Corporate Fiduciary Duties and Prudential Regulation of Financial Institutions

Edward M. Iacobucci*

While corporate fiduciary duties in many jurisdictions are generally understood to be owed to shareholders, recent Canadian Supreme Court cases have held that directors owe their duties to the corporation, period, not to shareholders or any other stakeholders. This development has introduced significant indeterminacy to the law since it is not clear what such a conception of the duty requires. The Supreme Court did, however, make one clear statement: it held that directors owe a fiduciary duty to ensure that their corporations obey statutory law. Such a duty encourages compliance with law, but may over-encourage compliance: individual directors do not necessarily gain personally from legal breaches, but may lose personally from them because of fiduciary liability, so they will have excessively strong incentives to avoid such breaches. The Article connects the fiduciary duty to obey law with recent developments in financial regulation that have increased the obligations on directors of financial institutions to oversee risk. By requiring directors to be engaged with risk at a governance level, regulators have enhanced the probability that directors will face liability under their fiduciary duties if their institutions do not comply with financial regulations. As the Article explains, the policy tradeoff between enhanced compliance benefits and over-compliance costs of fiduciary liability is different in the context of financial regulation from that in other settings. For example, significant corporate penalties, as

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opposed to penalties borne by individual directors, may be inconsistent with the prudential goals of regulation, perhaps because of too-big-to-fail concerns. The fiduciary duty to cause the corporation to obey financial regulation, and a stricter application of this duty than the highly deferential standard that exists in Delaware law, has advantages that do not exist in other legal and regulatory contexts.

**INTRODUCTION**

In an article published in 2001, Henry Hansmann and Reinier Kraakman declared the “End of History for Corporate Law.” They concluded that the major battles over the objectives of corporate law were over:

There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value. This emergent consensus has already profoundly affected corporate governance practices throughout the world. It is only a matter of time before its influence is felt in the reform of corporate law as well.²

The thesis was debatable when it was published, and remains debatable today. Indeed, some have suggested that the influence of powerful shareholders such as hedge funds over corporate governance, and the corresponding concern about other stakeholders such as creditors, should complicate easy acceptance of the shareholder primacy norm in Delaware.³ For Canadian observers, there is something especially striking about Hansmann and Kraakman’s declaration: when the article was published, many would have described Canadian corporate law as based on shareholder primacy, but shortly after the time of publication, the Canadian Supreme Court held in *Peoples Department Stores v. Wise*⁴ that corporate fiduciary duties were owed to the corporation, period, not to shareholders or any other stakeholder. That is, shortly after the so-called end of history, things took a dramatic turn in Canadian corporate law.

My focus in this Article is on fiduciary duties and the connection between these duties and the prudential regulation of financial institutions. The question of how fiduciary duties interact with risk at financial institutions has provided fodder for debate in the U.S. commentary, but recent developments in Canada

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2 Id. at 439.
4 Peoples Dep’t Stores v. Wise, [2004] 3 S.C.R. 461 (Can.).
help shed light on these matters. Aside from rejecting shareholder primacy in *Peoples*, the Canadian Supreme Court in another recent case, *BCE*, almost in passing observed that corporate fiduciary duties require directors and officers to ensure that their corporation obeys statutory law. The duty to obey the law, while without any strong doctrinal foundations in Canada, is more consistent conceptually with the Court’s rejection of shareholder primacy: a *fiduciary* duty to obey law makes more sense (though not perfect sense, as I will discuss) where the class of the duty’s beneficiaries is not restricted to shareholders and includes the government and the public. From a normative, policy perspective, there are conflicting considerations. A fiduciary duty to obey the law creates the risk of personal liability for a director of a law-breaking corporation, thus creating deterrence and greater compliance with law. The threat of personal liability may, however, over-deter: it may induce excessive caution on the part of the corporate fiduciary.

The Article concludes that however this tradeoff is resolved in general settings, financial regulation is different. Because of particular institutional features of financial regulation, including most prominently concerns over whether institutions are too big to fail, and consequential shortcomings of corporate liability for failing to obey prudential regulation, a fiduciary duty to obey law, with its attendant threat of personal liability, makes more sense in the financial regulation context than in other settings. This conclusion offers support for the tendency of prudential regulators recently to mandate certain risk governance practices that tighten the connection between directors and risk oversight, thus increasing the potential threat of personal liability for a breach of fiduciary duty for a failure to comply with prudential regulation.

The Article proceeds as follows. Part I outlines and analyzes recent developments in Canadian fiduciary law, reviewing the uncertainty that *BCE* introduced into Canadian law. Part II discusses the introduction into Canadian fiduciary duties of an obligation to obey law, reviewing its advantages and disadvantages. Part III shifts the focus to financial regulation, observing that prudential regulators increasingly have intervened in corporate boardrooms, requiring certain governance arrangements concerning prudential risk, for example. Part IV connects the analysis of the fiduciary duty to obey law to recent, board-oriented developments in financial regulation, pointing out that these developments combined with a duty to obey law increase the threat of personal liability for directors of financial corporations for the failure of their firms to comply with prudential regulation. Because corporate liability for financial institutions’ failure to comply with regulation may be problematic,

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there is a policy basis for director liability in the financial context that does not exist in other settings.

I. SHAREHOLDER PRIMACY AND RECENT DEVELOPMENTS IN CANADIAN CORPORATE LAW

Canadian corporate law historically has drawn heavily on English, and sometimes American, jurisprudence. Until recently, English cases were considered authoritative on the question of to whom, exactly, corporate fiduciaries under Canadian corporate law were owed.6 Under the law established in classic English cases, directors and officers were, as a matter of common law, understood to owe their fiduciary duties to the company, which was understood further to require them to act in the interests of the shareholders. *Hutton v. West Cork Railway Co.*7 provided the following colorful observations:

Take this sort of instance. A railway company, or the directors of the company, might send down all the porters at a railway station to have tea in the country at the expense of the company. Why should they not? It is for the directors to judge, provided it is a matter which is reasonably incidental to the carrying on of the business of the company, and a company which always treated its employees with Draconian severity, and never allowed them a single inch more than the strict letter of the bond, would soon find itself deserted . . . the law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.8

This passage makes it clear what the Court had in mind about the scope of the fiduciary obligation: while providing employees with benefits to which they are not legally entitled is permissible, it is only permissible if it promotes the business of the company. The case was cited with approval decades later in the 1962 House of Lords case, *Parke v. Daily News.*9 The Court stated: “In *Greenhalgh v. Arderne Cinemas Ltd.* Lord Evershed M.R. said, in a different context, that the benefit of the company meant the benefit of the shareholders

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6 Note that there are fourteen Canadian corporate law statutes, one for each province and territory, and one for the federal government. The most important of these statutes is the Canada Business Corporations Act (CBCA), R.S.C. 1985, c. C-44 (Can.), to which I generally will refer. The statutes are generally very similar, and are virtually identical on the questions on which I focus.
8 Id. at 672-73.
9 Parke v. Daily News Ltd., [1962] Ch. 927 (Eng.).
as a general body, and in my opinion that is equally true in a case such as the present.\footnote{Id. at 963 (footnote omitted).} The directors’ duty to act for the betterment of the company is a duty to act for the betterment of the shareholders. In revising its \textit{Companies Act} recently, the United Kingdom considered again how to frame a director’s duty to the company. It adopted language that, while encouraging directors to consider other stakeholders in making decisions, clarifies that the directors must adopt decisions that are good for shareholders.\footnote{The Companies Act, 2006, c. 46, § 172(1) (Eng.) in effect reproduces what the Court held in \textit{Hutton}: there are to be no cakes and ale unless cakes and ale are good for the shareholders as a whole. It provides in part: A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —
\begin{itemize}
  \item a) the likely consequences of any decision in the long term,
  \item b) the interests of the company’s employees,
  \item c) the need to foster the company’s business relationships with suppliers, customers and others,
  \item d) the impact of the company’s operations on the community and the environment,
  \item e) the desirability of the company maintaining a reputation for high standards of business conduct, and
  \item f) the need to act fairly as between members of the company.
\end{itemize}
  

Canadian law has taken a markedly different turn. The key antecedent for the recent departure from shareholder primacy is \textit{Teck Corporation v. Millar}.\footnote{Teck Corp. Ltd. v. Millar (1972), 33 D.L.R. 288 (Can. B.C. S.C.).} This case concerned the appropriate response of directors to a hostile takeover bid for a mining company. There was no dispute in the case about the conception of the company’s good that was at stake; all parties made arguments about shareholder value. The Court, however, offered \textit{obiter dicta} about the appropriate role of shareholders in the corporate hierarchy:

A classical theory that was once unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting \textit{bona fide} in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered \textit{bona fide} the interests of the shareholders.
I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company’s shareholders in order to confer a benefit on its employees: *Parke v. Daily News*. But if they observe a decent respect for other interests lying beyond those of the company’s shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.  

This quotation is ambiguous. Allowing that directors may respect interests beyond shareholders’ seems to treat other stakeholders’ welfare as important not just as a means of achieving shareholder welfare, but also as an end in itself. On the other hand, the Court cites *Parke*, an unambiguously pro-shareholder case, with approval.

Whatever *Teck* intended, the Supreme Court made a clear break with shareholder primacy in *Peoples Department Stores v. Wise*. Creditors argued that there is a shift from the fiduciary duty being owed to shareholders to being owed to creditors when the corporation is either approaching insolvency or insolvent. The Supreme Court rejected such a shift in *Peoples*, and did so for surprising reasons. The duty does not shift from shareholders to creditors, the Court opined, because it was never owed to the shareholders. Rather, the fiduciary duty found in section 122 of the *Canada Business Corporations Act (CBCA)* speaks of a duty to act in the best interests of the corporation, not a duty to shareholders, creditors, or any other stakeholder.

The Court revisited this matter in *BCE*. In this case, a group of debenture-holders objected to a leveraged buyout that in expectation lowered the value of their debentures, while generating considerably more value for shareholders. On the basis of a generous reading of the oppression remedy in the CBCA that has been held to protect extra-contractual reasonable expectations, the Quebec Court of Appeal, in a five-zero decision, would have enjoined the transaction. The Supreme Court heard the case on an expedited basis and unanimously overturned. The Court characterized the *Peoples* decision, entirely accurately in my view, as having established that while directors may consider the

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13 Id. at 314 (citation omitted).
15 Peoples Dep’t Stores v. Wise, [2004] 3 S.C.R. 461 (Can.).
16 Canada Business Corporations Act (CBCA), R.S.C. 1985, c. C-44 § 122 (Can.).
18 I served as a consultant to lawyers advising BCE. See also Edward Iacobucci, *Indeterminacy and the Canadian Supreme Court’s Approach to Corporate*
interests of a wide variety of stakeholders, including creditors, in fulfilling their fiduciary duties, it did not hold that they must consider all stakeholders. The decision of the board to seek to maximize shareholder value subject to meeting BCE’s contractual obligations to creditors (but no more than this) was consistent with fiduciary duties.

Peoples and BCE clearly depart from shareholder primacy when it comes to fiduciary duty. There are, however, reasons to doubt whether this has had any kind of significant impact on governance in practice. For one, shareholder primacy is embedded in corporate law in many ways, not just through fiduciary duties. Most fundamentally, it is shareholders who vote for directors, not creditors or any other stakeholder. While directors may have the discretion to consider non-shareholder stakeholders following Peoples and BCE, it would be unsurprising if they continued to look to shareholder value as a touchstone given the contingency of their positions on shareholder support. This is especially true in an era of increased shareholder activism.

Another reason to doubt the significance for governance of the Supreme Court’s rejection of shareholder primacy is that, in most cases, fiduciary duties are engaged because of a conflict of pecuniary interest. Whether a fiduciary duty is owed to shareholders or someone else does not matter much in assessing a self-dealing transaction. For decisions that do not come with a possible taint of self-interest, directors and officers have wide discretion under the Canadian business judgment rule, which protects directors from duty of care liability as long as their decisions are reasonable. Even under a shareholder primacy standard, almost any decision that in fact benefits a non-shareholder stakeholder could be framed as one that benefits shareholders. Protecting the environment, for example, could be framed as protecting the corporation’s brand, which in turn promotes shareholder value. Treating employees generously could be framed as encouraging productivity. Even if fiduciary duties established a shareholder primacy standard, they do not have much bite in contexts where there is no pecuniary conflict of interest.

One area, however, where the beneficiary of the fiduciary duty might well have had significant implications concerns takeovers. Under Peoples and BCE, directors could, consistently with their fiduciary duties, refuse to remove defenses to a hostile takeover bid even if it were clear that the bid

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19 See, e.g., id.
20 This was emphasized in Peoples, 3 S.C.R. 461 ¶ 64.
21 See, e.g., Rock, supra note 3 (noting that the shareholder primacy norm would allow directors to accept a takeover bid where it was good for shareholder value even if value-destroying overall because of its effect on the value of debt).
would improve shareholder value. In my view, they could defend against the takeover, presumably indefinitely, on the basis of concerns for creditors, or employees, or customers, or any number of other possible stakeholders that are legitimate considerations under the Court’s conception of fiduciary duties.

As it turns out, however, the practical impact of Peoples and BCE on takeover defenses in Canada is deeply attenuated for two reasons. First, as Teck illustrates, courts in Canada have been reluctant in any event to interfere with directors’ decisions in hostile takeover settings, preferring to treat the matter as essentially one of business judgment. Second, for all practical purposes, it is securities law, not corporate law, that governs hostile takeover defenses in Canada. Under their authority to make orders in the “public interest,” securities regulators in Canada have taken the position that while poison pills may be adopted for a period, there is a time when the pills have to go.22 (There are recent proposals to extend this time to ninety days.23) The relatively strict rules against hostile takeover defenses in place under securities law significantly reduce the practical impact of the broadening of fiduciary duties on takeovers, which is the one area where the change in fiduciary law might otherwise have had an important effect.24

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24 There is an interesting comparison between Delaware and Canadian law. Canadian corporate law has rejected shareholder primacy, but securities regulators have taken a strict approach to takeovers. Delaware law, in contrast, has adopted shareholder primacy explicitly in the takeover context, see, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986), yet given the reluctance of the courts to interfere with the board’s responsibility to adopt policy for the corporation, has given boards wide latitude to resist takeovers. In the end, then, directors who wish to resist takeovers in Canada have relatively little freedom to do so notwithstanding the wide discretion that they have under fiduciary law, while directors in Delaware who formally have an obligation to act in the shareholders’ interests have wider discretion in practice to resist takeovers.
II. THE FIDUCIARY DUTY TO OBEY LAW

Peoples and BCE fail to provide meaningful guidance to directors simply looking to do their jobs.25 A duty to an inchoate legal fiction does not help directors. Indeed, the Court in BCE went so far as to indicate that there may be a conflict between the interests of stakeholders on the one hand, and the corporation on the other, in which case the directors owe their duty only to the corporation. But how can there be a conflict between a fiction and flesh-and-blood stakeholders? The indeterminacy of the Court’s approach dramatically undercuts the role of the hortatory, expressive function that fiduciary law might otherwise play.26

There is, however, one dimension of fiduciary duties along which the Court was much clearer, and it is this dimension that will provide the focus of much of the remainder of this Article. The Court in BCE stated that “[a]t a minimum, [the fiduciary duty] requires the directors to ensure that the corporation meets its statutory obligations.”27 The Court provides no authority for this proposition, and indeed there is very little precedent for it. A few cases have in obiter dicta referred to the possibility of such a duty, but have not established one.28 The Court also neglects to provide any kind of reason for the establishment of such a duty, only noting, again without precedent or reason, that directors have an obligation to ensure that corporations act as good corporate citizens. While the Court was at least clear in stating an obligation implied by the fiduciary duty, determining the contours of this duty, as well as the critically important

25 Iacobucci, supra note 18.
26 As I have written elsewhere:

Imagine that you are a bus driver. You are instructed to drive a number of passengers from City A to City B. You are told that there are at least two groups of passengers. One subset wants to take a scenic, hilly route. Another group of passengers gets motion sickness very easily and prefers a flat, boring route. Suppose that you do not have a specific contract telling you what route to take. You are puzzled over which route to take: scenic and potentially nauseating, or boring and benign? You are told that your conduct is governed by a fiduciary duty. Seeking guidance there, you are told that you have a fiduciary duty to act in the best interests of the bus. BCE and Peoples establish that boards of directors have a duty to act in the interests of a fictional being. This is . . . as useful a piece of guidance to directors as the duty to act in the interests of a motor vehicle is to the bus driver.

Id. at 233.
28 See, e.g., Nielson Estate v. Epton, 2006 ABQB 21 (Can.) (the court finding directors liable in tort and observing that directors “arguably” must comply with law in order to act in the best interests of the corporation).
question of the standard by which to assess the directors’ conduct, is difficult
given the absence of a clear foundation for the obligation.

A comparison with Delaware on this matter is helpful in relating the
obligation to obey law to shareholder primacy. In Delaware, Caremark
held that directors have an obligation to establish some sort of oversight apparatus
that is designed to ensure that a corporation complies with its legal obligations,
though it acknowledged that liability would be rare under this obligation.29
Stone v. Ritter held that the obligation to comply with law was grounded in
the duty of loyalty.30 More specifically, Stone held that consciously failing
altogether to oversee legal compliance, or causing the corporation to break
the law intentionally, would be in bad faith, which is a breach of the duty of
loyalty to the corporation.

There are both conceptual and practical concerns with a duty of loyalty
that requires directors to ensure compliance with law. The conceptual problem
with finding a fiduciary duty to obey law is more acute in Delaware, which
generally adopts shareholder primacy, than in Canada, which has rejected
shareholder primacy. It is incongruous to require directors, as a matter of the
duty of loyalty (as opposed to some other duty), to take actions that reduce
shareholder wealth in the context of shareholder primacy. Melvin Eisenberg,
who generally would require directors as a matter of their obligation to act
in good faith to ensure legal compliance, was skeptical of the invocation of
the duty of loyalty to establish such an obligation:

Why, and to whom, is a director or officer being disloyal if he causes
the corporation to take an action that violates the law, when he is not
self-interested in the action and the action is rationally calculated to
increase corporate profit and shareholder gain? Trying to squeeze such
conduct into the duty of loyalty is like trying to squeeze the foot of
Cinderella’s stepsister into Cinderella’s glass slipper — an enterprise
equally painful and fruitless.31

Such an obligation makes more sense given the recent turn away from
shareholder primacy in Canadian fiduciary law. Under the Canadian Supreme
Court’s formulation of the fiduciary duty, directors may consider a range of

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L. 1, 38 (2006); see also Claire Hill & Brett McDonnell, Reconsidering Board
Oversight Duties After the Financial Crisis, U. ILL. L. Rev. 859 (2013) (asking
whether fiduciary duties should be understood to be owed to a broader group
of stakeholders than shareholders in light of Caremark and Stone).
stakeholder interests when deciding how to conduct themselves. Stakeholders mentioned by the Court explicitly include government. Given that directors have the discretion to consider government, it makes sense to conclude that directors have the discretion to regard compliance with government-made law as a worthy end in itself. This is unlike a fiduciary duty under an orthodox shareholder primacy conception which would require directors to regard legal compliance only as a means to the end of increasing shareholder wealth.

But even under Canadian fiduciary law, there is a conceptual problem: since the ultimate beneficiary of fiduciary duties under Canadian law is the corporation, it cannot be that statutory compliance is required categorically by fiduciary duties. Under the Court’s description of fiduciary duties, directors generally have discretion to consider various stakeholder interests and act on their assessment of how these interests relate to the best interests of the corporation. While the best interests of the corporation under the Court’s analysis is indeterminate, at the least it can be said that there is no reason a priori to presume that the calculus must always point to legal compliance.

To take an admittedly extreme example, travelling at ten km per hour above a statutory speed limit to get a key employee to a hospital to save her life is in the best interests of the corporation however defined. On a less extreme basis, it would be reasonable to claim that it is in the best interests of a courier company to allow its drivers to incur parking tickets. Thus, even if one rejects shareholder primacy, a blanket fiduciary obligation to obey law is conceptually problematic.

This is not to say that there may not be other duties on directors personally to obey the law. Aside from general social norms of compliance with law that are no doubt influential on individuals whatever their office, statutes themselves often specifically establish obligations on directors, and corresponding threats of personal liability, to cause their corporations to obey statutes. A wide range of Canadian statutes, from environmental liability, to securities regulation, to tax law, impose personal liability on directors of corporations that violate statutory or regulatory rules, often establishing a due diligence defense. Concluding that the duty to obey law is a poor fit conceptually with fiduciary duties is not the same thing as concluding that there ought not to be duties on directors to cause corporations to obey the law.

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33 See the discussion of the dangers of such wide-ranging liability in Ronald Daniels, Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance, 24 CAN. BUS. L.J. 229 (1994).
Aside from the dubious conceptual coherence of fiduciary duties to obey law, there are practical, policy questions as well (questions that apply similarly to statutorily-created personal liability). In particular, there is a policy tradeoff associated with personal liability for directors when corporations violate a legal norm. The main advantage of personal liability for a failure to cause the corporation to obey the law is that it enhances deterrence.\footnote{See, e.g., Edward Iacobucci, \textit{Unfinished Business: An Analysis of Stones Unturned in ADGA Systems International v. Valcom}, 35 \textit{Can. Bus. L.J.} 39 (2001).} If the corporation alone bears liability for its legal wrongs, this may or may not establish incentives for its directors to cause the corporation to obey the law because of agency problems: directors do not internalize perfectly the costs and benefits of corporate incentives. If, for example, directors and officers realize upside risk in the corporation, but have only attenuated downside risk, perhaps because they are paid with stock options, then they may have private incentives to cause the corporation to disobey law and hope it does not get caught and penalized, even if it is not in the interests of the corporation to do so. Moreover, even in the absence of agency problems, corporate penalties may not deter appropriately where the corporation is thinly capitalized and the penalties that are required to deter are large.

While greater deterrence may be an advantage of personal liability, the disadvantage is that the threat of personal liability may induce directors to behave with excessive caution; that is, there may be over-deterrence.\footnote{\textit{Id.}} Directors bear the costs of personal liability for corporate legal violations themselves, while any benefits of unpunished corporate wrongdoing accrue to shareholders and other stakeholders as a whole. This will tend to induce directors to behave overly cautiously from a social perspective.

For example, suppose that there is a question whether selling a product infringes a patent. If \textit{BCE} is taken literally, directors have a fiduciary obligation to cause their corporations to obey the patent legislation, and presumably a corresponding threat of personal liability for any legal consequences of violations of the statute. While there will often be grey areas at the margins of a patent, directors facing personal liability for patent infringement will have incentives to refrain from even approaching the margin, which is not a good outcome from a private corporate perspective or from a social perspective.

The impact of legal liability on optimal deterrence, or suboptimal over-deterrence, is particularly acute in the context of fiduciary liability for law-breaking. This is because it may not be straightforward for directors and officers to enter into contracts that limit their exposure to risk. For example, Canadian corporate statutes explicitly forbid indemnification of directors
that failed to act in the best interests of the corporation, or who acted in bad faith.\textsuperscript{36} In Delaware, corporations under section 102(b)(7) may opt out of money damages for breaches by directors of the duty of care, but cannot do so for breaches of the duty of loyalty, including acts in bad faith.\textsuperscript{37} If there is liability under a fiduciary duty for corporate legal breaches, its practical impact on directors will be greater than other kinds of legal liability.

Delaware has clearly mitigated concerns about over-deterrence by adopting a very deferential standard in determining whether directors have established a compliance regime; \textit{Caremark} itself held that liability for failing to establish legal compliance would be very rare and difficult to establish. In contrast, the Supreme Court of Canada, in almost casually observing that directors have a fiduciary obligation to cause their corporations to obey the law, did not address the standard of review. As a consequence, what exactly the Court meant has yet to be determined. Presumably the Court did not mean exactly what it said; that is, presumably directors would not be liable \textit{per se} for failing to “ensure” that the corporation does not breach statutes, since doing so would be a fulltime, and only imperfectly successful, endeavor. Some kind of due diligence defense is likely to emerge if — or when — this \textit{obiter dicta} gets tested, though how deferential a posture remains to be seen.

\section*{III. Regulators in the Boardroom: Financial Regulation and Risk Governance}

This Part relates the discussion of the fiduciary obligation to obey the law to recent developments in prudential regulation. The analysis in Part II showed that there are deterrence advantages, and over-deterrence disadvantages, of personal liability for failure to comply with law. Part III discusses recent developments in prudential regulation that increase the responsibilities of board members for risk governance. This sets up the discussion in the next Part. To foreshadow the conclusion, personal liability in the prudential regulation context has justifications that are not available in other settings because of the shortcoming of corporate-level liability. This provides a justification for prudential regulation that increases the connection between directors and risk oversight.

\begin{footnotesize}
\textsuperscript{36} Canada Business Corporations Act (CBCA), R.S.C. 1985, c. C-44 § 124 (Can.).
\textsuperscript{37} Del. Code Ann. tit. 8 §102(b)(7).
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A. Developments in the Regulation of Risk Governance

Canadian financial institutions weathered the global financial crisis better than those in many other countries. But this does not mean that Canadian financial regulators considered the crisis to be unworthy of a response. Rather, the Office of the Superintendent of Financial Institutions (OSFI), the federal financial regulator, has sought to enhance protections against risk at financial institutions in a variety of ways. What is especially interesting for present purposes is the expansion of the regulatory arsenal beyond the traditional imposition of regulatory constraints on the specific conduct of financial institutions, and towards relatively fine-grained governance requirements for boards of directors. This is not the typical approach to regulation, and invites a closer analysis.

To illustrate the departure from the usual regulatory toolkit, consider, for example, environmental regulation. If the Canadian government were concerned about environmental waste, it would typically adopt legal rules and regulations that constrain business conduct in connection with the disposal of that waste. The regulator would not, however, typically rely on regulations that require the board of directors of relevant businesses to structure and conduct themselves in certain ways. It may be that a company with environmental sensitivities may choose to establish a committee for the environment, but environmental law and regulation will not require it.

In recent years, however, financial regulators in Canada (and elsewhere) have established themselves firmly in the boardroom of financial companies. OSFI, in particular, has used its position as prudential regulator to issue policies that require boards of directors to adopt governance mechanisms that they may not otherwise have chosen to adopt. OSFI adopted a Guideline on Corporate Governance issued in January 2013. Strictly speaking, the Guideline does not have legal force. OSFI, however, has considerable influence through these Guidelines. For example, if it were to deem a financial institution to be more risky without its recommended structures in place, the institution could be subject to costly audits and intrusive oversight.

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39 Office of the Superintendent of Fin. Inst. Can. (OSFI), Corporate Governance Guideline (2013), available at http://www.osfi-bsif.gc.ca/Eng/Docs/CG_Guideline.pdf. Strictly speaking, the Guideline does not have legal force. OSFI, however, has considerable influence through these Guidelines. For example, if it were to deem a financial institution to be more risky without its recommended structures in place, the institution could be subject to costly audits and intrusive oversight.
planning, etc., but also sets out specific expectations, such as the separation of the board Chair from the CEO.

The Guideline’s position on risk management is perhaps the strongest example of mandated corporate governance. The Guideline provides that, depending on the particular context, boards of financial institutions “should establish a dedicated Board Risk Committee to oversee risk management on an enterprise-wide basis.”40 The risk committee should include only non-executives. It should receive timely and accurate reports on significant risks, and be satisfied that the policies and controls that the institution has are appropriate for its risk appetite. The Guideline also provides that financial institutions should have a Chief Risk Officer (CRO), or equivalent, who is responsible for “the oversight of all relevant risks across the firm.” The CRO should be independent from operational management, should not be compensated based on specific business lines, and should have a direct reporting line to the board or the risk committee.

These developments in Canada are by no means isolated. Supranational bodies have also recommended these kinds of governance structures. The OECD published a study identifying the governance failures associated with the financial crisis.41 The report made several recommendations concerning risk management at financial institutions, in light of what it considered the many failures of institutions leading up to the crisis. As the report states,

boards were in a number of cases ignorant of the risk . . . facing the company . . . . One reason for this might have been an excessive focus on regulatory capital ratios . . . and on rate of return of equity, neither of which reflected a build up of leverage and of risk positions. In sum, the corporate governance aspect of risk management failed in too many instances in financial companies.42

The Financial Stability Board (FSB) reached similar conclusions. In its 2013 Thematic Review on Risk Governance, the FSB examines carefully the role of risk governance in the financial crisis, and how financial supervisors were responding to perceived failures.43 Its approach to firm-wide risk is summarized by the following observations:

40 Id. at 10.
42 Id. at 31.
Since the financial crisis, national authorities have intensified their oversight of firms’ risk management practices and raised their expectations for what is considered strong risk management, which is integral to the core business of a financial institution. The failure to have a strong, independent risk management function can lead to ill-informed boards and senior management teams as well as imprudent decisions . . . . To fulfil these responsibilities, risk management functions should be led by an influential and highly effective CRO.\textsuperscript{44}

As the OECD and FSB reports indicate, the focus of OSFI on risk management at financial firms in Canada is by no means anomalous.\textsuperscript{45}

**B. Regulatory vs. Voluntary Risk Governance?**

Certain regulatory interventions in the financial sector have obvious and uncontroversial justifications. For example, minimum capital requirements would generally not confront significant opposition in principle (although there may be strenuous debate over where the lines should be drawn). There are well-known justifications for such regulation. For one thing, government guarantees, whether explicit (e.g., deposit insurance) or implicit (e.g., because an institution is too big to fail) invite moral hazard at institutions that would assume a value-destroying degree of risk in the absence of regulatory constraints.\textsuperscript{46} For another, there are externalities given the systemic nature of the financial system that invite intervention: individual institutions may fail to internalize the negative effect on others of their own financial distress.

The move inside the boardroom that recent regulatory developments reflect, on the other hand, has less obvious justifications. While they followed on the financial crisis, and are obviously intended to respond to its lessons, they do not set any specific, risk-related, substantive standards for boards or institutions to follow. The FSB, OECD, and national authorities are obviously concerned that boards have not sufficiently appreciated risk in the past, but having a risk committee and CRO, while probably significant in getting matters concerning risk in front of directors, does not in itself cause directors to take any decisions differently from what they would have done in the past. If boards consciously acted the way they did in the run-up to the crisis because of too-big-to-fail

\textsuperscript{44} Id. at 17.

\textsuperscript{45} To give a specific national example, in the United States the Dodd-Frank Wall Street Reform and Consumer Protection Act § 165(h) Pub. L. 111-203, H.R. 4173 mandates explicitly that bank boards adopt risk committees and CROs.

\textsuperscript{46} See generally MATHIAS DEWATRIPONT & JEAN TIROLE, THE PRUDENTIAL REGULATION OF BANKS (1994).
moral hazard, or because of externalities, having a risk committee would not, in itself, necessarily change this behavior. So what explains and/or justifies the recent intervention in board structures?

Before turning in the next Part to discussing the connection between director liability and prudential regulation, one possible answer is hinted at in the policy papers put out by organizations such as the FSB and the OECD: boards were simply unsuitably structured in the lead-up to the crisis even from an expected profit perspective. As the FSB observes, for example, “[t]he failure to have a strong, independent risk management function can lead to ill-informed boards and senior management teams as well as imprudent decisions.”

By failing to have appropriate structures, including risk committees, in place, the leaders at financial firms were not in a position to appreciate the hidden, latent costs of certain of their activities, costs which ultimately led to crisis when they were no longer latent. On this theory, authorities are looking out for the interests of the firms themselves when requiring the adoption of governance institutions like risk committees and CROs. With these structures in place, the information about risk that is now available to the board will change decision-making in profitable, and more prudent, ways.

The question that this theory begs, of course, is why regulation would be necessary to look out for the interests of the firm. Why would investors in the firm not also look out for such interests and adopt such measures if it is optimal to do so? It is clear, for example, that some firms had been adopting risk governance institutions prior to the crisis, while it is also clear that many did not, and have been reluctant to do so even in the face of regulation.

One possible answer is that there is only imperfect information about the optimal governance arrangements concerning risk, and the crisis revealed that financial firms had underestimated their need for tighter governance around

47 See, e.g., Lucian Bebchuk & Holger Spamann, Regulating Bankers’ Pay, 98 GEO. L.J. 247 (2009) (noting that compensation reforms designed to align financial management’s incentives better with shareholders may make prudential concerns worse, given the existence of moral hazard); Jonathan Macey & Maureen O’Hara, The Corporate Governance of Banks, FED. RES. BANK N.Y. ECON. POL’Y REV., Apr. 2003, at 91 (noting that fiduciary duties only to shareholders at financial institutions present prudential concerns because of moral hazard).

48 FSB, supra note 43, at 11.


risk. With the lessons from the crisis, the optimality of a CRO and a risk committee became clearer. The problem with this response is that, if there was learning, it is not clear why such learning was confined to supranational agencies such as the FSB and OECD and national authorities. If risk committees became obviously optimal for financial firms, presumably investors would have taken note themselves. It is of course possible that the agencies, with their inside view of a wider range of financial firms than others, might have had better information about the necessity of risk committees.

There is a related, complementary argument that may have played a role. The institutions that would be best served by a risk committee are presumably those that were least effective at monitoring and managing their enterprise risks before and during the crisis. Financial institutions, however, during a crisis may be reluctant to be seen to be voluntarily adopting a risk committee even if optimal to the extent that this would send a negative signal about the existing state of the board’s knowledge of risk.51 Where there is asymmetric information about the state of the firm’s risk exposures, firms may send a signal that they do not want to send by adopting a risk committee structure hastily and voluntarily. This is especially so for self-interested individuals on the boards who may be reluctant to signal their acceptance of the sub-optimality of their prior approaches to risk management. Such concerns could lead to delayed adoption of risk committees even if this is a destructive strategy in substance. On the other hand, if the regulator imposes the risk committee structure on all firms, there is no signal from voluntary adoption, and moreover, the regulator does not send a negative signal about a firm, and a potential crisis of confidence, by singling out a subset of firms for such a requirement. A mandatory rule could overcome inertia brought about by asymmetric information.

Another possibility is that the crisis revealed that adopting risk committees and CRO positions is optimal for investors as a group, but may not be optimal for shareholders. Banks are highly leveraged, which creates tension between shareholders and creditors over risk. Shareholders are only concerned about the cost of risk if shareholder value is implicated; once this value hits zero in

some state of the world, further knowledge about the cost of risk is irrelevant to them. Indeed, because of this limited downside risk, shareholders may prefer very high levels of risk that increase the expected payoffs to them, but reduce the total value of the corporation. At the least, pricing risk is less important to shareholders over a range of investments than it would be to investors, including creditors, as a whole. Shareholders may therefore have relatively weak incentives to adopt costly risk governance apparatuses, or even perverse incentives not to have such institutions in place to the extent that such institutions would tend to reduce risk and thereby increase the value of debt rather than equity.

Moreover, the inadequate incentives of shareholders would explain government intervention to compel governance reform, rather than some private, contractual innovation on the part of creditors and shareholders. Governments are large creditors of financial institutions, either explicitly through deposit insurance, or implicitly because of the too-big-to-fail concern. Private creditors may not have the means to instigate governance changes in midstream, but in any event may themselves count on government guarantees to protect their interests. This would almost certainly be true of depositors at banks. Government agencies, in contrast, have the means to effect governance changes and have incentives to do so, given the risk associated with their implicit and explicit guarantees.

There is an important caveat that invites further analysis of the relationship between board reform and risk. The establishment of risk committees and CROs does not, in itself, compel any kind of action on the part of boards and management. It is not clear, therefore, that the mere establishment of these mechanisms would necessarily undermine a board’s decision to adopt a level of risk that is good for shareholders and not for overall value. It would depend on the reason why the risk committees were not voluntarily adopted.

To illustrate with a simple example, if the corporation has assets worth $10 and owes $8 to creditors, an investment that costs $10, has a 50% chance of paying back $13, and a 50% chance of zero payout, would increase shareholder value but reduce overall value. Shareholders get a 50% chance of $5 and a 50% chance of 0, which generates an expected value of $2.5, which is greater than the value of $2 that they would receive absent the investment. Creditors, however, get a 50% chance of zero, and a 50% chance of $8, which implies that debt would only be worth $4 if the investment were pursued. Enterprise value would fall from $10 to $6.5, but shareholder value would rise, with the risky investment.

See, e.g., Macey & O’Hara, supra note 47 (discussing the potentially perverse incentives of shareholders); see also Christopher Bruner, Conceptions of Corporate Purpose in Post-Crisis Financial Firms, 36 Seattle U. L. Rev. 527 (2013).

See, e.g., Bebchuk & Spamann, supra note 47.
by shareholders. If shareholders were simply mistaken in not adopting the structure, then the imposition of a risk committee predictably would change substantive decision-making. On the other hand, if shareholders do not want risk committees because they are rationally indifferent to, or even welcome, risky, potentially value-destroying choices, since these tend to be good for shareholder value over some range, then it is not obvious why the establishment of risk committees would change substantive decision-making. I turn to analyzing this question in the next Part, which discusses risk governance reform as a species of prudential regulation, not necessarily motivated by enterprise value.

**IV. FIDUCIARY OBLIGATIONS TO OBEY LAW, BOARD-ORIENTED PRUDENTIAL REGULATION, AND REGULATORY COMPLIANCE**

While it is possible that increased attention to risk governance is value-maximizing for firms themselves, as discussed in the previous Part, it is also of course possible that risk governance is good for society, perhaps because of too-big-to-fail moral hazard and/or systemic risk, but not for the firms. The OECD, for example, states in its 2009 Report that

> the banking sector has some quite specific risks that are of key significance for regulators . . . . The financial crisis has exposed gaps in risk management [of liquidity] with a number of firms relying on marketability of securities for liquidity needs, which with all trying to sell at the same time led to market failure. Closely associated with liquidity risk is reputational risk which has only been effectively kept under control during the crisis through widespread deposit and borrowing guarantees. The importance of public policy in this area means that the authorities have a legitimate interest in corporate governance arrangements in the banking sector that might extend beyond issuing guidelines and principles.\(^{55}\)

On the assumption that governments do not trust substantive decisions about risk at financial institutions to be in the public interest, it is not clear why the authorities would have an interest in the particular governance structures that the corporation adopts that lead to those decisions. Whether or not a corporation has a risk committee, for example, does not necessarily affect decisions to assume certain risks. Financial regulators do, of course, constrain financial institutions substantively, not just in their governance

\(^{55}\) OECD, *supra* note 41, at 32.
processes. But given that the authorities constrain substantive decisions, why also constrain governance?

A superficially appealing response is that the hard constraints can only go so far, and that it is therefore necessary to rely on softer measures such as mandatory governance structures to shore up regulatory lacunae. There are some reasons to accept this response. For example, if risk governance reform makes it more likely that information about risky, value-destroying investments would surface, this may affect investment choices for reputational reasons. But if regulation exists because of a concern that firms do not have the right incentives to adopt socially optimal attitudes to risk, it is not clear why beefing up governance will change decisions about risk in substance.56

The best answer, in my view, is that risk governance may affect decision-making by serving as a complement to regulatory and other legal constraints. At root, adopting a CRO and risk committee structure increases the knowledge of individual board members about the firm’s risks. As it is put in Canada, OSFI wants boards to “own” the firm’s risk profile to a greater extent than historically. As I will explain, such ownership increases the risk of legal liability of one kind or another for directors personally and thus will predictably change the way decisions are made.

Consider how a risk committee structure is complementary to hard regulatory constraints. Let us suppose that it becomes apparent that a firm is in violation of such a constraint, such as a capital ratio. The existence of a CRO and risk committee makes it more likely that there will be clear documentation within the organization that identifies that a firm is skirting close to a regulatory line. This information could be helpful for the regulator in identifying a breach of a hard constraint, and also in all probability would help establish that individuals on the risk committee, and perhaps the board, as well as the CRO, knew or ought to have known about the potential violation. This exposes the corporation, as well as individual board members, to potential legal penalties to which they might not otherwise be exposed. Individuals will be limited in their ability to make an argument that it was not their task to monitor and respond to risk. The greater threat of personal liability associated with “ownership” of risk will tend to encourage board members to seek to comply with hard regulatory constraints.

This connects the present analysis of governance changes to the above discussion of recent developments in Canadian corporate law. BCE held that directors have a fiduciary obligation to ensure that the corporation complies with statutory obligations.57 Given their root in statutes, it is reasonable to

56 See, e.g., Bruner, supra note 53.
conclude that this includes attention to regulatory obligations. This fiduciary duty to comply with regulatory obligations interacts with recent intrusions into corporate governance by prudential regulators. To the extent that the firm faces negative consequences (e.g., corporate fines, higher transactions costs in having to raise capital on short notice) from a failure to comply with regulatory constraints, directors who had greater awareness of the failure to comply will find themselves confronted with the threat of fiduciary liability suits. Fiduciary law complements prudential regulation, and governance requirements such as risk committees complement fiduciary law.

Canadian fiduciary law is especially well-suited to this role for personal liability. Directors owe duties to the corporation, and not any given stakeholder. It would thus conceivably be open to a creditor to bring a derivative action for failing to comply with regulations that offer protection to creditor interests. Moreover, Canadian corporate law has a broad oppression remedy that is also available to creditors to seek a remedy for a breach of their reasonable expectations, even if their contractual rights have been fulfilled. This could easily include an expectation that directors strive to comply with prudential regulation. For these reasons, enhancing board governance on risk puts directors in greater jeopardy of personal liability for fiduciary breaches and/or orders under the oppression remedy. As discussed above, it is not obvious


59 The procedural provision establishing derivative action procedures in the CBCA provides for standing as of right to “securityholders,” which includes at least bondholders and perhaps other kinds of creditors. Moreover, a court has discretion to grant standing under the derivative action procedure to any “proper person” which can include creditors. See Canada Business Corporations Act (CBCA), R.S.C. 1985, c. C-44, § 238 (Can.).

60 BCE was heard on appeal from the Quebec Court of Appeal which held, 5-0, that the decision of BCE to accept a leveraged buyout offer was oppressive to creditors even though creditors had not contracted for protection from leveraged buyouts. The decision was (rightly) overturned by the Supreme Court, but offers an indication of how far the oppression remedy’s protection may be perceived to extend.

61 It could also include an expectation that boards do not adopt a risky course of action that benefits shareholders but lowers overall value. The information generated by a risk committee may help creditors establish the basis for an order on this dimension as well.
that a categorical requirement to obey law fits conceptually within a fiduciary obligation to the corporation, but there may be a policy justification for such a duty in the context of prudential regulation.

The force of this explanation will depend importantly on the standards that courts adopt to enforce BCE’s fiduciary duty to obey the law, a question that has yet to be determined. American experience illustrates the importance of this unanswered question. In the United States, the connection between the fiduciary duty to obey the law and risk oversight has been the focus of debate. One question is whether Caremark standards ought to apply to risk oversight, not just legal compliance oversight. While the idea of risk oversight as part of fiduciary duties has received some scholarly support, though not unanimous, the Delaware Chancery Court was not overly receptive in Citigroup, which held that directors of Citigroup were not liable for failing to respond to so-called “red flags” relating to risk before the crisis.

As even supporters of such a risk oversight obligation acknowledge, however, the deferential posture in Delaware towards director discretion in establishing and maintaining oversight functions diminishes significantly the threat of liability, whatever its potential scope. If such deferential standards were adopted under BCE, the regulatory impact of a fiduciary duty to obey law and increased governance around risk would have a diminished practical impact. I discuss the normative case against the deferential Caremark approach in the context of prudential regulation below, but as a matter of positive law, there are reasons to predict that the fiduciary duty to obey prudential regulation will be enforced more strictly in Canada.

First, the Supreme Court of Canada has not elaborated on the standards of review that apply to scrutiny of the fiduciary duty to obey law. In expectation, there is at least the possibility of an intrusive approach until otherwise held by a court. Cautious directors have incentives to avoid testing the boundaries of judicial deference.

Second, in applying statutes that impose personal liability on directors, but also provide a defense of due diligence, Canadian courts have not been especially deferential to the business judgment of directors. In a case involving

65 In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009).
66 See, e.g., Bainbridge, supra note 63.
an environmental spill, for example, a director was liable for his actions because, while he took steps to deal with a problem when alerted to it, he did not do enough in the court’s judgment. A director in a different case was liable to pay penalties to tax authorities because he had not taken the initiative to inquire whether a corporation in distress had been remitting its withheld taxes regularly. Courts have been willing to find personal liability for failures to comply with law under specific statutes, and a similar approach is predictable under the fiduciary duty to obey law.

Finally, as discussed here, a risk committee structure, and a correspondingly greater chance of personal liability, may be justified by extrinsic regulatory objectives, not the corporation’s internal objectives. The Supreme Court of Canada, in a case involving mandatory disclosure under securities law, held that business judgment deference does not apply to a decision relevant to regulatory compliance. The decision concerned an evaluation whether directors and the corporation complied with disclosure law in relation to a financial forecast, and the Court observed that, “while forecasting is a matter of business judgment, disclosure is a matter of legal obligation. The Business Judgment Rule is a concept well-developed in the context of business decisions but should not be used to qualify or undermine the duty of disclosure.” If the courts emphasize the regulatory objectives associated with a fiduciary duty to obey statutes and regulations, there is further reason to suppose that courts will not review the duty to comply with financial regulation lightly. This too suggests that the fiduciary duty to obey the law is likely to influence behavior in practice.

As a matter of positive law, the threat of personal liability for a failure to cause the corporation to obey the law will predictably have practical significance in Canada in the context of prudential regulation, which implies that the enhanced governance structures with respect to risk that the regulator has imposed will have an impact on behavior. It is a separate question whether this is a normatively desirable development. As discussed, it is not always true that personal liability for directors produces socially optimal deterrence; rather, it could produce over-deterrence, as directors bear personal downside risks from such liability without internalizing the upside of such risks.

There are, however, explanations, and justifications, for personal liability in the context of prudential regulation that are not present in other contexts. One possible explanation, which is not necessarily a justification, is that the

70 Id. ¶ 54.
regulator may be able to impose governance changes, increase the threat of personal liability accordingly, and thus increase the prudence with which decisions about risk and compliance are made, without changing the hard regulatory constraints under which financial firms operate. The argument would be that there are political obstacles to changing hard regulatory constraints that do not exist for soft changes in regulation. Obligatory risk committees and CROs may increase the pressure on directors to adopt safer courses of action without any change to hard regulatory constraints. Such stealthy changes in effective regulation may be politically palatable where formal changes would invite opposition.

The idea that authorities may be able to rely on governance changes to indirectly increase the regulatory margins of safety while avoiding political opposition to direct increases is not necessarily consistent with social welfare. It could be, for example, that regulators have incentives to increase prudence to excessive levels: the regulator may only attract significant public attention if institutions fail on its watch, not if the rate of return in the financial sector is lower than it would otherwise be. Dodging political fallout from mandated changes to hard regulatory constraints through mandated governance changes thus may or may not be a good thing from a social perspective, even if it is good from the regulator’s perspective.

There are, however, explanations of greater personal liability for directors for their decisions on risk that are more clearly justifications. There is reason to suppose that personal liability may appropriately play a greater role in the financial context than in other sectors. The most powerful reason for this relates to too-big-to-fail concerns. Suppose that the regulator, for deterrence reasons, would like to establish strong penalties for financial firms that violate prudential constraints. In a significant subset of cases, however, it may be that significant firm-level punishments — a fine, for example — are counter-productive from a prudential regulation perspective. A firm that finds itself on the wrong side of regulatory constraints is more precariously situated than the regulator would like. Imposing significant financial punishments on a firm in a precarious state may make this condition worse, which is not something the regulator would like to see, and thus it may be hesitant to punish the firm. Financial penalties for failure to comply with prudential regulation may have

U.S. Attorney General Eric Holder offered the following response to a query as to why he had not indicted a financial institution for wrongdoing:

I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy.
pervasive effects, and consequently may not establish a credible threat *ex ante*. If, instead, there is the threat of punishment for individuals for failures to comply with prudential requirements, *ex ante* deterrence is achieved without the problems of *ex post* credibility associated with the precarious financial position of the regulated firm.

There is another reason to rely on personal liability more in the financial sector than in others. Corporate liability deters misconduct by individual directors and officers to the extent that individual directors and officers suffer personally from the imposition of a penalty on the corporation. The natural way for a corporate penalty to translate into a personal cost is for the directors and officers to have high-powered incentive compensation schemes that marry their personal wellbeing to that of the corporation. But there are misgivings about high-powered incentives in the financial setting because of the agency costs of debt: share-based compensation may induce directors to cause the corporation to take on share-value-maximizing, but total-value-eroding, levels of risk.72 Personal liability works directly on fiduciaries’ incentives, without providing additional reason to adopt high-powered incentive pay.

To relate the analysis more precisely to fiduciary duties, personal liability for directors would generally derive from harm to the corporation. Financial regulators can create this harm by penalizing the corporation, knowing that the penalty can be passed on to a significant extent to individual fiduciaries. Moreover, even if the penalty were not passed on in full, and even if regulators were reluctant to impose significant fines on the corporation, they could impose smaller fines that in turn expose individual fiduciaries to liability to encourage prudence. A $20,000,000 fine on a large bank may be trivial to the bank’s investors, but would not be at all trivial to individual directors who can be sued by investors for failing to ensure that the bank complied with its legal obligations. Thus, the regulator may be able to avoid too-big-to-fail concerns associated with significant financial penalties for the firm, while still encouraging prudence on the part of individuals managing the bank.

There is an interesting point of comparison between the United States and Canada on these matters. The connection that I have made here between fiduciary duty and prudential regulation has been made in U.S. commentary as well. In particular, there is a debate, in part precipitated by the *Citigroup* case,73 whether directors ought to have a fiduciary obligation to oversee risk,
just as they have a fiduciary obligation to oversee legal compliance. Miller argues that they should not: risk management per se concerns the exercise of business judgment like many other exercises of business judgment; and insofar as a failure to oversee risk results in a failure to comply with prudential regulation, then Caremark duties would apply. Bainbridge, in contrast, argues that there ought to be risk oversight duties, but acknowledges that the standard by which directors’ conduct would be reviewed would be very deferential.

The shortcoming of this debate on both sides is that there is insufficient appreciation of the distinctiveness of the prudential regulatory context, and in particular the merits of enhanced risks of personal liability in this setting relative to others. I concluded above that there is reason to conclude that Canadian courts will not be especially deferential in applying the fiduciary duty to obey law if directors of financial institutions allow their firms to breach regulatory requirements. This is different in Delaware, where conscious disregard for the law is required to ground fiduciary liability.

Given that financial penalties levied on a firm for failing to comply with prudential regulation may have perverse prudential effects, and thus may be undesirable, from a policy perspective, it is appropriate to put less weight on the usual reasons for deference towards individuals’ decisions about risk at financial institutions. This suggests that fiduciary liability for failures to oversee compliance with risk regulation should not be seen as a straightforward application of the highly deferential Caremark standard. A more robust approach to personal liability under fiduciary duty is, as we have seen, a potentially valuable substitute for firm-level liability, and is a useful complement to recent developments in the regulation of risk governance. Setting aside the positive prediction set out above that Canadian law will not take as deferential an approach to reviewing conduct under the fiduciary obligation to obey law as Delaware law takes, there is a normative argument that law ought not to be as deferential when it comes to financial regulation. In this sector, personal liability is more appropriate than in other sectors.

CONCLUSION

There is debate in the United States about the role of fiduciary duty in interacting with risk oversight obligations at financial institutions. This Article has drawn

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74 See, e.g., Bainbridge, supra note 63; Hill & McDonnell, supra note 31; Miller, supra note 64.
75 Miller, supra note 64.
76 Bainbridge, supra note 63.
on Canadian and comparative analysis to shed light on this debate. Canada is now an outlier compared to the United Kingdom and the United States in its approach to fiduciary obligations in establishing that directors owe nothing more to shareholders than they do to any other stakeholder. It is not apparent, however, how significant this deviation is in practice given the law’s indeterminacy and the broad discretion granted directorial decision-making under any conception of the duties. The one area where the duties could have had teeth, and where the precise definition of the duties could matter, is hostile takeovers. But in Canada any discretion given to boards to resist takeovers consistently with their fiduciary duties is essentially moot, since securities regulators have relatively strict rules against poison pills. There is little reason to suppose that governance in practice has changed much as a consequence of the legal developments.

By establishing a fiduciary duty to ensure that the corporation obeys the law, however, the Supreme Court of Canada changed the law in a manner that could be influential. In keeping with its expansive view of fiduciary duties, the Court stated that directors owe a fiduciary duty to cause the corporation to comply with its statutory obligations. This had no apparent basis in the case law, nor did the Court offer reasons in principle for the doctrine. There are advantages and disadvantages of the rule in general. Such an obligation, by establishing the possibility of personal liability for directors, enhances deterrence and corporate compliance with the law. It may, however, over-deter: the directors risk personal liability if they operate close to a legal margin, but do not realize personally the upside from such conduct.

The fiduciary obligation to obey law, while it may or may not be optimal in general, complements recent developments in financial regulation. Because of prudential concerns, financial penalties for a financial firm that has breached its regulatory obligations may be undesirable, and thus may not be a credible deterrent. In contrast, personal liability for directors and officers in the face of a failure to comply with regulations, perhaps through fiduciary duties, will be credible, and thus may be a useful deterrent. Recent intrusions of prudential regulators into board governance and structure may be in part understood in light of the desirability of personal liability for directors for prudential matters. In this sense, the fiduciary obligation to cause the corporation to obey law, a recent Canadian development, is complementary to the recent focus on boards in prudential regulation. Given the distinct policy advantages of personal liability in the prudential context, in applying the fiduciary standard in this context, there is reason for Canadian courts not to follow the highly deferential Caremark/Stone standards of review from the United States, but rather to take a more interventionist approach.