THE INEFFICACY OF PRIVATE ENFORCEMENT OF DIRECTORS’ DUTIES*
Company directors play an important role in society. Their activities have significant effects on the interests of their companies, shareholders and other stakeholders. Consequently, the law regards them as fiduciaries and imposes duties which set out behavioural expectations. The private enforcement regime is the primary mechanism adopted by many common law jurisdictions for securing compliance with directors’ duties. The crucial question is whether this regime is effective in securing enforcement of directors’ duties. This article addresses this question by examining the fundamental weaknesses of the private enforcement regime. In exploring these weaknesses, it focuses on the UK and Nigerian experience. It crucially argues that the private enforcement regime, due to its weaknesses, is unable to provide deterrence and compensatory benefits. It is therefore ineffective as an enforcement mechanism for breach of directors’ duties. This article therefore concludes that there is need for a complementary enforcement regime.
Introduction

‘Legal obligations that exist but cannot be enforced are ghosts that are seen in the law, but that are elusive to the grasp’.1

Over the years, the issue of enforcement has been the subject of concern among several scholars who have tried to study the relationship between enforcement and compliance.2 More specifically, within the corporate context, the concern has often been the need to ensure effective enforcement of directors’ duties.3 This focus on enforcement is justified as absent, or ineffective, enforcement of directors’ duties often results in non-compliance.4

In common law countries, such as the UK and Nigeria, the private enforcement regime for breach of directors’ duties are a key enforcement mechanism. As noted by Jackson and Roe ‘the tool of public enforcement (as opposed to fiduciary-oriented private litigation before judges) has not usually been strongly associated with the common law’.5 In spite of this,
available evidence suggests that private enforcement offers very limited effectiveness. Consequently, this article aims to identify and analyse the main weaknesses of the private enforcement regime.

The weaknesses of the private enforcement regime have been the subject of some scholarly attention. This article however fits in, and extends, the literature on the subject by utilising a theoretical framework to analyse the weaknesses of private enforcement. The theories on the purpose of enforcement provide a critical perspective on the effectiveness of the private enforcement regime. What ensues is a rich and in depth analysis of the subject.

Throughout the course of this paper, frequent reference is made to the Nigerian enforcement regime. While there is a plethora of literature on enforcement of corporate law in more developed countries, in developing countries there is a dearth of scholarly opinion on the subject. Yet effective enforcement is important for developing countries, particularly emerging markets, such as Nigeria. Arguably, developed countries can get by with sub-optimal enforcement as directors are often surrounded by a culture that discourages opportunism. In such countries, therefore, directors may routinely obey laws. However, in developing countries, such as Nigeria, where a bribery and corruption culture thrives, routine compliance with corporate law is unlikely to occur. Still, directors’ accountability and effective enforcement of directors’ breach is required for investors’ confidence. As noted by Millstein ‘capital does

---

7 Ibid.
8 See footnotes 3&4.
10 Ibid 1926.
12 There are a number of studies which demonstrate that effective enforcement is essential for investor confidence. See Rafael La Porta & others, ‘Investor Protection and Corporate Governance’ (2000) 58 Journal of Financial
not flow to dangerous neighbourhoods’. Effective enforcement is therefore essential if Nigeria is to take its place as a future economic giant alongside other emerging markets. This paper therefore intends to influence debate, and policy change, in the area of enforcement of directors’ duties in Nigeria.

This article is divided into two parts. The first part provides a theoretical foundation for the ensuing discussion. It starts by conceptualising enforcement. It goes on to discuss the purpose of enforcement of corporate law. Compensation and deterrence are identified as the key purposes of private enforcement of corporate law. It argues that both the deterrence and compensatory purposes of enforcement have their unique strengths and weaknesses. Undue reliance on either one can therefore produce absurd results.

Following this, the second part analyses the weaknesses of the private enforcement regime. In doing so, some references are made to the UK and Nigerian corporate law regime. It discusses how the weaknesses of the private enforcement regime impede its ability to produce deterrence and compensatory benefits. It therefore crucially argues that the private enforcement regime is ineffective in enforcing breaches of directors’ duties. Finally some concluding remarks are made.

Two notes on scope. First, private enforcement actions may be brought in respect of directors’ breaches in both private and public companies. This article is however particularly concerned with redressing breach in large public companies. In private companies, it is common for

---


14 Nigeria is regarded as one of five emerging markets, dubbed as ‘NIMPTS’, set to become future economic giants.
controlling shareholders of the company to function as the directors of the company. Consequently, the main conflict in such companies is often between the controlling shareholders and the minority shareholders. The agency problem between directors and shareholders is less prominent. However, in larger companies, this sort of agency problem is often the case due to the delegation of authority which is a frequent feature of such companies. Delegation enables skilled managers to utilise their skills in managing a corporation even when they lack the wealth to invest. It also allows wealthy individuals to invest even when they lack the skills to manage the entity. However, in spite of its many benefits, delegation also creates room for directors to act in their own self-interests to the detriment of the shareholders. Enforcement of directors’ breaches in such companies is therefore a matter of immense concern.

Second, this article’s analysis of enforcement focuses specifically on directors’ statutory duties. This however does not seek to underestimate the importance of effective enforcement in other areas of corporate law. While directors’ statutory duties are essential to good corporate governance, directors nevertheless owe other key obligations to the company. In spite of this however, this article focuses on directors’ duties as much of the analysis offered in respect of

16 It is crucial to note here that this does not imply that the agency problem between directors and shareholders is limited to public companies. Indeed, the factors that determine self-interested behaviour on the part of directors are quite varied. For a discussion of the three generic agency problems that arise in companies see Reiner Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2nd edn, OUP 2009) 35-36.
17 Frank Easterbrook and Daniel Fischel, ‘Corporate Control Transactions’ (1982) 91 Yale Law Journal 698, 700. The severity of self-interested behaviour exhibited by directors would often depend on the extent of dispersion of shares in the company. In a closely-held company, there is little room for directors to make decisions that benefit them directly at the company’s expense. The majority shareholders have sufficient incentives to monitor management. However in a widely-held company, the manager’s incentive to act in a self-interested manner can be fully activated as shareholders may lack the incentive to monitor management. For a discussion of the problem created by separation of ownership and control see Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (The Macmillan Company 1932). See also David Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 171–174.
19 See UK companies Act 2006, ss 171-177.
20 For example directors have certain key obligations with regards to companies’ annual accounts and reports. See UK Companies Act 2006, pt. 15.
private enforcement of directors’ duties would also apply to the enforcement of these other key obligations.\footnote{A derivative claim, for example, may be brought in respect of negligence, default, breach of duty or trust by a director. Hence, presumably, claims may be brought in respect of a director’s default or negligence with regards to a financial reporting obligation. See UK Companies Act 2006, s260(3).}

**Part One: Theoretical Foundations**

This section provides a theoretical framework for the discussion of the weaknesses of private enforcement which is to follow. It offers an analysis of the key purpose of enforcement in corporate law.

**Conceptualising Enforcement**

According to Posner, enforcement of law may be described as the ‘process by which violations are investigated and a legal sanction applied to the violator’.\footnote{Richard Posner, *Economic Analysis of Law* (9th Edn, Wolters Kluwer 2014) 859.} While this definition is accurate in several respects, the use of the term ‘legal sanctions’ is nevertheless restrictive. Although sanctions are an integral part of enforcement, those sanctions need not be legal or formal. Enforcement can still take place with non-legal or informal sanctions. These may include ‘reputational sanctions’,\footnote{John Armour ‘Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment’ in John Armour & Jennifer Payne (eds), *Rationality in Company Law: Essays in Honour of DD Prentice* (Hart Publishing 2009) 74.} ‘name and shame’, ‘truthful negative gossip’, or shunning the offender, amongst others.\footnote{See Robert Ellickson, *Order without Law: How Neighbours Settle Disputes* (Harvard University Press 1991) for a discussion of the role of norms and non-legal sanctions in enforcement.} Enforcement, then, generally involves two basic elements. The first is the *investigative* element, which entails examining and getting informed about a violation. The second element, *sanction*, connotes imposing some sort of penalty on the violator. These two elements ought to be present in any enforcement activity. Enforcement may
therefore be defined as the process of securing compliance through investigation and imposition of appropriate sanctions in case of breach.  

The Purpose of Enforcement in Corporate Law

Before going into the specifics of private enforcement, it is necessary to examine what purpose enforcement serves in corporate law. Generally, rules may be enforced for different reasons. The purpose of enforcement in each case would often depend on the nature of the rule being enforced. Criminal law, for example, may be enforced for a number of reasons. These include to ensure that offenders get their ‘just deserts’ i.e. retribution, to deter prospective offenders, to incapacitate offenders, and to rehabilitate offenders.

Similarly, within the corporate context, directors’ breaches may be enforced for different reasons. Two key reasons have been identified in literature. These are deterrence and compensation. While deterrence is aimed at preventing re-occurrence of the wrong, the aim

26 Retributivist theory of punishment is often associated with the works of Kant and Hegel. See George Wilhelm Hegel (1832), Hegel’s Philosophy of Right, (T. Knox (tr, Clarendon Press 1952) para 100; I Kant (1976), The Metaphysics of Morals, (Mary Gregor tr, Cambridge University Press 1991) 140.
30 Several scholars have argued that compensation and deterrence are the main rationale for the various enforcement mechanisms in corporate law. Cox, for example, argues that compensation and deterrence are the ‘joint missions’ of shareholder suits. See James Cox, ‘The Social Meaning of Shareholder Suits’ (1999) 65 Brooklyn Law Review 3, 8. Similarly, Coffee notes that from a policy perspective, securities class actions have two potential rationales: compensation and deterrence. See John Coffee Jr, ‘Reforming the Securities Class Action: An Essay on Deterrence and Its Implication’ (2006) 106(7) Columbia Law Review 1534, 1539.
31 See Jack Gibbs, Crime, Punishment and Deterrence (Elsevier 1975) 2.
of compensation is to, as much as possible, restore the victims to their previous position.\textsuperscript{32} It must however be noted here that deterrence and compensation are not the only purposes of enforcement in corporate law. Retribution may, in certain cases, be considered a purpose of enforcement in corporate law. Directors’ disqualification, for example, encompasses both protective (deterrence) and punitive (retributive) components.\textsuperscript{33} Similarly, there is often a public desire for retribution in respect of directors’ misconducts, which affects the public’s interests. A prime example is the UK banking crisis, which brought with it a strong desire for retribution by aggrieved members of the public. This desire for revenge was actualised in the vandalization of the Edinburgh home and car of the former CEO of RBS, Sir Fredrick Goodwin, by a vigilante group called ‘bank bosses are criminals’.\textsuperscript{34} The need for retribution may therefore in certain cases influence enforcement of corporate law. Having said that, however, retribution remains a secondary purpose of enforcement in private law and, by extension, corporate law. Therefore, the focus in this article would be deterrence and compensation.

\textit{Deterrence versus Compensation}


\textsuperscript{33} See Pearlie Koh, ‘Punishment and Protection – The Disqualification of Directors in Singapore’ [2013] Singapore Journal of Legal Studies 447-456. See also the English decision of Re Cladrose ltd [1990] BCLC [208] where the court disqualified only the chartered accountant and not the director because the latter was ‘very much less blameworthy’.

\textsuperscript{34} The attack came in the wake of statements by Max Hastings in the Daily Mail where he stated that ‘the time has come to address the entire robber banker culture’. See Max Hastings, ‘Seize their Porsches and throw them in jail! Shameless bankers are worse than Train Robbers’ (Daily Mail 23\textsuperscript{rd} March 2009) <http://www.dailymail.co.uk/debate/article-1163623/MAX-HASTINGS-Seize-Porsches-throw-jail-Shameless-bankers-worse-Train-Robbers.html> 23rd March 2009> accessed 8\textsuperscript{th} March 2018. See BBC, ‘Sir Fred Goodwin's home attacked’ 25th March 2009 <http://news.bbc.co.uk/1/hi/7962825.stm> accessed 8th March 2018.
Having identified deterrence and compensation as the main purposes of enforcement of corporate law, a pertinent question however remains. Which of these - compensation or deterrence - represents the primary purpose of private enforcement of corporate law?

This question is particularly important where private enforcement is concerned. With the public enforcement regime in corporate law, the focus is often on public benefits in terms of enhanced deterrence and overall improved corporate governance. Public enforcers are by nature often concerned with the public value of enforcement. They are therefore less likely to be concerned with the compensatory value of enforcement. Consequently, it can be argued that with the public enforcement regime, the primary purpose of enforcement is deterrence.

The situation is however quite different with private enforcement as its primary purpose is not often clear. Consequently, differing opinions have been offered on the matter. Cox, for example, argues that within the context of shareholder suits, compensation represents the primary purpose of enforcement. He argues that courts are generally more concerned with the compensatory aspects of shareholder suits rather than its deterrent effect. Similarly, shareholder suits are often dismissed if the plaintiff is unable to establish some harm suffered by the company as a result of the directors’ misconduct. He therefore maintains that the public role or social value of shareholder suits is subdued. Consequently, the compensatory, rather than deterrence, rationale is the main justification for shareholder suits.

35 Mayanja, (n 4) 11.
36 This is not to say that corporate regulators are never concerned with securing compensation for victims. Rather, the argument here is that they are primarily concerned with public rather than private interests. A key example of a public enforcer that considers compensation orders as a key part of its enforcement arsenal is the Australian Securities and Investments Commission. See Corporations Act 2001, s1317H.
38 ibid 11.
39 ibid 8.
Coffee and Schwartz however disagree with Cox’s viewpoint and argue that deterrence should be the primary purpose of shareholder suits, specifically derivative actions. They argue that while the courts have customarily assumed that a compensatory purpose underlies derivative actions, this can no longer be the case. The relationship that now exists between the shareholder and the company makes the compensatory rationale obsolete. They however argue that derivative actions are ‘naturally adapted’ to a deterrent purpose. Consequently the main accomplishment of derivative actions, or class actions, is not that they result in significant compensation, rather that they can provide real deterrence.

In the same vein, Coffee argues that deterrence is the only rationale that justifies the significant costs imposed on investors and the judiciary by class actions. He argues that from a compensatory perspective, class actions are unjustifiable as investors often recover only a small share of their losses. Likewise, most institutional investors who suffer losses do not submit claims in securities class actions. He however goes on to argue that despite its failure as a compensatory mechanism, class actions can still provide effective deterrence.

The conflicting opinions on the primary purpose of private enforcement actions demonstrate the key tensions between both sides of the debate. While the argument in support of the compensatory rationale of private enforcement has its merits, it must be said that there are several reasons why the compensatory purpose cannot reasonably be regarded as the primary purpose of private enforcement in corporate law. Three of this will be examined here.

The first reason relates to the difficulty with adequately compensating victims of wrongs committed by directors. Compensation involves the award of a sum of money to a claimant for

41 ibid.
43 ibid 1547.
losses suffered.\textsuperscript{44} One of the key problems with compensation as the key purpose of private enforcement, however, is the difficulty with identifying and adequately compensating the victims of directors’ breaches. This difficulty becomes more acute where the company is a widely held company with hundreds or perhaps thousands of shareholders. In such companies, share ownership changes very frequently such that those who own the shares at the time of wrongdoing are unlikely to be the same owners at the time of recovery.\textsuperscript{45}

Similarly, while the interests of the company and that of the shareholders are often considered synonymous as evident by the ‘no reflective loss’ rule,\textsuperscript{46} injury to the company is not always the same as injury to the shareholders.\textsuperscript{47} Indeed, the shareholders’ losses may even exceed that of the company. In addition to this, even when the total amount recovered from an enforcement action is substantial; the amount that accrues to any individual shareholder is unlikely to be significant based on individual shareholding.\textsuperscript{48} Consequently, shareholders can hardly be said to have been compensated for their losses. Furthermore, other than the shareholders of the company, directors’ breaches may also cause loss to other stakeholders such as creditors,

\textsuperscript{44} Andrew Burrows, \textit{Remedies for Torts and Breach of Contract} (3\textsuperscript{rd} edn, OUP 2004) 29.

\textsuperscript{45} Coffee and Schwartz, ‘The Survival of the Derivative Suit’ (n 40)302.

\textsuperscript{46} The basic rule of reflective loss is that a shareholder cannot recover a loss which is only ‘reflective’ of the company’s loss. Where a shareholder suffers loss in respect of wrong done to the company, such loss is said to be a ‘reflective loss’. Only the company may sue in respect of that loss. Consequently, a shareholder cannot sue in respect of reduction in the value of his shareholding where that merely reflects the loss suffered by the company which can be remedied by the company itself enforcing its rights against wrongdoers. See \textit{Johnson v Gore wood} [2002] 2 A.C 1. The ‘no reflective loss’ principle is aimed at preventing ‘double recovery’ by the shareholder as well as ‘double jeopardy’ by the wrongdoer. For a further discussion of the ‘no reflective’ loss principle see Charles Mitchell, ‘Shareholders’ Claim for Reflective Loss’ [2004] Law Quarterly Review 45; Joyce Lee Suet Lin, ‘Barring Recovery for Diminution in Value on the Reflective Loss Principle’ (2007) 66(3) Cambridge Law Journal 537; Brenda Hannigan, ‘Drawing Boundaries between Derivative Claims and Unfair Prejudicial Petitions’ (2009) 6 Journal of Business Law 606. See also John Parkinson, \textit{Corporate Power and Responsibility: Issues in the Theory of Company Law} (OUP 1993) 76-77.

\textsuperscript{47} Indeed, the possibility that a shareholder could suffer a loss which is ‘separate and distinct’ from that of the company was recognised by Lord Bingham in \textit{Johnson v Gore wood} [2002] A.C 35.

\textsuperscript{48} Coffee and Schwartz, ‘The Survival of the Derivative Suit’ (n 40) 304.
employees, customers,\textsuperscript{49} and members of the public.\textsuperscript{50} In such cases, it will be difficult to identify, or fully compensate, all the victims.

The second reason relates to the very nature of the compensatory remedy. As mentioned earlier, compensation is generally intended to reimburse for losses suffered. Where no loss is suffered, compensation is generally inapplicable. Consequently, an acceptance of compensation as the primary purpose of private enforcement would imply that enforcement is \textit{unnecessary} in situations where the company has not suffered any loss from directors’ breaches. It is therefore only when the company has suffered a loss that such breaches should be enforced. This approach is however questionable. In reality, it is quite possible for a director to breach his duty without causing actual loss to the company. An example would be directors’ breach of duty to exercise powers for the purpose for which they have been conferred.\textsuperscript{51} This duty operates to limit directors’ authority and, potential, abuse of power. This remains so even if their actions are carried out in what they \textit{genuinely} believe to be the best interests of the company.\textsuperscript{52} A breach of this duty therefore requires enforcement even where the director’s actions has not caused any tangible loss to the company. Hence, if compensation is considered the primary purpose of private enforcement in corporate law, a suitable defence for wrongdoing directors in such situations would be that their breach has not caused any loss to the company or indeed that the company has gained from the breach.\textsuperscript{53}

\textsuperscript{49} An instance where a director’s breach may cause loss to customers is where substandard or even harmful goods are sold to customers in order to increase the company’s profits.

\textsuperscript{50} The global financial crisis provides a classic example of cases where directors’ breaches had far-reaching consequences on members of the public.

\textsuperscript{51} Companies Act 2006 s171(b).

\textsuperscript{52} It is important to point out that the ‘proper purpose’ duty has been enforced by the courts even in circumstances where directors are not motivated by self-interest. This is particularly true with regards to the power to issue shares. See \textit{Howard Smith Ltd v Ampol Petroleum Ltd} [1974] AC 821.

The third and final reason why compensation cannot reasonably be regarded as the primary purpose of private enforcement is that the central theme of corporate law and corporate governance is the reduction of agency costs and problem. The basis of the agency problem is the assumption that the interests of principals and agents diverge. Consequently, the agents (directors/managers) do not always make decisions that are in the principal’s (shareholders) best interests. Managers may misuse their managerial power for personal financial benefits or make decisions that are detrimental to the company’s overall interests. A general concern of corporate law has therefore been how to align the manager’s interests with the shareholders thereby ensuring that the company is run in its best interests. This arguably has at its core a need to deter managers from acting in their own self interests.

Despite the many arguments against compensation as the primary purpose of private enforcement, it must be said that the deterrence purpose is not without its own flaws. Two key problems have been identified here.

The first problem is that the deterrence theory itself is subject to several criticisms. We discuss some of those criticisms within the corporate context. The deterrence theory is 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. Deterrence theorists assume

---

57 Christine Mallin, Corporate Governance (4th edn, OUP 2013) 17.
58 On the mislabelling of the ‘deterrence doctrine’ as a ‘theory’, see Jack Gibbs, Crime, Punishment and Deterrence (Elsevier 1975) 5-9. This term ‘deterrence theory’ would however be used in this article as it is the most used term.
that human beings are ‘self-interested, rational and reasoning’ creatures.\textsuperscript{60} Therefore, all things being equal, a person would commit an offence if the expected utility to him exceeds the utility he could get by using his time and other resources at other activities.\textsuperscript{61} Consequently, an increase in the probability of conviction and the severity of punishment reduces the utility expected from the offence. This invariably reduces the number of offences committed.\textsuperscript{62}

The first issue with the applicability of the deterrence theory is that it assumes that potential wrongdoers can distinguish between right and wrong behaviour and make a choice between both alternatives.\textsuperscript{63} However, if the law does not clearly define ‘wrongful behaviour’, then the deterrence theory cannot apply as this choice between right and wrong conduct can no longer be made.\textsuperscript{64} Scholars argue that corporate law does not clearly define the sort of conducts that will amount to a breach.\textsuperscript{65} The boundaries are therefore blurred and vague. Directors’ duties, for example, are written in broad terms such that directors may not immediately realise that their actions constitute a breach.\textsuperscript{66} If directors do not realise that their actions constitute misconduct, they will not engage in any rational evaluation of attendant costs and benefits.\textsuperscript{67}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{62}] See further Brian R Cheffins, \textit{Company Law: Theory, Structure and Operation} (OUP 1997) 199.
\item[\textsuperscript{64}] Lisa M Fairfax, ‘Spare the Rod, Spoil the Director –Revitalizing Directors’ Fiduciary Duty through Legal Liability’ (2005) 42 Houston Law Review 393,434
\item[\textsuperscript{65}] ibid. It is noteworthy that Directors duties in the UK Companies Act 2006 are codified in general terms by way of statement of principles. The Law Commission and Scottish Law Commission considered the case for codifying directors’ duties in more detailed terms. However, due to the risk of loss of flexibility, a more broad and general approach was adopted. This however leaves the duties open to various interpretations thereby impairing accessibility by directors. See Law Commission and Scottish Law Commission, ‘Company Directors; Regulating Conflicts of Interests and Formulating a Statement of Duties’ (CP 153) para 14.14; Law Commission and Scottish Law Commission, ‘Company Directors; Regulating Conflicts of Interests and Formulating a Statement of Duties’ (1999) Nos 261 & 173 para 4.48.
\item[\textsuperscript{66}] For example will a director be liable for breach of duty due to failure to attend board meetings? What if they attend and don’t ask questions or fail to ask the right amount of questions?
\end{itemize}
\end{footnotesize}
In response to this criticism, however, it can be argued that case laws provide sufficient information regarding which kinds of behaviour constitute breach of duty. Similarly, corporate governance principles exist which create greater clarity. Directors therefore have sufficient guidance on the behaviour expected of them.

The second issue lies with the ability of legal sanctions to deter director misconduct. Several scholars question the ability of legal sanctions to deter. For example, Braithwaite and Makkai in their empirical study found little support for the deterrent effect of certainty or severity of punishment on compliance. Robinson and Darley were also particularly sceptical of the deterrence theory. They argued that potential wrongdoers rarely know the law, cannot calculate the expected costs and benefits of their actions and do not make rational self-interested decisions. Similarly, Toby argues that punishments are unnecessary because the 'socialisation’ process prevents most deviant behaviour.

In spite of this, however, it is important to point out that most scholars who question the effectiveness of deterrence focus on ordinary offenders. These criticisms do not properly apply to the type of persons who occupy directorship positions. Indeed, one can argue that the deterrence theory is more applicable to upper and middle class individuals than those in the lower class. According to Geerken and Gove, ‘the effectiveness of the deterrence system will increase as the individual’s investment in and rewards from the social system increases’.

---

68 Fairfax (n 64) 435-436. While this claim is made within the US context, it remains applicable as there is a significant body of case law on the subject of directors’ duties and liabilities in the UK.
73 ibid 509.
Hence, persons who are future oriented and think of factors like their career and family are usually more concerned with the consequences of their misconducts. Directors fall into this category. Similarly, directors are, on average, likely to be people who are well educated and informed.74 Their position would often require them to make rational and well-reasoned business decisions on a daily basis. Directors’ actions, and indeed misconducts, are also often motivated by economic considerations.75 They therefore belong to the category of rationally minded people who can calculate the costs and benefits of their actions as required by the deterrence theory.76

In further support of this, an empirical study by Welsh suggests that enforcement activities by ASIC, the Australian corporate and securities regulator, act as a deterrent for potential offenders.77 The interviews conducted by Welsh particularly reveal that the James Hardie case had a considerable impact on compliance as some of the interviewees stated that it encouraged them to review their compliance policies.78 Consequently, despite its many criticisms, the deterrence theory remains applicable to enforcement within the corporate context.

Having resolved the first problem, we move on to the second problem with the deterrence purpose of enforcement. Although legal sanctions can deter wrongdoing, as discussed above, it is sometimes difficult for private enforcement actions to meet this deterrence ideal. Deterrence generally depends on a wide range of factors.79 A key factor that determines the deterrent effect of enforcement actions is the substance of the claim brought against the

---

76 Chambliss argues that the deterrence theory will particularly apply to white collar offenders as they are not committed to a life of crime. See further William Chambliss, ‘Types of Deviance and the Effectiveness of Legal Sanctions’ (1967) Wisconsin Law Review.
78 ibid 161.
79 See Gibbs ‘Crime, Punishment and Deterrence’ (n 31) 524; Becker (n 27) 9.
wrongdoer and the manner in which it is perceived by the public. Hence, the deterrent, and reputational, impact of a private enforcement action will be weak and limited if it is perceived as a frivolous internal dispute.\(^8^0\) This, as will be discussed further below, can often be the case with private enforcement actions thereby effectively preventing it from offering deterrent benefits.

Similarly, directors rarely suffer out-of-pocket losses from shareholder litigation. Armour and others in their study found that it is rare for both outside and inside directors to face out of pocket liability in litigation arising under corporate law.\(^8^1\) Companies often purchase directors’ and officers’ liability insurance (D & O insurance) for its directors and officers against liability for negligence, default, breach of duty or breach of trust in relation to the company.\(^8^2\) Consequently, directors rarely contribute to settlements in shareholder suits as insurers often cover the settlement and litigation expense.\(^8^3\) Damages claims could also be dealt with through insurance which implies that the ultimate penalty payer might be the shareholder or consumer rather than the wrongdoers.\(^8^4\) While D & O insurance will not indemnify directors from liability arising from dishonest, fraudulent or criminal conduct,\(^8^5\) they nevertheless still offer significant protection. This arguably reduces the deterrent effect of private enforcement and casts doubts on its efficacy as such.\(^8^6\)


\(^8^2\) UK Companies Act 2006, s233.

\(^8^3\) Coffee, ‘Reforming the Securities Class Action’ (n 42)1550-1553


\(^8^6\) It is commonly argued that D & O insurance increases the danger of ‘moral hazard’ and reduces directors’ incentives to pay close attention to their duties. See K.G Jan Pillai and Craig Tractenberg, ‘Corporate Indemnification of Directors and Officers: Time for a Reappraisal’ (1981) 15 University of Michigan Journal of Law Reform 101, 119; Finch (n 84) 888.
Overall, the varying opinions on the primary purpose of private enforcement actions in corporate law reveal the strengths and weaknesses of both sides of the divide. Both the compensatory and deterrence purpose suffer from certain weaknesses. While some of the scholarly opinion on the subject relates to particular enforcement mechanisms, specifically shareholder suits, the arguments put forward are generally applicable to the private enforcement regime. Crucially, it is worth noting that private enforcement actions in corporate law cover a wide range. Hence, neither deterrence nor compensation will always apply across board as the key purpose of private enforcement. Indeed, undue reliance on either rationale can produce ‘absurd results’. Some sort of balance in both the compensatory and deterrence rationale therefore remains essential for effective enforcement. Consequently, in appraising the effectiveness of the private enforcement regime, the main question to consider should be whether it is able to properly meet a deterrence and/or compensatory purpose.

**Part Two: The Private Enforcement Regime**

The previous section has highlighted deterrence and compensation as the central purposes of enforcement of corporate law. In order for the private enforcement regime to fulfil these purposes at least two conditions must be in place. First, the enforcement regime must be put to effective use by private enforcers. The effectiveness of an enforcement regime depends not just on its availability, but also its use. Hence, where enforcement mechanisms are not put to use, they offer little, or no, benefit. Second, enforcement activities must be accompanied by reasonable probability of success. Where attempts to use an enforcement regime are met with

---

87 Coffee and Schwartz, ‘The Survival of the Derivative Suit’ (n 40)308. Pure reliance on a deterrence rationale would justify litigation even where the costs far outweigh any potential recovery. Similarly, reliance on the compensatory rationale would permit the wrongdoers to keep the proceeds of their misconduct as long as the company has been adequately compensated.
minimal success, they are likely to be of little benefit. Hence, where neither of these conditions is in place, an enforcement regime would be unable to meet its purposes.

The private enforcement regime for breaches of directors’ duties encompasses various enforcement proceedings. These include corporate actions, derivative actions, unfair prejudice actions, and actions by insolvency practitioners. Corporate law literature is replete with in-depth discussions of these enforcement proceedings.88 This article does not intend to repeat what has already been said in that regard. Rather the focus in the ensuing section is an analysis of the core weaknesses of the private enforcement regime. The discussion in this section will reveal how the weaknesses of the private enforcement regime undermine its ability to offer deterrence and compensatory benefits and render it ineffective in enforcing breaches of directors’ duties.

Weaknesses of the Private Enforcement Regime

In this section, we shall focus on six weaknesses of the private enforcement regime.

1. Information Asymmetries

According to Reisberg, information is the ‘lifeblood’ of litigation.89 This is hardly an exaggeration as information is central to every litigation process.90 Consequently, its availability, or absence, on the part of either party to the case can determine the outcome of a litigation process. Similarly, enforcement of a standard requires not only information regarding

89 Arad Reisberg, Derivative Actions and Corporate Governance: Theory and Operation (OUP 2007) 85.
90 Litigants very often adjust their strategies in response to new information. A Party may therefore make the decision to settle in response to certain information in the hands of the other party. See Joseph Grundfest and Peter Huang, ‘The Unexpected Value of Litigation: A Real Options Perspective’ (2006) 58 Stanford Law Review 1267, 1270.
the standard but also information about its breach.\(^{91}\) Hence where potential enforcers lack necessary information, enforcement is practically impossible. This is often the case with private enforcement proceedings as discussed below.

\[i. \quad \textit{Shareholder Actions}\]

The extent to which private enforcement proceedings are affected by information asymmetries\(^{92}\) is dependent on the nature of the enforcement mechanism. The information asymmetry problem is however particularly evident with shareholder actions such as derivative proceedings. Shareholders frequently lack sufficient information about directors’ misconducts. This problem is particularly severe in public listed companies which are often ‘widely-owned’ making it impossible for the shareholders to be directly involved in the company’s management.\(^{93}\) Shareholders of such companies are generally unable to gain access to full information about several issues,\(^{94}\) they therefore ‘labour’ under information asymmetries.\(^{95}\) This makes enforcement inherently difficult.

The information asymmetry problem is attributable to the fact that directors generally determine the type of information that shareholders receive. Shareholders do not have a general right to information about the company’s affairs other than that which the company is statutorily required to disclose.\(^{96}\) They also often have limited rights with respect to inspection

---


\(^{92}\) Information asymmetry exists where one party has an informational advantage over another. Milgrom and Roberts distinguish between complete information, incomplete information and information asymmetry. See Paul Milgrom and John Roberts, ‘Informational Asymmetries, Strategic Behaviour and Industrial Organization’ (1987) 77(2) American Economic Review 184, 184-185.

\(^{93}\) Widely’ owned means that ownership is in the hands of very many shareholders, each of whom likely owns only a small proportion of the total share capital.


of company documents and indeed have no right to inspect certain company files.\(^97\) Therefore, whilst shareholders may obtain some information from the companies’ annual reports and other official statements, these sources of information are often inadequate for the purpose of enforcement.\(^98\) Where the profit and loss account reveals poor performance; it will not identify the particular businesses or transactions that resulted in that poor performance.\(^99\) Opportunities to ask questions at the annual general meeting are also of little use in these instances.\(^100\) Cases of directors’ malpractice are therefore not likely to be brought to the members’ attention. Similarly, auditors owe no duty to investigate management’s effectiveness or to comment on business decisions made by directors. Therefore, even auditors are unlikely to be a good source of information about managerial misconduct.\(^101\)

In addition to this, directors are, generally, aware of the amount of harm caused by their misconduct while shareholders do not possess this information.\(^102\) Shareholders are therefore often in a weak position to assess the strength of their claim against directors.\(^103\) The information required by shareholders to build a strong case is also likely to be in the directors’ hands.\(^104\) This creates significant difficulties for potential litigant shareholders.\(^105\)

\(^{97}\) Shareholders statutory rights to inspect company documents are very specific and limited. Hence, shareholders do not have a general right to inspect the minute of board of directors’ meetings or the company’s accounting records. See UK Companies Act 2006, ss 116, 229, 238, 358 & 423.\(^{98}\) These sources of information will not provide a claimant shareholder with the evidence needed to bring a lawsuit. See further L.C.B Gower, ‘Some Contrasts between British and American Corporations Law’ (1956) 69(8) Harvard Law Review 1369, 1387.\(^{99}\) Parkinson (n 46) 243; Fischel and Bradley argue that the lack of access to relevant information makes it difficult for minority shareholders to judge which management actions are wrongful or contrary to the company’s interests. See Daniel Fischel and Michael Bradley, ‘the Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical Empirical Analysis’ (1985) 71 Cornell Law Review 261,273.\(^{100}\) Parkinson (n 46) 245.\(^{101}\) ibid 244.\(^{102}\) Reisberg, ‘Derivative Actions and Corporate Governance’ (n 89) 86.\(^{103}\) Joseph Lee, ‘Shareholders Derivative Claims under the Companies Act 2006: Market Mechanism or Asymmetric Paternalism?’ (2007) 18(11) International Company and Commercial Law Review 378,390.\(^{104}\) Where the board of directors are unwilling to take action against a wrongdoing director, they would be uncooperative in releasing information required by the shareholder in order to bring a derivative action.\(^{105}\) Joan Loughrey, ‘Privileged Litigants: Shareholder Rights, Information Disclosure and Corporate Privilege’ [2007] Journal of Business Law 778.
Consequently, shareholders often suffer from severe ‘informational disadvantages’ which deters them from litigating and reduces their chances of success where they choose to do so.

**ii. Corporate Actions**

As discussed above, shareholders suffer from information asymmetries, it is however worth considering whether the board also experiences this problem. Where the board is considering instituting corporate action against a wrongdoing director, one would be safe to presume that all the board members would possess the information required to vote in favour of, or against, litigation. This is however not necessarily the case as evidence suggests that information asymmetries often exist between executive and non-executive board members. Non-executive directors are generally outsiders who work part time and spend limited time at the company. They would therefore often have less knowledge and information about the business in comparison to their executive counterparts. In light of this, they must rely on the information provided by the CEO who usually has superior knowledge about corporate matters.

The information asymmetry that exists within boards of directors may result in the concealment of information regarding a director’s misconduct from other members of the board. This will be particularly so where the wrongdoing director is the CEO or a key member of the board. Even where information regarding the misconduct is disclosed to the board, it might be presented in a manner designed to hide the true extent of the misconduct or, indeed, elicit the

---

106 Reisberg, ‘Derivative Actions and Corporate Governance’ (n 89) 86.
109 The results of an empirical study by Hooghiemstra and Manen demonstrate that non-executive directors face significant limitations due to the information asymmetry that exists in boards. See Hooghiemstra and Manen (n 107) 314.
110 Ramirez argues that CEO primacy exists. He argues that CEOs of public corporations are generally very powerful and possess significant power on the board. See Steven Ramirez, ‘The Special Interest Race to CEO Primacy and the End of Corporate Governance’ (2007) 32 Delaware Journal of Corporate Law 345, 385-386.
desired response from the non-executive directors.\footnote{Hooghiemstra and Manen (n 107)317.} Therefore while non-executive directors are expected to approach issues more objectively than executive directors, and are in a better position to make litigation decisions, they will be unable to do this if they lack relevant information.

Consequently, while shareholders generally suffer from information asymmetry, the board of directors is not spared of this problem. Information asymmetry is therefore a significant weakness which either discourages private enforcement actions or, where such actions are instituted, reduces the chances of success. It therefore has an incidental effect on the ability of the enforcement regime to produce deterrence and compensatory benefits.

2. The Incentive Problem

The second weakness of the private enforcement regime is the incentive problem. This problem affects the various private enforcement mechanisms in different ways. Overall, however, it has the effect of dissuading private parties from bringing enforcement actions. First we consider corporate actions.

i. Corporate Actions

Power to bring legal proceedings on the company’s behalf is generally vested in the board of directors.\footnote{See Breckland Group Holdings Ltd v London & Suffolk Properties Ltd [1989] BCLC 100 where Harman J held that the decision to commence litigation is included in the power granted by Article 80 of Table A to directors to manage the business. See also Lord Wedderburn of Charlton, ‘Control of Corporate Action’ (1989) 52 Modern Law Review 401. Note that in the UK Table A of 1985 has been replaced by the Companies (Model Articles) Regulations 2008/3229 for companies registered on or after the 1st October 2009.} Hence, where there has been a breach by a director, or any other party, the board
has the power to institute corporate action against the offending party.\textsuperscript{113} In spite of this litigation power however, boards generally lack the incentive to bring corporate actions against fellow directors.\textsuperscript{114} This is due to several inter-related reasons. Three of these would be examined here.

The first reason why boards generally lack the incentive to bring private enforcement actions against wrongdoing directors is loyalty ties. Directors often develop friendship and loyalty ties to each other similar to those found among family members or members of a society.\textsuperscript{115} Such friendship relations are governed by norms which require individuals to care for each other’s welfare and come to each other’s aid when needed.\textsuperscript{116} Hence, boards of directors who have developed friendship ties among each other are naturally inclined to protect fellow directors’ rather than subject them to litigation.\textsuperscript{117} This applies irrespective of fault on the part of the wrongdoing director or whether or not the director remains a member of the board. Members of the board are therefore for this reason generally unlikely to have the incentive to sue fellow directors.\textsuperscript{118}

The second reason why boards lack the incentive to bring action against other directors is the group think syndrome.\textsuperscript{119} Boards of directors are often affected by group think. Boards

\begin{itemize}
\item[\textsuperscript{113}] See CAMA, s 63(3) which provides that the board of directors may exercise all the powers of the company except those which have been expressly vested by the in the general meeting.
\item[\textsuperscript{114}] It has long been accepted by corporate law scholars that members of a board generally have poor incentives to sue fellow directors. Dent, for example, argues that both inside and outside directors cannot be expected to act independently in making the decision to sue a fellow director. See George Dent Jr, ‘The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit’ (1980) 75 Northwestern University Law Review 96, 110-118. Similarly Scott argues that people generally lack the motivation to sue themselves. See Kenneth Scott, ‘Corporation Law and the American Law Institute Corporate Governance’ (1983) 35 (5) Stanford Law Review 927, 940.
\item[\textsuperscript{115}] David Kershaw, Company Law in Context: Text and Materials (2nd edn, OUP 2012) 591.
\item[\textsuperscript{116}] Mady Wechsler Segal, ‘Varieties of Interpersonal Attraction and Their Interrelationships in Natural Groups’ (1979) 42(3) Social Psychology Quarterly 253,254.
\item[\textsuperscript{117}] Patton and Baker argue that directors generally value each other’s friendship and want to keep their seats on the board. They are therefore likely to treat shortcomings by other directors in an indulgent manner. See Arch Patton and John Baker, ‘Why won’t directors rock the boat’ (1987) Harvard Business Review 10, 10-11.
\item[\textsuperscript{118}] Ibid.
\item[\textsuperscript{119}] The group think theory was developed by Irving Janis. See Irving Janis, Victims of Groupthink: A Psychological Study of Foreign-Policy Decisions and Fiascos (Houghton Mifflin 1972).
\end{itemize}
generally act as unified groups; division or failure to agree on key issues is therefore incredibly rare.\textsuperscript{120} As noted by Cox and Munsinger, strong psychological factors at work within the boardroom create a cohesive and legal in-group that will support its members for both positive and negative reasons.\textsuperscript{121} Members of the board may therefore unanimously decide to refrain from commencing litigation against a fellow director even where it is the company’s best interests to sue.\textsuperscript{122} Similarly, the board may ‘blindly’ agree with the opinion of a key member of the board who is averse to litigation. This view finds support in Hill’s empirical study where it was found that generally most executive and non-executive directors do not disagree with the CEO.\textsuperscript{123} Similarly, in an empirical study by Pettigrew and McNulty, it was noted that the chairman’s influence on the board can be very significant.\textsuperscript{124} Hence, where the CEO or chairperson decides not to sue a fellow director, it is likely that the votes of other members of the board would reflect this position.\textsuperscript{125}

The third reason why board members may lack the incentive to sue a wrongdoing director is the need to ensure \textit{reciprocity}. Directors may refuse to litigate against a wrongdoing director as a means of protecting their own interest in case they fall into the same position. Even where they do litigate, they may fail to pursue it diligently such that the action will fail. Kershaw has labelled this ‘reciprocal back scratching: this time I will help you out; I hope you’ll do the same

\textsuperscript{122} The Enron board provides a classic example of a board affected by group think. For a full discussion of this see Marleen O’Connor, ‘The Enron Board: The Perils of Group Think’ (2003) 71 University of Cincinnati Law Review 1233, 1257 -1293.
\textsuperscript{124} Andrew Pettigrew & Terry McNulty, ‘Power and Influence in and around the Boardroom’ (1995) 48 Human Relations 845, 857.
for me if I ever find myself in such a position’. 126 Directors might also refuse to vote in support of litigation against a fellow director as a means of ensuring that they remain in the ‘good books’ of the wrongdoing director. 127 This will be particularly so where the wrongdoing director is a key member of the board such as the CEO or chairperson. 128 Similarly, directors often require the support of other directors on the board for resolutions; they are therefore likely to vote in a manner that ensures that they can always get the support of the wrongdoing director should they require it in the future.

As a result of the various disincentives to corporate actions against directors, it is hardly surprising that such actions are often a rare occurrence. 129 As mentioned earlier, in order for an enforcement mechanism to offer any deterrent or compensatory benefits, it must be put to good use. This lack of incentive to bring corporate actions against directors therefore means that this enforcement action is hardly used and consequently offers little benefit.

ii. Derivative Actions.

The incentive problem is not limited to corporate actions; it is also evident in other private enforcement actions. This is especially so for derivative actions. Shareholders generally lack the incentive to bring derivative actions. 130 This lack of incentive may be attributed to at least

---

126 Kershaw, company law in context (n 115) 591.
128 As mentioned earlier CEOs and chairpersons often exercise significant influence on the board. See text accompanying footnotes 123 to 125.
130 Ramsay argues that the main obstacle to shareholders contemplating bringing derivative actions is not deficiencies with the common law due to Foss v Harbottle; rather it is a lack of incentives to commence litigation. See Ian Ramsay, ‘Corporate Governance, Shareholder Litigation and the Prospects of A Statutory Derivative Action’ (1992) 15 University Of New South Wales Journal 149,150.
two factors. The first is the absence of *direct* benefit for litigant shareholders and the second is the *free rider problem*.

The first factor - absence of direct benefit - arises from the very nature of derivative actions. Derivative actions are proceedings brought in the company’s name to enforce rights due to the company.\textsuperscript{131} The company is the real plaintiff in a derivative action. Consequently, any damages or other corporate recovery goes directly to the company.\textsuperscript{132} Corporate recovery however does not necessarily provide equivalent benefit to shareholders in form of compensation.\textsuperscript{133} Indeed, it may find its way back into the directors’ pockets in form of managerial remuneration.\textsuperscript{134} The claimant may therefore only receive an indirect benefit in the event that the proceedings lead to a rise in share price.\textsuperscript{135}

Even where corporate recovery results in some sort of tangible compensation for shareholders, it is likely to be an insignificant amount per shareholder. While a corporate recovery might be large; on a per share basis, it amounts to very little for individual shareholders.\textsuperscript{136} If all that the derivative action accomplishes is a few pennies per share to thousands of shareholders, it is difficult to justify shareholders’ efforts in bringing the action. This sort of pro rata gain for shareholders is not even guaranteed as a successful derivative action may lead to a reduction in share value due to bad publicity associated with litigation or loss of confidence in the

\textsuperscript{131} Iesini v Westrip Holdings Ltd [2010] B.C.C 420 [73].
\textsuperscript{133} In this respect Wilson argues that the fact the damages from any successful derivative action go directly to the company and not the litigant plaintiff has a ‘significant impact’ on a prospective litigant’s incentive to commence litigation. See John D Wilson, ‘Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholders’ Derivative Action’ (1985) Windsor Yearbook of Access to Justice 142,171. See also Lee, (n 103) 389.
\textsuperscript{134} Coffee and Schwartz, ‘The Survival of the Derivative Suit’ (n 40) 304.
directors’ abilities. The lack of direct benefit therefore significantly reduces shareholders’ incentives to bring enforcement action.

The second factor responsible for shareholders’ lack of incentive to bring derivative actions is the free rider problem. Several scholars have discussed the rational apathy and free rider problem which exists among shareholders in the company. The free rider problem arises because shareholders who do not participate in bringing litigation, or bear any risk involved in litigating, will benefit from a derivative action if successful. While a shareholder may benefit from instituting a derivative action, he or she will gain more if other shareholders bear the costs. The free rider problem may therefore cause shareholders to refrain from litigating in order to prevent other shareholders from benefitting from their efforts or even in the hope that someone else will commence proceedings. However if all shareholders share this view, the likelihood of getting a shareholder to sue is quite slim.

The incentive problem therefore remains one of the biggest difficulties preventing shareholders from using derivative actions as an enforcement mechanism.

### iii. Other private enforcement actions

In addition to corporate actions and derivative actions, other private enforcement actions also suffer from the incentive problem. This is particularly so with regards to public listed

---


139 Keay, ‘Assessment of Private Enforcement Actions’ (n 6)88.

140 Gordon, ‘Ties that Bond’ (n 138)44.

141 Lee (n 103) 389.

142 Reisberg, ‘Derivative Actions and the Funding Problem’ (n 137) 446.
companies. Two of these are mentioned briefly here. The first is the unfair prejudice petition. Shareholders of public listed companies generally lack the incentive to bring unfair prejudice petitions. This is due to the inadequacy of the remedy on offer. In an unfair prejudice petition, the default remedy often provided by the court is an ‘exit remedy’. This exit option is however undesirable to those shareholders who still desire to stay in the company and are rather interested in the deterrent effect of an enforcement action on wrongdoing directors. This will be particularly so where the misconduct has affected the company’s share value. Even where shareholders are interested in exiting the company, this remedy is still of limited use to shareholders of public listed companies who are generally much better off selling their shares on the market. The exit option is therefore generally unsuitable for shareholders of public listed companies. Consequently, unfair prejudice petitions are hardly used by shareholders of such companies.

The second enforcement action to be considered is action by insolvency practitioners. Corporate insolvency can prompt litigation against wrongdoing directors. Insolvency practitioners therefore often have authority to bring actions in the name of the company. These include actions against the company’s directors for breaches of duty. While this power exists in theory, in practice, liquidators rarely sue directors of insolvent companies. This is particularly so for public listed companies. In a study carried out by Armour, it was found

---

144 This is an order for the purchase of the petitioning shareholder’s share by the company or majority shareholders. See Grace v Biagioli [2006] BCC 82 CA.
147 A statistical survey by the Law Commission over a two year period reveals that petitions brought by minority shareholders in small private companies make up the majority of petitions brought under section 459 of the UK Companies Act 1985 (now section 994 of the Companies Act 2006). It was found that 82% of companies involved in unfair prejudice petitions had five or fewer members. See Law Commission, Shareholder Remedies Report (LC 246, 1997) para 3.13.
148 Insolvency Act (UK) 1986, s212.
149 Armour and others, ‘Private Enforcement of Corporate Law’ (n 6) 715.
that over a 16 year period, there was only one instance in which an insolvency practitioner had
instituted a claim against former directors of a public listed company.\textsuperscript{150} This dismal track
record is perhaps due to the fact that in the event that the claim fails, the insolvent company
would be required to pay the defendants’ legal costs ahead of other creditors.\textsuperscript{151} Liquidators
are often more keen on saving the corporate estate for the creditors’ benefit rather than
commencing enforcement action against badly behaved directors. Therefore, while a liquidator
may be keen on retrieving corporate assets which have been wrongfully transferred to directors,
he is likely to be less enthusiastic in pursuing other ‘speculative’ claims like negligence against
directors where the outcome is less assured.\textsuperscript{152} Insolvency practitioners therefore generally
have little incentive to bring enforcement action against directors in respect of breaches of duty.

The incentive problem is arguably the most significant weakness of the private enforcement
regime. The private nature of this enforcement regime means that potential enforcers will often
sue only when they believe it is in their best interests to do so. This in itself is hardly surprising,
as the law does not compel private individuals to bring actions that are contrary to their
interests. Thus, a person who suffers loss is not compelled to seek redress for the wrong no
matter how offensive the conduct is to public policy.\textsuperscript{153} The incentive problem however has a
consequential effect on the ability of the private enforcement regime to produce compensatory
or deterrence benefits thereby impeding its effectiveness.

\textbf{3. Costs of Enforcement}

\textsuperscript{150} Armour, ‘Enforcement Strategies in UK Company Law’ (n 23).
\textsuperscript{151} Armour and others, ‘Private Enforcement of Corporate Law’ (n 6)715.
\textsuperscript{152} Pursuing private actions in these circumstances are also unlikely to be cost effective. See Parkinson (n 46) 239.
\textsuperscript{153} See Franklin Gevurtz, ‘Who represents the Corporation? In search of a better method for determining the
Enforcement resources are generally limited. Potential enforcers are therefore expected to weigh the costs and benefits of an enforcement action before embarking on it. Consequently, a key factor that determines the use, and effectiveness, of an enforcement regime is the amount of benefits to costs which it offers. This is known as the cost-benefit approach to decision making.

Costs and benefits in this regard may be understood in two different senses. The first is the public cost and benefit of the enforcement regime to the society while the second is the private cost and benefit of enforcement to the enforcer. The public benefits of enforcing directors’ duties may include greater deterrence, enhanced compliance, increased investments, stronger capital markets and overall improved corporate governance. On the other hand, the public costs of enforcement may include the financial costs of investigating and enforcing, possible reduction in the willingness of qualified persons to take up executive positions, and negative publicity potentially affecting the market.

The private benefits of enforcement of directors duties include corporate recovery by the company i.e. compensation, deterrence, greater returns to shareholders and possible reduction in agency costs. The private costs of enforcement include the monetary expenses, time spent in pursuing the enforcement action and the potential negative publicity for the company. It would also include the chilling effect of the enforcement action on directors causing them to be more risk averse, the possibility of ‘soured future relations’ with the erring directors, and

---


156 Gevurtz (n 153) 299.
the potential reduction in the pool of qualified persons willing to act as directors due to fears of potential sanction.

Although there are clear areas of interplay between the two, some tension may occur between the public and private costs and benefits of enforcement. Public benefits of enforcement do not always translate to private benefits for the enforcer and company. An enforcement action may offer immense public benefits in terms of enhanced general deterrence and increased compliance with the relevant rules and standards. It may nevertheless offer little private benefit to the company or may indeed be detrimental to it. Similarly, a private enforcement action may be costly to the company and its shareholders, while being socially beneficial due to its general deterrent effect. In this instance, there is an obvious conflict between the public benefits and the private benefits of enforcement. Consequently, private enforcers in the company will often calculate, and be mostly concerned with, the private benefits and costs of enforcement.

The problem occasioned by the costs of enforcement affects the private enforcement regime in its entirety. Litigation is expensive; the costs of litigation have therefore been the subject of much discourse over the years. In private civil litigation, there is evidence which suggests that litigation costs can exceed the amount received by a successful claimant. Consequently, several scholars have argued that litigation, including shareholder actions, should be viewed as an investment decision. The resources to be invested include time and money while the future results would include recovery of compensation and deterrence of future misconduct. A key

---

157 Reisberg, ‘Derivative Actions and Corporate Governance’ (n 89) 222.
factor which determines potential claimants’ decision to sue is therefore whether the potential private benefits are likely to outweigh the costs of litigation.\(^{161}\)

Generally, a company is unlikely to sue a director unless a substantial amount is at stake.\(^{162}\) Consequently, where a director’s breach, and potential recovery, is considered insignificant,\(^{163}\) the board of directors are likely to view litigation as an unworthy venture. Similarly, where the chances of success are low, litigation becomes extremely unattractive for the board.\(^{164}\) In addition to this, the board may consider the potential non-financial costs of enforcement in terms of the attendant negative publicity, valuable time expended, and the chilling effect on other directors. They may therefore calculate that the costs of enforcement outweigh its benefits.

The cost problem is particularly evident in derivative actions due to the lack of direct benefits for claimant shareholders as discussed in the previous section. A rational shareholder would only expend the effort needed to bring enforcement action where the expected benefits exceed the costs.\(^{165}\) Generally, however, on a cost-benefit scale, the costs of bringing derivative actions are likely to outweigh its potential benefits. This problem is further exacerbated by the fact that in many common law jurisdictions such as the UK and Nigeria, losing is more costly due to the ‘losers pay’ rule.\(^{166}\) Shareholders are therefore likely to be deterred by the potential monetary costs of enforcement.


\(^{163}\) Evidence suggests that where the amount to be recovered is small, the legal fees paid by both sides are likely to be equal to, or more than, the amount recovered by the plaintiff/claimant. See Trubek and others, (n 158) 121.

\(^{164}\) Shavell, (n 160) 69.


\(^{166}\) The plaintiff in litigation is therefore at risk for two sets of legal costs if he or she loses. See CPR – Rules and Directions, Rule 44.2(2)a for the UK’s position. See also Hazel Genn, ‘Have Past Reformers Truly understood the Cost of Litigation?” (1999) 20(2) the Justice System Journal 163, 166. In respect of Nigeria see Akinbobola v Plisson Fisko (1991) 1 N.W.L.R. (Pt 167) 270.
It is worth mentioning that both the UK and Nigeria make provision for reimbursing shareholders for costs incurred in bringing derivative actions.\textsuperscript{167} However, in both countries, the court’s power to order indemnification for costs is discretionary. Similarly, the availability of indemnity cost orders generally does not provide any incentive for shareholders to bring derivative actions. Hence, while it is sometimes believed that indemnity cost orders can provide a substantial incentive to use derivative actions,\textsuperscript{168} this is not the case.\textsuperscript{169} As argued by Reisberg, the view that indemnity cost orders can increase shareholders’ incentive to litigate ‘ignores the realities of derivative action litigation’.\textsuperscript{170} He further argues that an indemnity cost order does not cure the funding problem neither does it provide a strong incentive to litigate.

Asides from the monetary costs, litigation may also impose unforeseen costs. Litigation may take up valuable management time and distract key personnel.\textsuperscript{171} The company may have to find a replacement for the wrongdoing director, if necessary. Similarly, litigation may increase the costs of attracting new directors. It could also deter legitimate risk taking thereby adversely affecting profit maximisation.\textsuperscript{172} The potential costs of private enforcement may therefore significantly outweigh the potential benefits. This deters private enforcers from bringing claims and limits the efficacy of the private enforcement regime.

4. \textit{Procedural Rules for Derivative proceedings}

Another weakness of the private enforcement regime is the procedural rules governing derivative proceedings. While derivative proceedings are just one strand of the private

\textsuperscript{167} \textit{Wallersteiner v Moir (No.2) [1975] 1 Q.B. 373}; Companies and Allied Matters Act 1990 (CAMA), s304(2)d.
\textsuperscript{168} The UK Law Commission was of the opinion that an indemnity cost order provides a ‘significant incentive’ to use derivative actions. See Law Commission, \textit{Shareholder Remedies (CP 142, 1996)} 18.1.
\textsuperscript{169} See Parkinson (n 46)241.
\textsuperscript{170} Reisberg, \textit{‘Derivative Actions and the Funding Problem’} (n 137) 447.
\textsuperscript{172} ibid 665.
enforcement regime, they nevertheless represent a key enforcement mechanism. Hence, the problems occasioned by the procedural rules governing derivative proceedings are worth discussing in their own right.

Due to the nature of derivative proceedings, controls and checks in form of procedural rules are often introduced to prevent frivolous litigation. The Law Commission, for example, in its report on shareholder remedies recommended ‘tight judicial controls’ at all stages of the statutory derivative claims process. These sorts of controls are beneficial in preventing abuse. However, in certain cases, they operate to hinder the effectiveness of derivative proceedings as an enforcement mechanism. This is evident from the UK and Nigerian experience.

In the UK, as a response to the inadequacies of the common law regime, the Law Commission recommended that there should be a new derivative procedure with ‘more modern, flexible and accessible criteria’ for determining when shareholders should be able to bring derivative actions. This resulted in the statutory derivative claims regime set out in part 11 of the Companies Act 2006. However, while the statutory regime represents an improvement on the previous common law era, potential claimants still need to overcome

173 The UK, for example, has historically relied significantly on derivative proceedings as a means of enforcing breaches of directors’ duties. See Keay, ‘An Assessment of Private Enforcement Actions’ (n 6)83.
177 Law Commission, Shareholder Remedies Report (n 175) para 1.23V.
the procedural hurdles imposed by the Act. Section 263 of the UK Companies Act 2006 contains both mandatory and discretionary factors which the court should consider in determining whether permission to continue a derivative claim should be granted. It is worth noting that this list is not exhaustive and the court may consider other factors in determining whether to grant permission to continue the claim. Similarly, judicial discretion remains a key part of the regime; resulting in a significant amount of uncertainty.\(^\text{179}\) In light of this, it has been argued that the procedural obstacles to continuing derivative claims under the UK statutory regime are similar to those which existed under the common law thereby reducing accessibility to this enforcement mechanism.\(^\text{180}\)

The Nigerian experience in this regard is arguably worse than the UK. The Nigerian rules on derivative actions are codified in the Companies and Allied Matters Act 1990 (CAMA). These rules have already been the subject of in-depth analysis, and criticisms, by a range of commentators.\(^\text{181}\) There is no need to repeat what has already been said. Generally, however, criticisms of Nigeria’s derivative action regime include its retention of the common law wrongdoer control requirement, the lack of clarity in the scope of wrongs covered, its treatment of litigation costs, and the uncertainty in its provisions.\(^\text{182}\)

CAMA imposes requirements which potential claimants must fulfil in order to bring derivative actions.\(^\text{183}\) Some of these requirements such as the wrongdoer control and the notice

---

\(^{179}\) Sykes argues that there has been some inconsistency in the court’s approach resulting in increased litigation costs and delays. Paul Sykes, ‘the Continuing Paradox: A Critique of Minority Shareholder and Derivative Claims under the Companies Act 2006’ (2010) 29(2) Civil Justice Quarterly 205, 226.


\(^{182}\) For a full discussion of these problems see Awolalu (n 181) 13; Nwafor (n 181)214.

\(^{183}\) CAMA 1990, s303(2).
requirement however act as pitfalls to shareholders in their quest to enforce directors’ duties. Consequently, the likelihood of a shareholder successfully bringing a derivative action in Nigeria is extremely low. This is clearly demonstrated by the fact that since the codification of the rules governing derivative actions in Nigeria more than two decades ago, this enforcement mechanism has barely been used by shareholders.\(^{184}\) It is therefore evident that the procedural rules governing derivative proceedings act as an impediment to its use thereby preventing this enforcement mechanism from providing any deterrence or compensatory benefits.

5. General unsuitability for countries with weak judicial systems

Asides from the specific weaknesses of the private enforcement regime, one general weakness of the regime is its unsuitability for countries with weak judicial systems. Due to its nature, the private enforcement regime depends significantly on a well-functioning and efficient judicial system. While this is not a problem in itself, it substantially prevents effective enforcement in countries with weak judicial systems. Nigeria provides a classic case.

Black and Kraakman, in their article on the self-enforcing model of corporate law, highlight the weaknesses of formal enforcement particularly for emerging countries. A weak judicial system is pinpointed as the most significant factor limiting enforcement in such countries.\(^ {185}\) Some of the problems identified include cumbersome judicial procedures, overburdened court system, lack of judicial experience and corruption. In countries where these problems are prevalent, judicial enforcement of corporate law will fail.\(^ {186}\) While Black and Kraakman’s

---

\(^ {184}\) Awolalu (n 181) 14.


\(^ {186}\) Ibid 1926.
analysis relates specifically to enforcement of corporate law in Russia, Nigeria shares these
difficulties.

The inefficiencies of the Nigerian judicial system have been the subject of much discussion.187
The Nigerian judiciary is plagued with several problems which impede its ability to efficiently
administer justice. One of the key problems is corruption. Corruption is a general issue in
Nigeria;188 however, available evidence suggests that the judicial system is not spared from
this problem.189 Judicial corruption exists in some form in many countries of the world;190 in
Nigeria however, it has been described as a common feature of the judicial system.191

Lack of judicial independence is also a problem in Nigeria. The Constitution of the Federal
Republic of Nigeria provides that money belonging to the judiciary in the consolidated revenue
fund should be paid directly to the National Judicial Council or heads of courts, as
appropriate.192 The executive arms of government however often breach this provision and
have been reluctant to recognize the judiciary’s financial independence.193 Judges are also
liable to political influence and pressure from the executive and legislative arms of
government.194

187 See Okechukwu Oko, ‘Seeking Justice in Transitional Societies: An Analysis of the Problems and Failures of
the Judiciary in Nigeria’ (2005) 31(1) Brooklyn Journal of International Law 9; Philip Aka, ‘Judicial
Independence under Nigeria’s Fourth Republic: Problems and Prospects’ (2014) 45 California Western
International Law Journal; F.A.R Adeleke and O.F Olayanju, ‘The Role of the Judiciary in Combating Corruption:
188 In the 2016 corruption perception index by Transparency International, Nigeria was ranked among the top 50
most corrupt countries in the world. See Transparency International, ‘Corruption Perceptions Index 2016’ (25th
March 2018.
189 Over the years there have been various allegations of corruption in the Nigerian judiciary. See Adeleke and
Olayanju (n 187) 604. See also BBC, ‘Nigeria Seizes $800,000 in ‘Anti-Corruption Raids’ on Judges’ (9th October
190 Judge Wallace, in 1998, noted that there have been incidents of judicial corruption in all countries around the
28(2) California Western International Law Journal 341, 342.
191 Oko, (n 187) 25.
192 Constitution of the Federal Republic of Nigeria 1999, ss 81, 84 & 121
193 See Olisa Agbakoba v FG, The NJC and National Assembly Suit No: FHC/ABJ/CS/63/2013
In addition to corruption and lack of judicial independence, Nigeria’s judicial system is also faced with other problems which reduce its ability to effectively administer justice. These problems include delay in the judicial process, strike actions, understaffing, underfunding, and lack of necessary equipment and IT facilities. Consequently, potential claimants are faced with the prospect that litigation against a wrongdoing director may be unduly influenced by the directors themselves or last several years. Similarly, the courts may lack the facilities required to effectively determine the case. These factors may discourage private enforcement actions and therefore have a domino effect on the efficacy of the enforcement regime in countries that have similar problems.

6. Inadequate deterrence

A final weakness of the private enforcement regime is that it offers inadequate deterrence. The deterrence hypothesis has been discussed earlier on in this article. Two key factors have been shown to determine deterrence. 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 severity of punishment. It is said that to ensure its effectiveness, punishment should be sufficiently severe and proportionate to the offence.

---

195 Oko’s research shows that an average trial at a court of superior record in Nigeria can take as long as 5 to 6 years, with another 3 to 4 years spent on appeal proceedings. See Oko (n 187) 39. See further Jedrzej Frynas, ‘Problems of Access to Courts in Nigeria: Results of a Survey of Legal Practitioners’ (2001) 10(3) Social and Legal Studies 397, 410.


197 See Beccaria (n 27) 49-70.

Based on these key factors, there are two main reasons why the private enforcement regime offers inadequate deterrence. First, the certainty of punishment offered by the regime is low due to the fact that, as discussed, it suffers from several weaknesses. These weaknesses have a dual negative effect. They reduce incidences of private enforcement actions and, where instituted, they reduce claimant’s chances of success. These invariably reduce the likelihood that a director will suffer any detriment or penalty as a result of the existence of the private enforcement regime.

Second, the penalties provided by the private enforcement regime generally offer low severity. Private law in many countries restricts punitive damages in civil proceedings. This is mostly due to the absence of sufficient protection for defendants in such proceedings compared to criminal trials.199 Hence, for private enforcement actions in respect of directors’ breaches, the courts do not impose punitive damages neither do they increase the penalties imposed as a way of compensating for the often low risk of apprehension.200 Private enforcement actions therefore generally only cancel the gain that directors intending to benefit at the company’s expense could have made.201 A classic example of this is seen in the case of Re Produce Marketing Consortium Ltd202 where Knox J held that the court’s jurisdiction under s214 of the UK Insolvency Act 1986 was ‘primarily compensatory not penal’. Therefore, the amount the director was liable to contribute was limited to the amount by which the company’s assets had depleted by the director’s conduct. Damages in such cases are therefore often restricted to compensating the company for any losses suffered. The wrongdoing director remains in the

201 ibid.
same position he would have been if the wrong had not been committed. The director therefore, arguably, has little to lose from an award of judgement.

This problem is further exacerbated by the fact that, as noted previously in this article, directors rarely suffer out-of-pocket losses from litigation brought against them. Consequently, there is limited deterrence. A critic of this viewpoint could argue that while wrongdoing directors may not suffer financial detriment from private enforcement actions, they suffer social stigma or shame which in itself is a significant penalty with attendant deterrence. It can be further argued that this stigma penalty may even deter misconduct at other companies as well. The problem with this argument however is that private enforcement actions, in reality, often produce very little stigma or shame. Publicity is a core element of the stigma penalty, however private enforcement actions are often kept in the private sphere. Therefore, while enforcement actions by regulators are likely to attract significant publicity and moral condemnation, the same cannot be said of private enforcement actions. Even where a private enforcement action is able to garner publicity, it may be perceived by the public as a mere internal disagreement between directors and shareholders. It will therefore offer limited stigma and deterrence.

**Conclusion**

Directors’ duties are an essential means of providing checks on those who control companies. The functionality of these duties however significantly depends on the effectiveness of available enforcement mechanisms. As noted by Keay, ‘The prescription of duties can educate

---

203 See text accompanying footnotes 81-83.
205 ibid 1428.
207 Keay, ‘The Public Enforcement of Directors’ Duties’ (n 3) 110.
and set norms of conduct, but unless there is some form of effective enforcement there is, arguably, no deterrence which is often regarded as an important element of any prescriptive requirements’. Similarly, it has been said that a right without a remedy is of no value. Consequently, directors’ duties ought to be accompanied by an effective external disciplinary mechanism.

This article has examined the weaknesses of the private enforcement regime, a key disciplinary mechanism in corporate law. It identified compensation and deterrence as the main purposes of enforcement of corporate law. It noted that in determining the effectiveness of an enforcement regime, the crucial question is whether it is able to adequately meet a deterrence, and, or compensatory purpose. In order to achieve this, however, the enforcement regime must be put to effective use and offer reasonable prospects of success.

The discussion in this article has revealed that the private enforcement regime in corporate law suffers from several weaknesses. These weaknesses have the effect of significantly deterring private parties from bringing enforcement actions against directors. This in turn hinders the private enforcement regime from successfully providing both deterrence and compensatory benefits thereby rendering it wholly ineffective. Consequently, in jurisdictions such as Nigeria which rely on private enforcement for breach of directors’ duties, there is need for a complementary enforcement regime. The Australian civil penalty regime provides a potential model in this regard. The success of Australia’s public enforcement regime for breach of directors’ duties has been the subject of discussion among various commentators. An

---

208 Keay, “An Assessment of Private Enforcement Actions” (n 6) 76.
analysis of how an Australian-type public enforcement regime can benefit Nigeria however merits in-depth consideration. It therefore falls within the scope of a separate article.

A final note; the weaknesses of the private enforcement regime have been discussed within the context of a theoretical framework. No empirical data on the private enforcement regime has been used. This perhaps represents a limitation of this article. A future empirical study of private enforcement actions, particularly within the Nigerian context, would therefore be particularly useful in providing further insight into the weaknesses of the private enforcement regime.

211 With regards to the UK, Keay and Welsh’s article already provides a useful discussion of how the Australian enforcement model would benefit the country. See Andrew Keay and Michelle Welsh, ‘Enforcing Breaches of Directors’ Duties by a Public Body and Antipodean Experiences’ (2015) 15 Journal of Corporate Law Studies 255.