual would therefore generally choose that course of action which has greater benefits than costs (Bentham, p.1). Bentham's original deterrence model was therefore based on the premise that compliance with the law depends on increasing the severity of punishment to the point that it removes the pleasures normally associated with breaking the law (Bentham; Scholz, 1997, p. 254).

Following its initial dominance, the deterrence theory was subsequently neglected for nearly two centuries in favour of other perspectives on criminology (Pratt et al 2008). Modern day interest in the 'deterrence theory' was however reignited in 1968 by Gary Becker's seminal article on *Crime and Punishment*. According to Becker, all things being equal, the higher the probability of a person's conviction or punishment for offences, the lower the number of offences he commits (Becker 1974). This decrease may be substantial or negligible; nevertheless, there is still a decrease. The deterrence theory is therefore generally based on

the cost-benefit approach to decision making. It is argued that people would often choose that course of action which offers greater individual benefits than costs. The theory is therefore based on a view of human beings as ‘rational utility maximizers’, who consider the consequences of their actions and are influenced by these consequences in their decisions. (Pyle, 1983, p. 10). Based on the deterrence theory, then, a director may decide to breach his statutory duties if the perceived future benefits are greater than the costs. The expected benefits of a director’s breach of duty would include tangible benefits such as monetary gains as well as intangible benefits such as reputational gains due to improved social status. The costs would include monetary expenses incurred to commit the breach, time expended and the anticipated punishment for committing the offence (Posner, 2014). The argument therefore is that in order for directors to comply with their duties, the costs of breach of duty, in form of punishment, must be made to outweigh its benefits.

Three major factors have been said to determine the deterrent effect of punishment (Simpson, 2002); this article focuses on three key ones. The first is the *certainty* of punishment. It is argued that the greater the likelihood that punishment will be imposed, the higher the deterrent effect of that punishment. The second factor is the speed with which punishment is applied. This is also known as *celerity* (swiftness) of punishment. The idea is that when punishment is swiftly applied, there is a greater association between the criminal acts and its costs in the minds of offenders. The third element, which is also considered very essential, is the *severity* of punishment. To ensure its effectiveness, punishment should be sufficiently severe and proportionate to the offence. The argument therefore is that in order to deter directors’ breach of duties, and ensure compliance, the certainty, severity and celerity of punishment for breach should be increased.

i. Criticisms of the Deterrence Theory

The general deterrence theory is commonly used to theorize about the efficiency of legal sanctions (Williams & Hawkins, 1986). It has been the subject of much discourse, particularly in the area of criminal justice, it has however also been the subject of some criticisms. Two of such criticisms will be addressed here.

The first criticism is based on the premise that deterrence itself is a *complex phenomenon* and depends on a wide range of factors. Robinson and Darley (2002) have criticised the deterrence theory on the basis that in order for a law to deter potential offenders certain conditions must exist. These are that the potential offender must be aware of the law; he must be able to calculate that the cost of violation is greater than the benefit, and he must be willing to let this calculation influence his conduct at the time of offence. Robinson and Darley however argue that potential offenders rarely know the law, cannot calculate the expected costs versus benefits of their actions and do not make rational self-interested decisions (Robinson & Darley, 2002).

While this viewpoint may be accepted for ordinary criminal offenders or offenders who are motivated by substances like drugs, alcohol or influenced by passion (crimes of passion), the same seems less true of the sorts of people who ‘on average’ tend to be rational. At the inevitable risk of some simplification, directors are, on average, likely to be people who are relatively well educated and informed. Moreover, their training and experience would often require them to make rational and well-reasoned business decisions on a day-to-day basis. They are therefore fully capable, and indeed well versed, in making rational decisions that involve costs-benefits calculations. Directors in large public listed companies also know that the control of the company lies with them and that shareholders may lack the incentive to monitor or enforce their rights, they may therefore have a higher incentive to mismanage the

company. An increase in the certainty, celerity, and severity of punishment for breach of directors' duties could therefore provide the incentive required for compliance.

The second criticism of the deterrence theory is based on the argument that members of a society do not comply with rules and standards due to the *fear* of sanctions. Rather, they comply because they have *internalised* certain norms and values of the society. Consequently, compliance with the law is not as a result of the fear of potential sanctions, but due to internalised norms. Toby (1964) argues that punishments are unnecessary because the 'socialisation' process prevents most deviant behaviour. Persons who have accepted and internalised the moral norms of the society would not commit crimes. It is therefore only the 'unsocialised' who will be deterred by a plain calculation of the punishment and pleasure of committing a crime. Toby's argument is therefore based on the premise that societal norms and values play a greater role in securing compliance. Similarly, Tyler (2006) argues that people are influenced by social values of right and wrong, and only obey the law if they believe it is legitimate and moral.

Truly, people refrain from violating the law for several reasons. For some it may be due to their moral values or religious beliefs, while others may be influenced by the stigma associated with violating the law (Gibbs, 1975, p. 12). Hence, individuals may refrain from violating the law or committing an offence because they have internalized the norm. In spite of this however, the deterrence theory is applicable in several respects. While societal norms and individual values play an important part in defining our conducts, or condemnation of wrongful actions, those norms and values are nevertheless influenced by the punishments available for actions classified as wrongful by the society. The 'internalisation of norms' argument ignores the fact that enforcement actually reinforces social condemnation of particular actions. Therefore, if an individual condemns an action but subsequently discovers that the action is not punished, the severity of condemnation towards that wrong is likely to

reduce. Similarly, if directors' breaches of duties are not appropriately enforced, noncompliance with those duties is likely to become acceptable. Hence, while individuals may refrain from certain illegal acts, not due to fear of punishment but, because they evaluate that act to be wrong, that moral evaluation is itself greatly influenced by the sanctions available for that wrong. Similarly, in the absence of sanctions, persons who are inclined to comply due to their internalised norms or values, may be discouraged from doing so if they perceive that those who fail to comply are not punished. Sanctions therefore contribute both to the internalization of norms as well as deterrence of potential violators who fail to internalize those norms.

As mentioned earlier, an individual may refrain from committing an offence or violation due to several reasons besides from the fear of sanctions, hence any empirical assertion of deterrence is hardly irrefutable. The deterrence theory however does not assert that the threat of sanctions deters *all* individuals in *all* circumstances (Ball, 1955). As argued by Dodd one would have to be an especially 'hostile critic' of directors to deny that a good number of them are motivated by a genuine desire to comply with corporate law, not just because it is 'legal and safe' to do so but, because they believe it is the morally right thing to do (Dodd, 1935, p 199). Consequently, the deterrence theory does not apply to *all* individuals or, more specifically, *all* directors. It is nevertheless sufficient to say that 'in some situations, some individuals are deterred from some crimes by some punishments' (Gibbs, 1975, p 11). Hence, while we cannot assert that deterrence applies in *all* situations and that directors *always* calculate the costs and benefits of their actions before committing a breach, there are definitely *some* directors who will be deterred only by punishment.

VI. Some Empirical Evidence of Deterrence in the Corporate Context

Having looked at the theoretical arguments on deterrence, it is necessary to examine whether there is any empirical evidence in support of deterrence. Although the word ‘crime’ was used in Becker’s analysis, he however intended his analysis to cover all violations and not just felonies (Becker, 1974). As such, the deterrence theory has been used in different areas of law including the corporate context. The theory has therefore been used to explain tax compliance as well as compliance by directors and corporate entities with the applicable rules. The question has frequently been whether certainty and severity of punishment influence compliance.

Klepper and Nagin (1989) in their study on tax compliance analysed the deterrent effect of enforcement and found that taxpayers’ compliance was based on the perceived risk of detection and prosecution for non-compliance. They found that taxpayers make a cost–benefit analysis in their decision to comply and the effect of their calculations was closely related to the enforcement process. Similarly, in an empirical analysis by Zubcic and Sims (2011) on the effect of enforcement actions by ASIC (Australia’s Securities and Investment Commission) on corporate compliance, it was found that the number of complaints against companies which had previously been the subject of prior enforcement or investigation was much lesser than companies who have not previously been subject to enforcement action. This empirical analysis therefore supports the argument that enforcement action affects compliance of companies who have previously been the subject of enforcement action.

A study by Welsh (2012) on the effect of increased sanctions and enforcement activity on corporate compliance also shows that there is a link between enforcement and increase in compliance. During the interviews conducted on the impact of enforcement on the incentive to comply, most interviewees (which included company secretaries, compliance managers and partners) agreed that the introduction of new enforcement regimes caused them to pay more attention to their compliance system. Similarly, a court decision on enforcement was

also found to have incentivized companies to pay more attention to their compliance policies as they realized that there is a real risk of prosecution for corporate offences.

In a study by Gunningham, Thornton and Ragan (2005) conducted to understand the motivation for firms' environmental behaviour; most respondents stated that the threat of fines or prison sentence was a principal motivating factor in their environmental actions. The fear of detection and penalties was therefore an important factor precipitating changes within the firms. Many respondents to the study also believed that without effective enforcement, compliance would decrease over time. The compliant firms would lose confidence in the system due to the injustice inherent in the lack of sufficient punishment for offenders.

From the foregoing, it is clear that there is an obvious link between enforcement actions and level of compliance even within the corporate context. This therefore provides a justification for effective enforcement of directors' duties in order to secure compliance.

VII. Deterrence theory and Directors' Compliance

The deterrence theory is indeed applicable to efforts to secure compliance with directors' duties. As mentioned earlier, Directors are often well-educated and rational persons who can fully calculate the costs and benefits of their actions. Therefore, in order to ensure compliance by directors, the *costs* of non-compliance should outweigh the potential benefits. To increase these costs, the certainty, severity and celerity of punishment should be increased. Where the probability of punishment is low, directors may continue to engage in breach of their duties to the detriment of shareholders. Similarly, sanctions imposed for directors' breach should be reasonably severe and swiftly applied after the breach. This will increase the likelihood that directors who are predisposed to engaging in certain misconducts are deterred from doing so due to the costs of noncompliance thereby securing both specific and general deterrence.

Consequently, both the offending directors as well as other directors would have a greater incentive to comply thereby enhancing corporate governance.

While effective enforcement of directors' duties is unlikely to *totally* eradicate all forms of mismanagement, it nevertheless has a role to play in *reducing* it. As Becker argues, the optimal level of crime will rarely be zero. Hence, there will always be some level of crime in the society (Becker 1974). Similarly, agency costs can never be zero as confirmed by Jensen and Meckling (1976). However, it is possible to find the right mix of certainty, celerity, and severity of punishment that will reduce agency costs and agency problems. In the absence of effective enforcement of directors' duties and norms of conduct, there is unlikely to be proper compliance (Keay 2014). There is therefore an essential need for effective enforcement mechanisms for dealing with breach of directors' duties.

VIII. Conclusion

Directors' duties are an essential part of corporate governance and are intended to ensure that directors exercise their powers in the interests of the company, and not their personal interests. Directors, however, very often do not 'passively' obey the legal rules or standards that apply to them (Cheffins, 1997, p. 199). Breaches of duties therefore occur frequently. Consequently, while having directors' duties and other norms may provide some educational benefit, they are unlikely to be of much use in the absence of effective enforcement (Keay, 2014). This is the crux of this article's argument.

This article has drawn on the deterrence theory in order to highlight the crucial need for enhanced and effective enforcement of directors' duties. It has argued that in order to ensure compliance with directors' duties, the certainty, severity and celerity of punishment should be increased. This will increase the likelihood that directors calculate that it is in their best interests to comply, due to the risks of punishment. Countries, generally, should therefore

ensure that they possess appropriate and effective enforcement mechanisms for responding to breaches of directors' duties.

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