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Paper 6: Outside Director Liability

By

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Outside Director Liability

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Outside Director Liability

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Abstract

Outside directors can do a bad job, sometimes spectacularly. Yet outside directors of U.S. public companies who fail to meet what we call their "vigilance duties" under corporate, securities, environmental, pension, and other laws almost never face actual out-of-pocket liability for good faith conduct. Their nominal liability is almost entirely eliminated by a combination of indemnification, insurance, procedural rules, and the settlement incentives of plaintiffs, defendants, and insurers. The principal risk of actual liability is under securities law, for an insolvent company (which can neither pay damages itself nor indemnify the director) and a seriously rich (hence worth chasing) director, where damages exceed the D&O insurance policy limits and the director does not represent an institution that can indemnify him. The principal sanction against outside directors is harm to reputation, not direct financial loss.

In a companion paper, Bernard Black & Brian Cheffins, Outside Director Liability Across Countries (2003), we study six comparison common-law and civil-law countries (Australia, Britain, Canada, France, Germany, and Japan). We find huge differences in legal rules and nominal liability. Securities and corporate law risk recedes, while nominal liability under other laws becomes central. Yet we find a similar pattern of a tiny but nonzero risk of actual liability. This suggests that a barely open window of actual liability is a stable solution, both politically and in the D&O insurance market. A barely open window may also be a sensible policy solution, given the multiple goals of incenting directors to be optimally (not maximally) diligent, wanting directors to be aware of potential liability for misconduct yet not overly risk averse, and wanting good candidates to become directors. The details of where the liability risk comes from may have only a small effect on director behavior.
Outside Director Liability

I. Introduction

Outside directors are at the core of most prescriptions for good corporate governance. The Enron, WorldCom, Tyco, Adelphia and other recent scandals illustrate what can go wrong when directors do a poor job. But what makes outside directors work hard and pay attention? What makes them meet what we will call their "vigilance duties" under corporate, securities, bankruptcy, environmental, and other laws? What role does fear of personal, out-of-pocket liability (which we will call actual liability) play? What role does nominal liability play (where a director is potentially liable, but someone else pays any damages or legal expenses)?

These questions implicate multiple areas of law, standard corporate practices, the market for directors' and officers' (D&O) insurance, and the settlement incentives of plaintiffs, defendants, and insurers. We are unaware of a prior effort to assess outside directors' risk of actual liability across all relevant laws, taking into account corporate practice, procedural obstacles to derivative lawsuits, and what we will call the "three I's" -- indemnification, D&O insurance, and settlement incentives. Instead, scholars often address director liability under a single legal regime, most often corporate or securities law. They often focus on nominal rather than actual liability, or discuss inside and outside directors together.

The conventional wisdom in the U.S. is that with lawsuits against companies and directors and settlement size increasing, "being an outside director is often too risky." The scandal-responsive Sarbanes-Oxley Act is believed to bring "more potential liability if things go awry." Some recent court decisions are believed to further increase this risk. Fear of liability is a leading reason why potential candidates turn down board positions. The conventional wisdom outside the U.S. is even more strongly that U.S. directors face significant personal risk. Reformers often believe that their own directors could benefit from greater risk exposure, akin to the risk that they believe U.S. directors face.

The reality is otherwise. Standards of nominal liability differ greatly across different bodies of law. But for actual liability, the bottom line is simple. Outside directors of U.S. public companies face a tiny risk of actual liability for good faith (non-self-interested) conduct, no matter how careless or reckless they are. They almost never pay anything to anyone, whether for damages, fines, or legal expenses. The

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2 James Cox, Boards Find it Harder to Fill Hot Seats; Scandals, Legal Threats Make Many Decline Slot, USA TODAY, July 31, 2002 (cover story).
3 Carol Mymowitz, How to Be a Good Director, WALL STREET JOURNAL, Oct. 27, 2003, at R1.
4 See What Directors Think (survey by Korn/Ferry International and Corporate Board Members Magazine, 2002), question 21 (of 2042 respondents to an early 2002 survey, 48% have turned down board positions because they believed that "the risk was too great"); Korn/Ferry Press Release, Fortune 1000 Board Members are Turning Down Directorships at Twice the Rate of Last Year Due to Personal Liability Risk (Oct. 28, 2003) (23% of directors of Fortune 1000 firms turned down additional board seats in 2002 due to liability risk, compared to 13% in 2001). [update when receive full 2003 Korn/Ferry survey].
principal sanction against outside directors is harm to reputation, plus the nuisance of being sued.

The principal goal of this paper (Part II) is positive: to defend our claim that outside directors almost never incur actual liability for good faith conduct, under any source of law. We describe the narrow circumstances in which outside directors of public companies may face actual liability for good faith conduct. The principal liability window is under securities law, when the company is insolvent (and thus cannot indemnify the director), damages exceed the D&O insurance policy limits, and the director is wealthy enough to be worth chasing, yet does not represent an institution that can indemnify him. The Sarbanes-Oxley Act does not alter this conclusion. Indeed, contrary to conventional wisdom, Sarbanes-Oxley is likely to reduce outside directors' exposure.

Our analysis is complex, but the bottom line is simple. To our knowledge, no outside director of a public company has paid out-of-pocket for either damages or legal expenses under securities law, ever, nor under corporate law since Van Gorkom in 1985 (after which corporate law changed to prevent liability the next time). The Enron bankruptcy offers a nice case study. Enron's board did little and missed much. The head of Enron's audit committee, Stanford accounting professor Robert Jaedicke, may now wish he had never heard of Enron. Yet, as we discuss below, his reasons should not include serious worry about actual liability.

Our broad, practice-sensitive approach to actual liability risk corresponds, we believe, to how directors respond to liability. They do not know in detail their liability risk under particular laws. They operate instead with a general sense of how likely they are to be found liable for something, under some law (nominal liability), and how likely it is that nominal liability, if found, will result in actual liability. They likely care more about actual liability than about nominal liability. Yet, once one takes the three I's into account, nominal liability can be large while actual liability remains tiny.

Directors' limited risk under corporate law has been explored before. The new claims in this paper are: (1) directors' risk under corporate law hasn't changed in the post-Enron era; and (2) more centrally, directors face a tiny risk of actual liability regardless of the source of law.

Our second goal is also positive (Part III): If actual liability risk is small, its power to motivate outside directors to meet their vigilance duties is likely limited as well. What, then, does motivate them? Market forces play a role, but if they were sufficient, we wouldn't need formal legal duties. What role does nominal liability, without actual liability, play? In our view, nominal liability interacts with and reinforces a number of "soft" sanctions, including reputation, cultural norms and sense of professionalism, the nuisance cost of being sued also matters, and procedural rules for board conduct.

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5 Most famously, by Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 *Yale Law Journal* 1078-1103 (1968), at 1099 (“The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack”).
We turn in Part IV to some normative implications of our analysis. We sketch an argument, to be developed in future work, including a companion paper that surveys outside directors' liability across countries,\(^6\) that a change in the liability rules, unless implausibly extreme, won't greatly affect actual liability, given the mediating effect of the three I's. We also suggest reasons why a barely open window may be a sensible policy solution, given the multiple goals of incenting directors to be optimally (not maximally) diligent, wanting directors to be aware of potential liability for misconduct, yet not to be overly risk-averse or to resign at the first sign of trouble, and wanting good candidates to become directors. Finally, we argue that the differences in nominal liability between corporate law and securities law are hard to justify, and discuss some implications of our analysis for other countries that are considering adopting or adapting U.S. liability rules.

A word on the scope of this article. We focus on the financial liability of outside directors of public companies, for actions taken (or not taken) in good faith, giving good faith its classic meaning of loyalty to the corporation and shareholders. The civil and criminal sanctions against inside directors and controlling shareholders for conflict-of-interest transactions, and against all directors for actions not taken in good faith, are beyond the scope of this article.

We assume that companies, through a charter provision and indemnification bylaws, limit director liability to the maximum extent legally possible, and buy D&O, environmental, and ERISA insurance with policy limits sufficient to cover all but extreme outlier claims. This is how almost all public companies behave. We consider director liability under corporate and securities law with some care, and address bankruptcy, environmental, pension (ERISA), workplace safety, and other laws in less detail. We may miss some possible bases for liability under these other laws, but not, we think, important ones. We do not address the functions that fiduciary duties play, apart from serving as a basis for nominal or actual liability -- for example, as a basis for injunctions.

Some terminology. We use the terms firm, company, and corporation interchangeably. We use the term vigilance duties to refer broadly to a director's obligations under all relevant laws to act responsibly and carefully, including the duty of care under corporate law and banking law, the duty of disclosure under corporate and securities law, duties to creditors under corporate and bankruptcy law, and assorted duties under environmental, pension, and other laws. One can also define vigilance duties by exclusion, as all director duties that can be violated without a conflict of interest, intentional misconduct, or other clear moral turpitude. We use the term "damages" to refer to all payments to plaintiffs or their counsel, whether after trial or in settlement, and to civil and criminal fines and penalties. We use the term "legal expenses" to refer to out-of-pocket costs to defend a lawsuit, including attorney fees. We use the term inside director to refer to a director who is, now or recently, an officer, a controlling shareholder, or a representative of a controlling shareholder; and the term outside director to refer to directors who are not inside directors.

One cannot study outside director liability without coming to appreciate that inside directors also rarely face actual liability for good faith conduct. Insiders, however, have far greater motive and opportunity to cross the line into bad faith conduct. They also occasionally face actual liability, albeit modest relative to their net worth, for conduct that may be reckless but does not involve direct financial self-interest, cooking the company's books, or other clear wrongdoing. Insiders' and outsiders' risks are related: insiders' concerns about liability help to shape the web of protections that insulate all directors from actual liability. An extension of this work, that we hope to undertake, would assess inside directors' risk using similar analysis -- cutting across multiple areas of law, focusing on actual rather than nominal liability, and emphasizing settlement incentives and actual outcomes, not theoretical risk.

This article proceeds as follows. Part II offers a detailed map of the nominal and actual liability terrain. Part III assesses the role of reputation in promoting director vigilance. Part IV questions the reasons for the differences between directors' nominal and actual liability in corporate versus securities law. Part V asks whether a change in the rules governing nominal liability would significantly affect directors' actual liability. -The likely answer, for plausible changes in the rules governing nominal liability, is "no." Part VI addresses the possible big-picture logic behind the current pattern of actual liability. Part VII concludes.

II. Outside Directors' Actual Liability Risk

What risk of actual liability does an outside director of a U.S. public company face? The director is, let's assume, confident that he can act in good faith (which largely means not having a personal financial interest in a transaction that he approves). The director is worried, however, about putting personal assets at risk of liability for unintentional conduct, whatever the standard of care (whether negligence, gross negligence, or the variant of recklessness that counts as "scienter" under the securities laws), and whatever the legal basis for liability (whether under corporate, securities, bankruptcy, banking, environmental, ERISA, workplace safety, or any other law). "How much risk do I face"?, he asks counsel. "It's a risky world out there," counsel will likely reply. "The courts are expecting more of directors than ever." But, counsel may add, "it's much less risky if you hire my firm to help you through the minefields."

This experienced-based answer is right, in a sense. The risk of nominal liability is significant, especially under securities law. New risks emerge with some regularity. Standards for director conduct are higher than they were a generation ago, or even five years ago. Yet the risk of actual liability is extremely low, even without the advice that counsel hopes to be paid to offer. In our experience, few corporate lawyers or corporate law scholars fully understand why this is so. They often know pieces of the story we will tell, but rarely know the entire story. Indeed, the reasons for the rarity of actual liability emerge only from the complex interplay among several legal regimes, procedural rules, corporate charter and bylaw provisions, and the three I's -- indemnification, D&O insurance, and the settlement incentives of plaintiffs, defendants, and insurers.

Our goal in this part is to map the narrow windows within which outside directors can be personally liable for good faith actions or omissions. This positive analysis is important for several reasons. First, outside directors are a core pillar of American
corporate governance. But what motivates outside directors to try hard? Their direct financial stake in the firm is commonly a small fraction of their net worth and a tiny fraction of the value of the firm. Most are busy people who are modestly compensated for serving as directors relative to the opportunity cost of their time, and compensated mostly through a flat fee, which gives them little incentive to work hard at the margin. Fear of liability is one possible reason why most outside directors, most of the time, might try to do a good job.

Section A reports data on the incidence of actual liability. Sections B-D consider corporate and securities law liability for solvent firms, as mediated by indemnification, insurance, and settlement incentives. Section E considers what changes if the firm is insolvent. Finally, Section F considers liability under other laws, including banking, bankruptcy, environmental, ERISA, and workplace safety law.

A. Evidence and Sources

Table I presents our best knowledge about cases in which an outside director of a public company has paid out-of-pocket for either damages or legal expenses, under any source of law, in the 35 years (1968 - present) since Joseph Bishop described the lack of cases under corporate law (then the principal source of liability risk). We know of no case of actual liability under securities law, ever, nor under corporate law other than the Van Gorkom case in 1985 (after which corporate law changed to prevent liability the next time). We know of a few securities cases where outside directors have paid modest amounts to settle the case, but in each of these, the director represented a large institutional shareholder and was indemnified.

Table I: Outside Director Actual Liability, 1968-2003

<table>
<thead>
<tr>
<th>Type of law</th>
<th>Actually liable (not covered by indemnification or insurance)</th>
<th>Paid damages</th>
</tr>
</thead>
<tbody>
<tr>
<td>corporate law</td>
<td>1 (Van Gorkom, 1985)</td>
<td>0 (paid by acquirer)</td>
</tr>
<tr>
<td>securities law</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>bankruptcy and insolvency law</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>other (environmental, ERISA, tax, workplace safety, etc.)</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Moreover, in securities law, which is the area of principal risk, there are almost no decided cases that might, as in Van Gorkom, produce a verdict that exceeds the D&O policy limits. Table II presents what we know about securities cases tried to a verdict against officers and directors of public companies from 1991 to date. During this period, there were 2930 federal securities cases filed and 1557 federal cases settled, through June 2003. At least xxx cases were dismissed prior to trial.8

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7 Bishop (1968), supra note xx.
8 Data on filed and settled federal cases is from Elaine Buckberg, Todd S. Foster, Ronald I. Miller & Adam Werner, Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides? (NERA Economic Consulting, 2003). Somewhat smaller numbers of cases are reported
We lack good data on state-law-only cases, but these might add another few hundred filed cases, almost all prior to 1998, after which most state cases were preempted by the Securities Litigation Uniform Standards Act.9 One source reports a partial count of 49 state cases between 1996 and 1998.10

What we have been able to find out about non-settled cases, after extensive inquiry, is summarized in Table II. For cases tried to verdict which include outside directors as defendants, we know of zero federal cases and one state case. The defendants won, and in any case, the company was solvent and the directors were indemnified and insured.11 Tried cases against companies, insiders, or both, are also very rare. Since pleading standards were raised in 1995 by the Private Securities Litigation Reform Act (PSLRA), we know of: one trial against the former CEO of a bankrupt company, won by the defendant. We also know of two pre-PSLRA cases; one trial against a solvent company and its chairman for a statement by the chairman, won by the defendants; and one 1991 case against two officers of Apple Computer, won by the plaintiffs, where the officers were both insured and indemnified.12


10 See PRICEWATERHOUSE COOPERS (2002), supra note xx.


12 The post-PSLRA case is Howard v. Everex Systems (N.D. Cal. 2002). See Brenda Sandburg, Ex-CEO Not Liable in Federal Trial, NATIONAL LAW JOURNAL, Feb. 18, 2002. The defendant's legal expenses were covered by the D&O policy. Telephone conversation with Michael Davisson of Sedgwick Dietert Moran & Arnold (Dec. 2, 2003). The Apple Computer case produced a $100 million jury verdict against two Apple Corp. executives. In re Apple Computer Securities Litigation (N.D. Cal. 1991). See Mark Cursi, Apple Verdict Could Change Securities Cases, THE RECORDER, June 6, 1991. The remaining defense-verdict case was against Biogen. See Biogen Urges Law Changes After Fraud Case Victory, BIOWORLD TODAY, May 8, 1998 [need to confirm that the chairman was sued, as well as the company]. Michael Davisson, Is Anything But the Soft Market Driving D&O Policies, DELAWARE CORPORATE LITIGATION REPORTER, Nov. 15, 1999, asserts that there are two other post-1995 trials, in addition to Everex, but he did not name them and did not recall them when we called him to inquire.
Table II: Securities Cases Against Inside and Outside Directors:
Tried to Verdict, 1990-June 2003

<table>
<thead>
<tr>
<th>Type of law</th>
<th>Filed</th>
<th>Against inside directors only</th>
<th>Plaintiff victories</th>
<th>Against outside directors</th>
<th>Plaintiff victories</th>
</tr>
</thead>
<tbody>
<tr>
<td>federal securities law</td>
<td>2930</td>
<td>3 (1 since PSLRA in 1995)</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>state securities law</td>
<td>&gt; 49</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

We are also aware of two securities cases tried to verdict against the general partners of limited partnerships.\(^{13}\) There are also a number of jury verdicts involving accountants or investment bankers.\(^{14}\) These cases, however, involve rather different settlement dynamics and policy concerns.

It is hard to prove a negative (the absence of actual liability in Table I; the absence of cases against outside directors tried to verdict in Table II). We made, however, extensive efforts to find counterexamples. We asked many securities lawyers, on both the plaintiff and defense side, as well as people at leading securities litigation consulting firms. Some of these people are thanked in the introductory footnote. In several cases, we asked them to survey their partners, to see if someone else knew of a case.\(^{15}\) We presented our work at practitioner conferences and asked the audience if they knew of counterexamples. We read widely, asked our academic colleagues, and vigorously chased down leads. We had a research assistant methodically scan practitioner journals that would be likely to report any cases.\(^{16}\) Moreover, the one actual liability case we know about, *Van Gorkom*, produced huge publicity. Other cases would likely be visible also, and thus harder to miss. In the end, we may have missed some cases, but we are confident that we didn't miss many.

**B. Corporate Law Claims: Duty of Care Liability as Null Set**

In this article, we consider directors' nominal and actual liability under Delaware corporate law, because Delaware is the host state for most public companies. The Revised Model Business Corporation Act (*MBCA*) and other major state corporate laws are generally at least as favorable to outside directors as Delaware's. If they were not, these other states would be likely to lose the public company incorporations they now retain.


\(^{15}\) The surveyed firms are [list to come].

\(^{16}\) [list of practitioner journals and dates scanned to come].
Directors have fiduciary duties to the corporation and are potentially liable for breach of these duties. In the usual depiction, directors owe two basic fiduciary duties -- the duty of care and the duty of loyalty. The relevant duty for good faith conduct by outside directors is the duty of care. In this depiction, good faith and non-applicability of the duty of loyalty are basically synonymous. This terminology creates a linguistic problem for recent cases which suggest that inattention, heretofore seen as raising only a duty-of-care issue, might involve bad faith if extreme enough. We treat these cases as duty-of-care/good faith cases.

The care/loyalty dichotomy is overly simple as a depiction of directors' obligations. Directors have two other identifiable fiduciary duties -- a duty of disclosure and a duty of special care when one's company is a takeover target. However, the care/loyalty dichotomy is sufficient when assessing outside director liability. Absent a conflict-of-interest, an outside director's failure to ensure proper disclosure is treated as a duty of care violation. So too for an outside director's decision to accept or oppose a takeover offer. For simplicity, we adopt here the care/loyalty dichotomy.

Lawsuits for breach of fiduciary duty can be either direct (brought by the shareholder directly against the directors), or derivative (brought by a shareholder in the name of the corporation, with damages paid to the corporation). The sometimes fine distinctions that control which suits may be brought directly and which must be brought derivatively are not worth exploring here. Suffice it to say that directors face more risk in derivative suits (because indemnification is limited), but shareholders prefer direct actions when possible (because derivative suits face strong procedural hurdles).

Below, we consider first suits for damages (subsections 1-3). We then consider what changes if the suit is for injunctive relief (subsection 4), or is brought under the duty of loyalty even though the director in fact acted in good faith (subsection 5).

1. Nominal Liability: Business Judgment Rule and Section 102(b)(7)

The duty of care sounds scary: Directors must act "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." However, Delaware has long limited director liability for breach of the duty of care through the lax standard by which compliance with this duty is measured -- the business judgment rule, under which a director who is reasonably informed and acts in good faith is irrebuttably presumed to have satisfied the duty of care. The nominal standard for business judgment rule scrutiny is gross negligence in becoming informed. The de facto standard, outside the takeover context, is likely lower.

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18 On the direct versus derivative distinction and the procedural aspects of derivative suits, see, e.g., WILLIAM ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION ch. 10 (2003).

19 AMERICAN LAW INSTITUTE, Principles of Corporate Governance: Analysis and Recommendations [below, ALI Principles of Corporate Governance] § 4.01 (1994); see also MODEL BUSINESS CORPORATION ACT § 8.30(b) (1984) (directors must "discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances").

than this, and catches only "directors who failed to pay any attention to corporate business."21

The business judgment rule, as the first line of defense against liability for breach of the duty of care, proved to be barely permeable in a famous 1985 takeover case--Smith v. Van Gorkom22. This decision led to a crucial change in Delaware law and practice. Delaware adopted a new corporate law rule, in section 102(b)(7), under which companies can adopt charter provisions that limit or eliminate the liability of directors (but not officers) for breach of the duty of care.23

Almost all public companies have used this freedom to eliminate director liability for breach of the duty of care.24 Shareholders routinely support charter amendments to adopt these provisions. Thus, the small risk of actual liability for breach of the duty of care that was once present is now almost gone. The Delaware courts, relying on section 102(b)(7) charter provisions, routinely grant motions by outside directors to dismiss duty of care claims for damages.25

A sliver of duty-of-care exposure may remain, involving gross inattention, severe enough for a court to conclude that the directors acted in bad faith. Two recent cases illustrate this new class of claims:26

22 488 A.2d 858 (Del. 1985). In hindsight, we can understand Van Gorkom as applying not the usual lax business judgment rule scrutiny of ordinary decisions, but instead a heightened, intermediate level of scrutiny to decisions by a target board of directors to accept or oppose a takeover bid. See Bernard Black & Reinier Kraakman, Delaware's Takeover Law: The Uncertain Search for Hidden Value, 96 NORTHWESTERN UNIVERSITY LAW REVIEW 521-566 (2002).
23 DEL. GEN. CORP. L. § 102(b)(7) (adopted 198x). This provision allows a company charter to include "A provision eliminating or limiting the liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director [other than] (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 [for declaring an improper dividend]; or (iv) for any transaction from which the director derived an improper personal benefit." Despite the complex and overlapping wording of the exclusions, the import is clear enough. A company's charter can limit or eliminate liability for good faith conduct (which would be judged under the duty of care, not the duty of loyalty).

The MBCA is even broader. It allows a company charter to eliminate a director's liability "except liability for (A) the amount of a financial benefit received by a directors to which he is not entitled; (B) an intentional infliction of harm on the corporation; (C) [an improper dividend or share repurchase]; or (D) an intentional violation of criminal law." MODEL BUS. CORP. ACT § 2.02(b)(4).

24 See Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 EMORY LAW JOURNAL 1155-1189 (1990), at 1160-61 (over 90% of the sample companies had adopted § 102(b)(7) provisions).
26 We can imagine such a claim leading to a conduct remedy (plus fees for plaintiffs' counsel), but think it highly unlikely that the Delaware courts would find directors personally liable for what is, at bottom, a duty of care violation. If they did, D&O coverage would likely still remain available.
(i) a Delaware case involving Disney's lavish severance agreement with Michael Ovitz, which paid Ovitz $140 million in cash and vested stock options for less than a year of work. The Delaware Chancery Court found that the alleged facts, if proven, would sustain a claim of intentional failure by the board to review Ovitz's compensation package, and this could involve bad faith and thus not be protected by Disney's section 102(b)(7) charter provision.27

(ii) an Illinois case involving Abbott Laboratories, where the board failed to follow up on several FDA warning letters about production weaknesses at one Abbott Labs facility, the FDA eventually imposed a $150 million fine and suspended production until the problems could be fixed.28

These cases stretch the boundaries of what counts as bad faith conduct, to permit a corporate law recovery in what would normally be a duty-of-care case, despite a section 102(b)(7) provision. Abbott Labs even finds in Delaware law a duty of good faith, in addition to the conventional duties of care and loyalty. It suggests that directors may face some incremental risk outside Delaware, as inexpert judges apply, and perhaps misapply, the governing corporate law.29

At this point, Disney and Abbott Labs have merely survived a motion to dismiss. If they survive a motion for summary judgment, the settlement incentives discussed below make settlement likely, which would leave indemnification and D&O coverage available. If not, D&O coverage should remain available.30 Thus, the risk of actual liability for even extreme nonfeasance seems highly remote. The remaining topics, to which we turn next, are:

- indemnification and insurance, which protect directors against legal expenses and against any remaining risk of damages liability remains (subsections (2-3)), and

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28 See In re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (7th Cir. 2003) (applying Illinois law); see also McCall v. Scott, 239 F.3d 808 (6th Cir. 2001), supplemented, 250 F.3d 997 (6th Cir. 2001) (complaint alleges directors consciously disregarded known risk of health care fraud by senior management; if proven, this would be evidence of bad faith). Other variations on the theme of gross inattention are possible. For an effort to construct a possible good faith claim premised on insufficient effort by audit committee members plus a claim that the committee members knew or should have known their effort was insufficient, see Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUSINESS LAWYER 1371-1402 (2002), at 1385-95.

29 In Abbott Labs, the 7th Circuit interpreted Illinois corporate law, which it says follows Delaware. The court found that directors have three duties, a duty of care, a duty of loyalty, and a duty of good faith. However, the Delaware cases, fairly read, do not create a duty of good faith distinct from the duty of loyalty. See ALLEN & KRAAKMAN (2003), supra note xx (recent textbook, one of whose authors is a former Delaware judge, adopting the standard division of fiduciary duties into care and loyalty); cf. Henry Ridgely Horsey, The Duty of Care Component of the Delaware Business Judgment Rule, 19 DELAWARE JOURNAL OF CORPORATE LAW 971-998 (1994) (referring to the "duty of good faith and loyalty") (Mr. Horsey is a former Delaware Supreme Court Justice).

30 This conduct should not fall within the standard D&O policy exclusion for intentional misconduct. If it did, we believe that huge market pressure would arise for policies to cover this sort of nonfeasance.
• the risk that a director who in fact acted in good faith will be found to have violated the duty of loyalty (subsection (4)).

2. Indemnification

Indemnification plays two distinct roles. First, for duty-of-case suits, directors may have to pay legal expenses to defend against a lawsuit, even though they are not liable for damages. The suit could be for damages or, perhaps more likely, for an injunction. Injunction claims arise in two principal contexts: suits by a bidder in a takeover contest and suits by plaintiffs' lawyers seeking conduct remedies plus attorney fees. Second, especially under other bodies of law, where the section 102(b)(7) shield is not available, and indemnification provides a key protection against liability for damages.

We focus here on indemnification against having to pay legal expenses. There are two related risks -- the risk of paying expenses out-of-pocket in first instance, and the risk of not recovering these payments from the company or an insurer. Both of these exposures are eliminated by a combination of indemnification (this subsection) and D&O insurance (subsection (3)).

Under Delaware corporate law section 145(e), a corporation may advance legal expenses to a director to defend a direct or derivative suit. The corporation may also indemnify a director for these expenses (in other words, not demand repayment of the advance), if the director "acted in good faith and in a manner [he] reasonably believed to be in or not opposed to the best interests of the corporation." In a direct suit, both

31 For recent settled cases involving conduct remedies, see Patrick McGeehan, Sprint Settles Suits with Policy Shift and $50 Million, NEW YORK TIMES, Mar. 20, 2003 (Sprint settles securities class action with $50 million payment and settles fiduciary duty lawsuit by agreeing to corporate governance changes); Press Release, Westell Technologies Announces Settlement, BUSINESS WIRE, Feb. 20, 2003.

32 DEL. GEN. CORP. L. § 145(e) allows a corporation to pay a director's legal expenses "in advance of the final disposition of [an] action, suit, or proceeding [if the director agrees] to repay such amount if it shall ultimately be determined that [the director] is not entitled to be indemnified by the corporation."

33 DEL. GEN. CORP. L. § 145(a) addresses indemnification for direct (non-derivative) suits and provides that "A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any . . . action suit or proceeding [other than a derivative suit] by reason of the fact that the person is or was a director . . . or was serving at the request of the corporation as a director . . . of another [entity], against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actual and reasonably incurred by the person . . . if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation . . . .".

The MBCA is even broader. A company's charter may permit or require indemnification and advancement of expenses for all actions except "(A) receipt of a financial benefit to which [the director] is not entitled; (B) an intentional infliction of harm on the corporation or its shareholders; (C) [an improper
expenses and damage awards are indemnifiable. In a derivative suit, only expenses are
indemnifiable. The company's ability to indemnify directors in direct suits will be
important for securities lawsuits. The key point here is that the company can indemnify
directors against legal expenses, whether a corporate lawsuit is direct or derivative.

Almost all public companies have turned the "may" of Delaware section 145 into
"shall" by adopting bylaws that provide that the company shall advance expenses to and
indemnify directors, officers and employees to the fullest extent permitted by Delaware
law. Thus directors will always have their expenses covered if they act in good faith.
Directors will also be generous to their fellow directors in deciding whether conduct was
in good faith.

In theory, a firm could refuse to pay expenses and force the director to sue to
recover them. However, this is unlikely in the real world absent strong evidence of bad
faith. Many suits are against most or all directors, so the directors will be voting to
reimburse themselves. Even if not, directors will usually be sympathetic to a fellow
director. One can imagine collegial loyalty dissipated if there is abrupt board turnover.
But even so, the company's current directors will likely vote to spend the shareholders'
money to treat even former directors as they would want to be treated themselves. The
requirement that conduct be in or not opposed to the firm's interests does not affect this
analysis. Good faith conduct will be arguably in or not opposed to the corporation's
interests, and other directors will likely give their fellow director the benefit of any doubt.
This is especially true given that: (i) the directors will be advised by counsel on their
legal obligation to advance expenses and on the risk that a bald refusal to do so could be
bad faith conduct that would expose the directors to (largely theoretical, to be sure) risk
of liability; and (ii) if they refuse to advance expenses, they can expect to be sued
themselves, and will likely lose the suit.

The bottom line on advancing expenses is simple: We know of no case where a
solvent public company has not honored a bylaw requiring it to pay outside directors' legal expenses.

3. D&O Insurance

D&O insurance plays the same two roles as indemnification. It protects directors
against paying legal expenses in a duty-of-care lawsuit, and against paying damages
under other bodies of law. It thus gives directors a second layer of protection against
actual liability. Delaware law allows a company to purchase D&O insurance for both
damages and legal expenses in a suit for breach of fiduciary duties. In practice,
essentially all public companies do so. Defense counsel send their legal bills to the company and the insurer, who allocate payment responsibility between them. The directors don't pay a penny and may not even see the bills.

For most claims, especially direct claims, D&O insurance and indemnification overlap. There are several ways in which insurance offers a different and sometimes stronger shield against actual liability than indemnification. The principal differences are:

- D&O coverage remains available even if the firm is insolvent.
- Insurance, unlike indemnification, covers damage awards in a derivative suit.
- D&O insurance policies have a maximum payout amount. However, insurers are willing to sell, and companies routinely buy, policies with limits high enough to cover any plausible legal expenses and all but the most extreme settlement amounts.
- Insurers are willing to sell, and companies routinely buy, policies without copayments or meaningful deductibles.
- D&O policies typically exclude coverage for claims based on intentional misconduct (the standard phrasing is "criminal or deliberately fraudulent acts") and for duty of loyalty violations (the standard phrasing is "the gaining of any personal profit or advantage to which the insured is not legally entitled").

There are technical issues involved in ensuring that the D&O policy will remain available come what may and will cover all of a director's potential nominal liability. Important current issues include (i) severability of coverage (does the policy cover good faith conduct by one director, even if another director's misconduct makes coverage unavailable for that director); (ii) severability of the application (does the policy cover outside directors, even if the officers misrepresented the company's legal or financial situation in applying for coverage); (iii) "time gap" risk (the company must have a new policy in place before the old one runs out); and (iv) "complementary coverage" risk (D&O policies often exclude claims that are expected to be covered by separate insurance policies, including environmental and ERISA claims). Finally, there is a risk that the insurer will go broke, as Reliance did in 2001. But most D&O insurance is provided in

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36 See TILLINGHAST TOWERS PERRIN, 2002 DIRECTORS AND OFFICERS LIABILITY SURVEY 17 (98% of U.S. firms with over 500 shareholders respondents had D&O insurance).

37 See TILLINGHAST TOWERS PERRIN (2002), supra note xx, at 36 (94% of surveyed firms purchase insurance with no deductible for personal coverage, most have no copayments, the exceptions on copayment are "almost exclusively" New York corporations, which must comply with a New York insurance rule that requires a $5,000 deductible, plus a 0.5% copayment for the first $1 million in damages); JOHN F. OLSON, JOSIAH O. HATCH, III & TY R. SAGALOW, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 10.06(7)(a) (2001). Policies often include significant deductibles for claims that would be paid by the company, directly or through indemnification.

38 OLSON, HATCH & SAGALOW (2001), supra note xx, § 10.06(5)(a), at 10-29 to -30; see also MODEL BUS. CORP. ACT, Official Comment to § 8.57 (D&O policies "typically do not cover . . . dishonesty, self-dealing, bad faith, knowing violations of [law] or other willful misconduct.").

39 For an overview of current coverage issues, see Directors & Officers Liability Insurance: Striking Out Risk (2003 Special Supplement to Corporate Board Member Magazine) We discuss additional coverage issues specific to bankrupt firms in section D infra.
layers by a number of insurers. If one insurer is bankrupt, the other layers will usually offer sufficient coverage.40

When a new coverage risk arises, several factors reduce the chance of actual liability. First, loss of D&O coverage does not affect other layers of protection. Second, the new risk is typically short-lived. Market pressures cause changes in contracting practice that reduce or eliminate coverage risks once they arise. In the case of application fraud, insurers, for a price, will either offer application severability or else separate noncancelable coverage (either dedicated coverage for nonindemnified claims or a separate policy covering only the independent directors). Moreover, courts often interpret the policy to provide coverage to outside directors, or the insurer uses the threat of non-coverage to negotiate a lower coverage limit, but does not walk away entirely.41

Application severability illustrates this dynamic. In a few recent cases, insurers have invoked application fraud and sought to rescind coverage for all directors. In most of these (including Adelphia, Enron, Sunbeam, Tyco, and WorldCom), the outside directors ended up covered, sometimes with reduced limits, after a court order or a negotiated settlement.42 In HealthSouth, the dispute is ongoing, but HealthSouth is not bankrupt, so the dispute is over whether the company or the insurers will pay the directors’ legal fees and damages, not whether the directors will pay.43 In the one remaining case, involving Peregrine Systems, AIG rescinded coverage, but the securities class action was brought only against the company and two inside directors who participated in the fraud, so there has been no need for the outside directors to seek to reinstate coverage.44

40 On Reliance, see Penn. Battles for Reliance Cash, INSURANCE CHRONICLE, Aug. 13, 2001; Geraldine Fabrikant, Private Concern, Public Consequences, NEW YORK TIMES, June 15, 2003 (Reliance provided $20 million out of a total of $50 million in D&O insurance for the Trace directors). When an insurer fails, the failure is often not total. It remaining assets will be divided among the claimants; state insurance funds may provide additional recovery sources.

41 See Christopher Oster, Insurers Seek to Trim Their Exposure on Directors Policies, WALL STREET JOURNAL, Jan. 28, 2003, at C1 (“insurers seeking to get out of a policy will [often] try to negotiate a deal with the policyholders, perhaps agreeing to pay some amount less than the full coverage”); Barbara Aarsteinsen, Less For More, CANADIAN INSURANCE, March 1, 2003 (describing the new "dedicated Side A" and "independent director liability" coverage offered by AIG and Chubb).


44 See Complaint, Krinsky v. Peregrine Systems (S.D. Calif. 2002). There is also private litigation against Peregrine founder John Moores. Moores realized $611 million from sales of Peregrine shares before the fraud was disclosed. Unless he participated in the fraud, he is likely at risk only for giving back some of his gains. For background, see Scott Bigelow, CFO's Cooperation Takes Peregrine Probe to Next Level, SAN DIEGO UNION-TRIBUNE, Apr. 27, 2003; Don Bauder, Texans File Suit Against Moores and Colleagues, SAN DIEGO UNION-TRIBUNE, Feb. 28, 2003; Complaint, Securities and Exchange Commission v. Peregrine Systems (S.D. Calif. 2003).
Thus far, D&O coverage risks have been small enough, and the resulting coverage holes have been closed quickly enough, so that outside directors have not become actually liable in fact. There is reason to believe this pattern will continue. A D&O insurer which relied on a new hole and left outside directors facing actual liability would suffer reputational damage that would likely far exceed the savings from avoiding a coverage payment or two.

The bottom line for duty of care lawsuits, from a combination of indemnification and insurance: Outside directors of public companies who act in good faith are never personally liable for either damages or legal expenses. We know of no cases of actual liability for conduct after the 1987 adoption of section 102(b)(7).

4. Duty of Loyalty Claims (With No Loyalty Breach in Fact)

The last class of corporate law actions we need to consider are those claiming breach of the duty of loyalty, even though the director in fact acted in good faith. Section 102(b)(7) won't apply, so damages are available. Moreover, the availability of damages for loyalty claims ensures that plaintiffs will make these claims whenever possible. In a world with decisionmaker error, some of these claims will have a chance of winning at trial, and hence also have settlement value before trial.

This is a narrow set of cases. Outside directors can usually avoid a significant personal financial interest in the company's actions, apart from routine director compensation, which the Delaware courts don't treat as a duty of loyalty issue. If such an interest surfaces (say for an out-of-the-ordinary-course transaction between two companies when a director has positions at both), the director can protect himself by abstaining from the decisionmaking process at both companies. To be sure, a director may overlook a financial interest, or a court may see a conflict where the director didn't. But these will usually be minor conflicts that often won't produce enough potential damages to interest plaintiffs' counsel.

Still, such claims can arise. Most will settle. Both sides will agree to treat the conduct as being in good faith, because this keeps the D&O policy available to pay the claim. One can imagine a derivative lawsuit (hence no indemnification), plus facts strong enough to produce a settlement exceeding the policy limits. But the situation we address here (a perceived conflict, despite actual good faith conduct) is unlikely to produce a plausible claim for damages that exceeds reasonable policy limits.

It is also possible for a loyalty claim not to settle, the judge to make the wrong decision, and the plaintiffs to win a case they should have lost. If this occurs, the section 102(b)(7) and indemnification shields vanish. D&O insurance becomes less than fully

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45 A mixed care/loyalty claim, unlike a pure duty of care claim, can survive a motion to dismiss. See Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001).

46 One can imagine a D&O insurer objecting to an agreement between plaintiff and defendant to treat the directors' conduct as being in good faith, but so far as we know, this does not happen in practice. The practice of relying on company counsel to defend the case means that the insurer will usually lack sufficient information to make such a claim. Moreover, a D&O insurer who challenged a settlement on this basis, where actual misconduct was debatable (the director in fact acted in good faith), would likely suffer reputational harm that would outweigh any near-term savings.
reliable because the adverse outcome may give the insurer a defense under the policy. However, as we discuss in the next section, the risk of losing indemnification and D&O coverage creates strong pressure for both sides to settle.

C. Settlement Incentives in Corporate Law Cases

Settlement incentives are a minefield of complexity. Even two-party (plaintiff and defendant) incentives have given rise to a substantial literature.\(^{47}\) The incentives of plaintiffs' counsel add further complexity, especially for derivative and securities class action lawsuits, where counsel represents a diffuse class of often passive shareholders.\(^{48}\) So does the divergence of interest between directors (who make settlement decisions for companies) and shareholders (who effectively pay the company's share of the settlement). D&O insurers' incentives add yet another layer. In this article, we can only sketch the main lines of plaintiffs', directors, and insurers' incentives. To simplify the analysis, we treat plaintiffs' counsel as the effective party in interest. To provide a focus for the analysis, we assume a duty-of-loyalty cases (without a loyalty breach in fact). Most of the settlement incentives we discuss also apply to the new "bad faith" duty-of-care cases and to securities and other non-corporate-law litigation.

The bottom line is simple: There are powerful incentives pushing toward settling and toward doing so with payment coming entirely from indemnification, insurance, or both. The best evidence of this is that our discussion is entirely speculative. We don't cite any decided cases that impose actual liability on outside directors, because post-section 102(b)(7), we don't know of any.\(^{49}\)

1. Defendant Directors

The defendant directors' incentives to settle are obvious: If a director settles, damages and legal expenses will be paid by indemnification, insurance, or both. If the director goes to trial and loses, he is not indemnified for damages, may also lose indemnification for expenses, may lose D&O coverage, and thus faces a risk of actual liability.

One can imagine a director refusing to settle because he believes that he will be found not liable and doesn't want to bear the reputational cost of a settlement, but misjudging the outcome. However, examples of such misjudgment leading to actual liability don't exist. Such a misjudgment is most likely when the misconduct was marginal. If so, indemnification, insurance, or both may remain available despite a loss at trial.

\(^{47}\) For a survey, see Bruce L. Hay & Kathryn E. Spier, Settlement of Litigation, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 442-450 (Peter Newman ed. 1998).


\(^{49}\) Liability for "true" duty of loyalty violations is beyond the scope of this article. However, the settlement incentives that we discuss greatly reduce the risk of actual liability for true violations, as well as the alleged-but-not-true violations we address in text.
In a direct lawsuit, indemnification is available in a settlement but might not be after a loss at trial. Typically, the board of directors will approve indemnification as part of the settlement, and the company will pay the damages directly, rather than the director paying and then seeking reimbursement. The need for board approval is not a significant obstacle. Most suits are against multiple directors, and even if not, directors won't want their fellows to take the risk of going to trial, when they wouldn't want to take this risk themselves.

In a derivative suit, indemnification is not available for damages and might not be available for legal expenses. This imposes a further constraint -- the case must settle within the policy limit (less defense costs, which will be paid from of the D&O policy) or the directors will face actual liability. However, plaintiffs' and insurers' incentives make such a settlement almost always achievable.

2. Plaintiffs

Plaintiffs' incentives to settle are less obvious than the directors' incentives, but are at least as powerful. Unless a defendant director is seriously wealthy, the plaintiff will settle to avoid the risk of either losing or winning! Let's see why. A successful plaintiff in a duty of loyalty case may have foregone access to the "deep pockets" provided by indemnification and the D&O policy, and be left with a wholly or largely uncollectible judgment. Moreover, the plaintiff faces an almost certain appeal, with the director's legal expenses advanced by the company or the D&O policy. The case will likely have been a close one (remember that the director in fact acted in good faith). Thus, the plaintiff faces a good chance of losing on appeal. Far better to settle within the policy limits.\footnote{For more detailed analysis of the settlement incentives of plaintiffs' counsel, see John C. Coffee, Jr., Understanding the Plaintiff's Attorney: the Implications of Economic Theory for Private Enforcement Through Class and Securities Actions, 86 COLUMBIA LAW REVIEW 669-727 (1986); James D. Cox, Making Securities Class Actions Virtuous, 39 ARIZONA LAW REVIEW 497-524 (1997).}

For a derivative suit, or a direct suit that is close to the direct/derivative line, the plaintiff has a further incentive to settle. The trial court's decision that a derivative suit has overcome the procedural hurdles to these suits, or that a case is direct rather than derivative, is appealable after trial but not before. If the plaintiff wins, the defendants will reraise on appeal the legal arguments on these issues, with at least some chance of success.

Plaintiffs' unwillingness to risk success on the merits helps to ensures that settlement within the policy limits is achievable. Indeed, plaintiffs face an odd settlement dynamic. They often can't negotiate too hard for settlement at or too close to the policy limit, even in a strong case, because if the case goes to trial, the outcome could be either that the directors aren't liable or that the directors are liable but the insurer isn't, with the plaintiff losing either way.

In a derivative suit, the plaintiff's incentive to settle is reinforced because indemnification is not available for damages, leaving the D&O policy as the principal deep pocket. The policy will first be used to pay the defendants' legal expenses. The longer the case goes on, the smaller the amount that is left to pay the plaintiffs. In contrast
to standard litigation, where plaintiffs' care about their own but not the defendants' costs, plaintiffs care about defense costs too. Settlement, ideally early, reduces these costs.

3. Insurers

A typical D&O policy requires the insurer to consent to a settlement, but provides that consent can't be unreasonably withheld. An insurer will weigh the certain loss from a settlement against the expected loss to it from going to trial. The cap on its exposure gives the insurer asymmetric payoffs, relative to the expected outcome for all possibly liable parties (company, directors, and insurer). This payoff pattern could lead an insurer to reject a settlement offer within the policy limits that an uninsured defendant would accept. The insurer's potential defense to liability under the policy if the directors are found not to have acted in good faith increases this payoff asymmetry for duty-of-loyalty cases. So does the insurer's relative risk neutrality, where the directors are likely to be highly loss-averse.

Countervailing factors, however, ensure that insurers will almost always settle within the D&O policy limits if plaintiffs' counsel will do so. One critical factor is procedural. D&O policies, unlike most forms of insurance, allow the defendants to choose their own defense counsel, rather than rely on the insurer's counsel. This ensures a vigorous and expensive defense, for which the insurer will pay. It also deprives the insurer of the information needed to oppose a settlement favored by the defendant directors and their counsel, if the settlement is at all plausible.

A second factor is the insurer's likely liability for refusal to settle if the case is lost at trial and damages exceed the policy limits. In addition to the contractual requirement that the insurer not unreasonably withhold consent, there is often a state law claim for bad faith refusal to settle, with punitive damages available, and an implied covenant of good faith and fair dealing under which:

Insurers generally are considered to be bound . . . to accept settlements within the policy limits when failure to accept such settlements might well result in excess liability for the insured; failure to accept such settlements might well result in insurers being held liable for the amount in excess of the aborted settlement that the defendants must later pay.

The insurer's risk is magnified because many directors have the resources to bring such a suit (often with the company paying their legal expenses), and because the insurer has refused to settle without full information about the case.


52 In insurance lingo, the D&O policy contains neither a duty (of the insurer) to defend, nor a right to defend. See Joseph F. Johnston, Jr., Corporate Indemnification and Liability Insurance for Directors and Officers, 33 BUSINESS LAWYER 1993-2036 (1978), at 2023; OLSON, HATCH & SAGALOW (2001), supra note xx, § 10.07(1)-(2).

53 See, e.g., Alan Sykes, Bad Faith Refusal to Settle by Liability Insurers, 23 JOURNAL OF LEGAL STUDIES 77-110 (1994); Alan Sykes, Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate, 72 TEXAS LAW REVIEW 1345-1374 (1994).

A third factor is the expense of litigating rather than settling. If the insurer refuses to settle, it ensures that further litigation will be highly costly. Counsel for the company and the directors will pull out all stops, at the insurer's expense, to prevent a finding of liability. The insurer cannot closely police legal expenses without opening itself up even more strongly to a suit for unreasonable or bad faith refusal to settle, compounded by refusal to pay for a proper defense. The insurer will need its own counsel; the directors may insist on separate counsel as well. If the directors lose at trial, an appeal is virtually certain. The insurer must weigh the possible gain from going to trial against the certain payment of these expenses if it rejects a settlement.

Many D&O policies have policy limits that are a modest multiple (not infrequently only 2-3 times) of potential defense costs, if a case is tried full-bore, through trial and appeal. An effort to model insurers' incentives is beyond the scope of this paper. But it should be apparent that the lower the ratio of the policy limit $L$ to the expected legal defense costs for a full-bore trial and appeal $D_{\text{trial}}$, the more likely the insurer is to be willing to settle if plaintiff and defendant are willing.

A fourth factor, perhaps the most powerful, is reputational cost to the insurer from refusing to settle within the policy limits, leading to an adverse verdict and actual liability for directors. The mere refusal to settle will become widely known within the community of law firms who commonly act as corporate and securities defense counsel to public companies. It will hurt the insurer's future business prospects, even if the case is won at trial, because directors won't want to face the time commitment, aggravation, stress, and ex ante risk of a trial.

A refusal to settle, followed by a loss at trial that exposes directors to actual liability, would be a reputational disaster for the insurer. The outcome will be widely publicized, in the financial press, by corporate and securities defense firms, and by the insurer's competitors. In addition to its potential obligation to cover this actual liability under the implied covenant of good faith and fair dealing, an insurer would face severe market pressure to cover any out-of-pocket payments the outside directors would otherwise have to make and settle before a decision on appeal is reached.

Put all this together, it is highly likely that the insurer will either settle within the policy limits, if the plaintiff and defendant will do so, or cover the directors' personal exposure if the insurer rejects such a settlement. Relaxing this assumption a little bit (all that is needed to make it fully realistic) would open up additional tiny windows of actual liability, but would not appreciably change our conclusions that directors face only a small overall risk of actual liability; the principal source of that risk comes from securities law, and this risk arises primarily when the firm is bankrupt.

D. Securities Law Claims

A typical securities class action alleges that the company has caused investors to misprice its shares or other securities either by saying something material that is untrue or misleading, or failing to say something important. We will refer to these twin possibilities as "misdisclosure." There are two basic types of claims: (i) claims under the Securities Act of 1933 ("Securities Act") for "primary" offerings of securities by the company to investors; and (ii) claims under the Securities Exchange Act of 1934
("Exchange Act") based on "secondary" trading between investors. For both, the outside directors' liability is effectively capped at 150% of their proportionate liability, with their share of total fault determined through special jury instructions.\footnote{See Securities Act § 11(f)(2), 15 U.S.C. § 77k(f)(2) (200x), Exchange Act § 21D(f), 15 U.S.C. § 78u-4(f) (200x). The proportionate liability rule falls away if the defendant had actual knowledge of the misdisclosure, but actual knowledge would violate our assumption of good faith.}

We assume that the company is solvent, but relax this assumption in the next section. We address both Securities Act and Exchange Act claims but, for simplicity, ignore control person liability.\footnote{See Securities Act § 15, 15 U.S.C. § 77o (200x); Exchange Act § 20(a), 15 U.S.C. § 78t(a) (200x).} Control person allegations are often made against outside directors. To oversimplify some complex doctrine, these claims often survive a motion to dismiss, because the plaintiffs must plead only control, but not scienter. The defendants have the burden, at a later stage, of showing good faith (roughly equivalent to lack of scienter).\footnote{See, e.g., S.E.C. v. First Jersey Securities, 101 F.3d 1450, 1472 (2d Cir. 1996); In re Enron Derivative, Securities and ERISA Litigation 258 F. Supp. 2d 576, 597-98 (S.D. Texas, Houston Div. 2003); In re Initial Public Offering Securities Litigation, 241 F.Supp. 281, 392-398 (S.D.N.Y. 2003) (discussing pleading and proof requirements under Exchange Act § 20(a) in different circuits).} Still, control person claims generally fail if the underlying direct claim fails. Thus, these claims don't significantly increase directors' exposure.\footnote{It is clear under the Exchange Act, and likely under the Securities Act, that proportionate liability applies to both direct and control person liability, so potential damages are the same either way. See Securities Act §§ 11(f)(2), 15, 15 U.S.C. §§ 77k(f)(2), 77o (200x); Exchange Act § 21D(f), 15 U.S.C. § 78u-4 (200x).} We also ignore claims under state securities law and common law. Most state law claims are preempted by federal law.\footnote{See Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. Law No. 105-353, codified at Securities Act § 16, 15 U.S.C. § 77p (200x); Exchange Act § 28(f), 15 U.S.C. § 78bb(f) (200x). Since the adoption of SLUSA, state-law only securities claims have essentially disappeared. See PRICEWATERHOUSECOOPERS LLP, 2002 SECURITIES LITIGATION STUDY 1. State claims are still sometimes appended to federal claims.} Considering these claims would not affect the main lines of our analysis.

We continue to assume that the outside directors acted in good faith and therefore without actual knowledge of misdisclosure. However, they could have been negligent or reckless. They also face a risk that a jury will so find, even if they weren't negligent or reckless in fact. Delaware corporate law claims are heard by expert judges. In contrast, securities law claims are decided by nonexpert jurors (plaintiffs invariably demand a jury trial). A jury decision on complex disclosure issues injects a large random element into trial outcomes.

1. Nominal Liability under the Securities Act and Exchange Act

Under the Securities Act, the company is strictly liable for misdisclosure in the "prospectus" (the offering document for the securities). The directors are also liable but
have a due diligence (roughly speaking, a non-negligence) defense.\textsuperscript{60} If the company is solvent, plaintiffs rarely have a reason to sue the outside directors. Even if plaintiffs name the outside directors as defendants, they usually won't seriously pursue this claim.

For Exchange Act claims, the company is liable if those responsible for the disclosure acted with "scienter." Officers and directors who had scienter with respect to the misdisclosure are also liable. Scienter is generally defined as encompassing intentional misdisclosure, conscious knowledge of misdisclosure, or strong recklessness (approaching conscious knowledge) with respect to disclosure accuracy.\textsuperscript{61} Plaintiffs can usually prove scienter more easily against inside than against outside directors. The insiders have greater access to internal documents, emails, and such that disclose the company's true position. Once again, if the company is solvent, plaintiffs rarely seriously pursue a claim against the outside directors.

The difference between Securities Act and Exchange Act liability is sharpened by the pleading rules added to the Exchange Act by the Private Securities Litigation Reform Act of 1995. These rules require the court to stay discovery until the court has heard a motion to dismiss. A motion to dismiss will be granted unless the complaint "state[s] with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."\textsuperscript{62} Without discovery, plaintiffs often can't meet this pleading standard. Their best chance is to find evidence that the director sold the company's shares in significant volume with suspicious timing, and claim that this evidence creates a "strong inference" of scienter. Well-counseled outside directors can protect themselves by not selling shares at all while on the board, selling on a pre-established schedule, selling only a small fraction of their holdings in any (say) six-month time period, or selling only to pay the exercise price of stock options.\textsuperscript{63} An Exchange Act pleading can also be sustained if the directors ignored warnings of fraud in news stories, other public sources, or internal documents that the plaintiffs have gained access to.\textsuperscript{64} Still in practice, outside directors typically are at greater risk for Securities Act than for Exchange Act claims.\textsuperscript{65}


\textsuperscript{63} Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (200x), provides a safe harbor from insider trading liability for sales on a predetermined schedule. Compliance with the safe harbor should suffice to defeat an inference of scienter based on the timing stock sales.

\textsuperscript{64} See, e.g., In re Lernout & Hauspie Securities Litigation, 286 B.R. 33 (D. Mass 2002) (directors ignoring auditors' warnings about lack of internal controls).

Some nuances. First, some D&O policies covers only directors and officers only, others cover the company also. The company, meanwhile, will be more willing to settle with the insurer's than with its own money. If the D&O policy covers only directors and officers, plaintiffs thus have an incentives to sue the officers, the outside directors, or both. Second, if a case goes to trial, the proportionate liability provisions of the PSLRA will produce separate judgments against each defendant. However, it's hard to imagine a fact pattern where the outside directors' proportionate share of liability will exceed the available D&O coverage. Even if (somehow) not, the company and the insurer can pay the entire judgment. The directors are then potentially liable for contribution, but the board will presumably decide not to sue them for contribution.\textsuperscript{66} If made with proper procedures (by a special litigation committee composed of non-liable directors), this decision is hard to challenge under applicable derivative suit rules.

One might wonder why plaintiffs ever sue outside directors, rather than only suing the company and the insiders, against whom proof is easier. There are several reasons. First, the company may be bankrupt. A second, more subtle reason involves the risk that the plaintiffs will prove intentional misdisclosure against the insiders, which makes insurance unavailable for them and perhaps for the company also -- or prove enough so the insurer has a plausible claim that the policy doesn't cover the insiders' conduct. To maximize the likelihood that the D&O policy will be available, the plaintiffs must sue the outside directors as well. Third, suing all directors may increase the pressure on the company to settle before trial.

The bottom line for securities claims against solvent companies: The company is directly liable and pays damages; outside directors don't.

2. \textit{Indemnification}

Because the company is always directly liable in a securities case, indemnification is a secondary concern. Still the rules on indemnification can only be described as peculiar. Delaware law is clear: Securities lawsuits are direct, not derivative. Thus, indemnification is permitted under Delaware law if the director acted in good faith, and is mandatory under a typical indemnification bylaw.

In contrast, the SEC's position is that indemnification, even against ordinary negligence liability under the Securities Act, is "against public policy as expressed in the [Securities] Act and is therefore unenforceable."\textsuperscript{67} The SEC stretches its statutory authority by requiring a company that wants the SEC to let a public offering go effective promptly (that is, every company) to promise that if a director seeks indemnification, other than for expenses of a "successful defense," the company:

will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such


\textsuperscript{67} Regulation S-K, Item 510, 17 C.F.R. § 229.510 (200x). The SEC would presumably take a similar view for scienter-based liability under the Exchange Act.
indemnification by it is against public policy as expressed in the [Securities] Act. 68

The SEC's position has never been tested in court. In a settled case, the company pays the judgment, the directors are therefore successful on the merits (they didn't pay damages), and their expenses can then be indemnified. Plaintiffs have no incentive to challenge indemnification. From their perspective, there are two principal sources of funds to pay damages: the company and the D&O policy. If indemnification of expenses were disallowed, D&O insurance would still cover them, so the overall pool of funds to pay damages would remain the same. Moreover, plaintiffs have no reasonable prospects of challenging insurability, which even the SEC agrees is appropriate. 69

In a case that goes to trial, the directors face some risk of not being indemnified, with greater risk for damages than for legal expenses. But there are good reasons why there no case yet addresses this issue. As discussed above, plaintiffs have little reason to sue the outside directors. Moreover, both sides have strong incentives to settle, discussed in the next section. The limits on indemnification if a case goes to trial enhance those incentives. And the combination of insurance and proportionate liability give directors little reason to worry, even if they to suffer an adverse outcome in court on both liability and indemnification.

3. Insurance

D&O insurance gives outside directors a third layer of protection against actual liability. As for corporate law claims, D&O insurance covers both damages and legal expenses. The insurer has a defense to payment under the insurance policy if the director committed "criminal or intentionally fraudulent acts," but this is a minor concern for outside directors who in fact acted in good faith.

This is doubly true because plaintiffs will intentionally try not to prove actual intent to mislead even when intent actually or arguably exists, to ensure that the D&O policy remains available to pay damages. Plaintiffs will try to prove that the outside directors met the culpability standard, whether negligence under the Securities Act or scienter under the Exchange Act, but will be careful not to offer evidence that the directors acted with intent or conscious knowledge.

4. The Effect of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act does not change the existing securities law standards for director liability, and thus does not directly affect our analysis of their exposure. It may increase or decrease the practical exposure faced by audit committee members, when the

69 See Securities Act Rule 461(c), 17 C.F.R. § 230.461(c) (200x). There are cases upholding the SEC's anti-indemnification policy for underwriters and legal counsel. See, e.g., Eichenholtz v. Brennan, 52 F.3d 478 (3d Cir. 1995); Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970). Asdar Group v. Pillsbury, Madison and Sutro, 99 F.3d 289, 291 (9th Cir. 1996). However, the balance of policy factors is more favorable for director than for underwriter or lawyer indemnification, especially for legal expenses.
firm is insolvent. But the sign of any effect is uncertain, and the likely magnitude seems small.  

On one hand, the Sarbanes-Oxley Act increases the audit committee's duties, and with more duties, there is more that can go wrong. Moreover, the Sarbanes-Oxley Act increases the information flow to the audit committee. This will leave a paper trail that could make it easier for plaintiffs to sustain an Exchange Act claim, which requires a showing of scienter. However, plaintiffs have no incentive for plaintiffs to pursue such a claim as long as the company is solvent. It will still be easier to show scienter for inside directors than for audit committee members.

On the other hand, the Sarbanes-Oxley Act requires the CEO and CFO to certify the firm's financial statements, so they can no longer claim ignorance of misdisclosure by subordinates. The CEO's and CFO's likely response is to be more conservative in their accounting, which should reduce the number of accounting restatements, and thus potentially reduce the number of viable cases that plaintiffs can bring. Also, within an overall system of proportionate liability, CEO/CFO certification increases their likely share of total fault, and thus implies less exposure for the outside directors.

The largest effects of the Sarbanes-Oxley Act on outside director risk are indirect and likely unintended. First, the requirements that the CEO and CFO certify the firm's financial statements are likely to make these executives more cautious, and thus reduce the frequency of restatements. Fewer restatements means fewer lawsuits, and less liability risk. Second, the Act gives the SEC power to fine a company for securities law violations and make the fines available to settle investor claims. The SEC used this authority in the WorldCom bankruptcy to create a $750 million fund, which will be the principal settlement pot in the ongoing securities litigation. Yet the more that bankrupt companies can pay some damages themselves, the weaker the plaintiffs' incentives to chase directors' personal assets.

E. What Changes if the Firm is Insolvent?

Thus far, we have assumed that the firm is solvent. We have looked for windows of actual liability under corporate and securities law, and found none with real-world importance. We consider in this section what changes if the firm is insolvent. Our risk analysis will change in important ways, and our bottom line conclusion will change a little bit.

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70 For a broader argument that Sarbanes-Oxley will have only a modest effect on corporate governance, see Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work), 36 UNIVERSITY OF CONNECTICUT LAW REVIEW 915-988 (2003).

71 See John C. Coffee, Jr., Is It Safe to Go on the Audit Committee?, NEW YORK LAW JOURNAL, May 2, 2003.


74 See Barnaby J. Feder, WorldCom Agrees to Pay $750 million in S.E.C. Suit, NEW YORK TIMES, July 8, 2003, at C6.
In many countries, corporate, bankruptcy, or insolvency law imposes liability on directors who allow the firm to go bankrupt, with some level of culpability (negligence, gross negligence, recklessness, intent). U.S. bankruptcy and insolvency law, however, has never taken this route. Fraudulent conveyance law, for example, lets the company's creditors recover amounts that the company paid improperly. It does not make the directors liable for approving the improper payments. Thus, the relevant question is whether (and how) the directors face greater exposure under corporate or securities law for conduct that already put them at risk of nominal liability, where indemnification or direct company liability protects the directors against actual liability as long as the company is solvent.

The directors' principal protection will now come from the D&O policy. There are some technical issues involved in ensuring that the directors' claim takes priority over the company's claim to D&O policy proceeds, but these are solvable. After a few recent disputes, none of which have caused the directors to lose coverage, they are being solved. There is also increased risk of a policy gap, because bankruptcy court consent is needed to renew the policy when it expires. As for D&O coverage generally, when a new hole arises, market pressures are likely to cause a change in contracting practice that closes the hole, and an insurer which relies on a new hole to deny coverage risks reputational harm if the directors end up being personally liable.

1. Legal Expenses

Assume, thus far counterfactually, that the D&O policy is not available. The corporation could be barred from advancing expenses if creditors object and the bankruptcy court rules in the creditors' favor. However, such objections are uncommon. Typically, the debtor's board runs the company during the bankruptcy process. Creditors have to pick their fights with the debtor. Disputing whether the company can pay the directors' legal defense costs makes debtor noncooperation likely across a host of issues and is probably not a sensible strategy if the debtor's board behaves reasonably. To be sure, if the company is being liquidated rather than reorganized, the creditors may care less about debtor cooperation. If creditors successfully object to payment of legal expenses, directors who paid their own expenses would become general unsecured creditors, who likely would not be fully paid in the bankruptcy proceeding. Moreover, legal expenses can continue after the company has been liquidated or sold.

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75 See Black & Cheffins (2003), supra note xx, at yy-zz (UK law, add other countries as relevant).  
76 This risk arises principally when the D&O policy covers both the directors and the company (so-called Side C or "entity" coverage). D&O insurers have responded by clarifying that the directors' coverage takes priority over the company's coverage, by offering separate policies (or separate coverage limits within the overall policy) covering just the directors and officers. Some companies have also dropped entity coverage. See Dickey et al (2003), supra note xx, at 16-22; Joseph M. McLaughlin, Directors' and Officers' Liability: D&O Insurance Policies in Bankruptcy, NEW YORK LAW JOURNAL, Aug. 29, 2002, at 5-6; Randy Paar, D&O Insurance and Bankruptcy: The Enron Experience and the Dangers Faced by Senior Management, 14 SECURITIES REFORM ACT LITIGATION REPORTER 7-10 (Oct. 2002).  
78 See Susanne Murray, Bankruptcy and D&O Coverage, DIRECTORS & BOARDS (June 2001).
2. Damages

When we turn from legal expenses to damages, the situation becomes more complex. To simplify the analysis, we will assume that the company cannot pay indemnification. The indemnification claim is an unsecured claim, which will often be of doubtful value. Moreover, the judge may invoke equitable subordination and pay other claims first. We also assume (but relax this assumption below, when needed) that if the company cannot pay damages.

Corporate law. Under corporate law, not much changes, because the risk was so small to begin with. The principal concern is a duty of loyalty claim (even though the director in fact acted in good faith). D&O insurance should still cover this claim. Because the underlying claim is weak (given our assumption that the director acted in good faith), a plausible settlement is unlikely to exceed the policy limits. The settlement pressures discussed above make it highly likely that such a settlement can be reached.

Securities law. For securities suits, a window of liability opens, because the company can no longer pay damages. The directors' first two layers of protection (the company's primary liability and indemnification) have vanished. Only the third layer, D&O insurance, remains. However, the D&O policy limit will often be less than the sum of legal defense costs plus alleged damages. Scienter remains hard to prove in an Exchange Act case, but a Securities Act claim will often be viable, and exposes the directors to negligence-based liability.

To simplify the analysis, we assume a worst case scenario. Damages exceed the D&O policy limits, perhaps by a lot. The outside directors would, to high probability, be found negligent (or, for an Exchange Act case, sufficiently reckless), if the case goes to trial. We explore in the next subsection the powerful settlement incentives that ensure that, even in this extreme case, the case will almost surely settle within the policy limits and the outside directors will not face actual liability.

3. Settlement Incentives in Securities Cases

The conventional wisdom is that the plaintiffs' bar almost always settles within the policy limits, even when the company is solvent.\textsuperscript{79} The available data is consistent with this, showing a sharp decline in the ratio of actual payment to potential damages as potential damages increase. Cases involving over $500 million in potential damages settle for a median of 2 cents per dollar of potential damages.\textsuperscript{80} Moreover, payments by

\textsuperscript{79} See Press Release, Chubb Vice Chairman Urges Insurers to Counteract Egregious Class Action Securities Suits to Prevent the Erosion of the D&O Liability Insurance Marketplace, Business Wire Feb. 5, 2003 (John Degnan, Vice-Chairman of Chubb, a leading D&O insurer, explains that "the plaintiffs' bar . . . almost methodically settles case after case for the limits of available insurance"); Cox (2002), supra note xx [James Cox, Boards Find it Harder to Fill Hot Seats; Scandals, Legal Threats Make Many Decline Slot, USA TODAY, July 31, 2002 (cover story).]

insureds in excess of policy limits are negligible across all lines of insurance, not just D&O insurance.81

To understand how exceptions may arise and why they are rare, we need to explore settlement incentives with some care. We will assume that the directors will settle within the policy limits if the plaintiffs will. We also assume that the insurer will either settle within the policy limits if plaintiffs and defendants will, or if it the insurer rejects such a settlement, it will cover the outside directors' actual liability after a loss at trial. We defend these assumptions for derivative suits in Section 4; the analysis is similar for securities cases. The key question is whether plaintiffs will settle within the policy limits. We again treat plaintiffs' counsel as the real party in interest.

Multiple factors combine to create incentives for plaintiffs to settle within the policy limits. Unless one or more directors has serious personal wealth or represents an institution that can indemnify the director, the plaintiffs' calculus is easy. There are several downside risks from proceeding to trial, and limited upside. One downside risk is obvious -- plaintiffs might lose the case altogether. A second risk is more subtle: The plaintiffs might prove too much against the insiders. If only the insiders are found liable, the insurer may deny coverage on the grounds that the misdisclosure was intentional. Even if the outside directors are also liable and remain insurable, the recovery may be reduced because the proportional liability rules limit the damages for which the outside directors are responsible. The two risks interact. Plaintiffs must be careful not to prove too strong a case, lest they give the insurer a defense to payment. This increases their risk of losing the case altogether, against the insiders, the outside directors, or both.

A third downside risk is that the directors will fight hard to avoid actual liability. Their hefty legal fees will be paid by the D&O policy, thus shrinking a principal deep pocket that the plaintiffs hope to collect from. If the directors lose at trial, an appeal, with accompanying delay and legal expense, is certain. Meanwhile, plaintiffs' counsel must work harder too, and any recovery is delayed for years.

Moreover, the upside from a large damages award is limited. The directors, if sensibly counseled, will by the time of trial likely have done some financial planning -- moving assets offshore, into their spouses' names, children's trusts, hard-to-collect-on assets, and the like. The remaining assets must be further discounted by the legal fees needed to collect them. Once again, plaintiffs bear both their own and the directors' legal fees, because the D&O policy will pay the directors' fees.

This calculus may change if a director is seriously wealthy or represents a deep-pocketed institution. Indeed, occasional cases exist where such an institution agrees to pay a modest amount to settle a securities lawsuit. An example: One of us (Black) was an expert witness in a Securities Act case against the directors of an insolvent company with a $20 million D&O policy, versus roughly $125 million in potential damages. The

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81 A bit of data: The Texas Department of Insurance reports comprehensive data on all closed claims involving Texas-licenses insurers. In 2000 (the most recent year for which data is available), there were 9,000 closed claims with payments over $25,000. Insurers paid a total of $1.2 billion. Insured made payments due to damages exceeding policy limits in 14 cases (0.15% of all cases), and paid a total of $854,000 (0.07% of total payments). See TEXAS DEPARTMENT OF INSURANCE, THE 2000 TEXAS LIABILITY INSURANCE CLOSED CLAIM ANNUAL REPORT, at www.tdi.state.tx.us [check for more recent data].
company had several representatives of venture capital firms on its board. The case was settled with gross payout of around $25 million, including around $5 million from the venture capital funds. The defendants' legal fees were around $7 million, and plaintiffs' collected around $18 million. We know of no cases involving wealthy outside directors paying personally, but they seem possible.

However, even if a director has serious wealth or is indemnified, plaintiffs face strong incentives to settle for at most a modest payment before trial, as this example suggests. If the case goes to trial, the outside directors' liability is limited to 150% of proportionate fault. Usually, most of the fault lies with the insiders, and perhaps the auditors or investment bankers. Each outside director's share of fault is further limited because there are many of them. Put these factors together, and a single director's share of fault will rarely exceed 5% or so.

A numerical example can illustrate this effect. The numbers are invented but we think they are realistic. Assume that the outside directors are together 25% at fault. This estimate is generous, given that the directors likely only failed to catch someone else's wrongdoing. Of this, assume that 20% is assigned to the audit committee members, and 5% to other outside directors, and a 5-member audit committee. Each audit committee member is then 4% at fault, which means a 6% (150% of 4%) cap on actual exposure.

To extend this example, assume that the company has $50 million in D&O coverage, and one wealthy outside director, with ample wealth to pay a damage claim. If the plaintiffs settle at or near the policy limits, they will collect, let's say, $45 million (the policy limit less $5 million in defendants' legal expenses). If they pursue a trial, the defendants' expenses will jump to $20 million, leaving $30 million in recoverable insurance proceeds, of which $3 million will be allocated to the wealthy director's share of the damage award. Plaintiffs' effective legal cost (the opportunity cost of counsel's time less any incremental fee award) will increase by $5 million as well. We can then ask at what damage award the plaintiffs will break even by going to trial. The answer is $383 million.82 Add in a multiyear payment delay for trial and appeal, and the effective breakeven is likely $500 million or more, even if the case is a slam-dunk winner.

Let's assume the breakeven level of damages is $500 million, and now add in trial risk. Outside directors who have acted in good faith and regularly attended board meetings will usually be able to present a respectable defense. The plaintiffs face a number of risks if they go to trial. They might simply lose. They might prove too much, and lose some or all of the D&O policy coverage. They might misjudge defendants' legal expenses, which deplete more of the D&O policy than they had expected. They might misjudge the percentage of fault that the jury will find for the outside directors. Plaintiffs' counsel faces reputational as well as financial risk -- their reputation will improve after a win at trial, but weaken after a loss. Put all this together, and it is hard to imagine that the plaintiffs will go to trial unless their expected judgment if they win is at least $1 billion -- twice the breakeven level.

82 The breakeven damages award $X occurs when the defendant's personal payment ($0.06 \times X - $3 million paid by insurance) exceeds the loss due to higher legal expenses ($15 million defense costs + $5 million plaintiffs' costs). Breakeven occurs when $0.06 \times X = $23 million, or $X = $383 million.
The numbers in this example are invented, but the general point remains: A very small number of securities cases offers the combination of a seriously wealthy outside director, very large potential damages, a high chance of proving negligence against the directors (so that the risk of losing at trial is low), yet not too high a chance of proving intent against the insiders. Yet only in these cases will plaintiffs plausibly reject a settlement within the policy limits and chase the directors' personal wealth. As discussed above, the Sarbanes-Oxley Act makes it possible for a bankrupt company to partly pay investor claims through a settlement with the SEC, which is then incorporated in a bankruptcy reorganization plan. This partial payment, when available, makes it still more remote that plaintiffs will chase directors' personal assets.

The available data, summarized in Part II.A, are consistent with this analysis. Trials against outside directors of bankrupt companies simply do not exist. Trial against outside directors of solvent companies almost never exist either.

4. Two Case Studies: Enron and WorldCom

Enron and WorldCom offer nice case studies of directors' risk in securities cases involving bankrupt companies. In each, the company went bankrupt and thus couldn't pay damages itself. Potential damages are huge and greatly exceed D&O policy limits. The company's visibility ensures that the cases will be prosecuted vigorously and the court won't dismiss possibly viable claims. There is little doubt that both companies' disclosure was misleading, nor that the directors missed much that they might have seen and accepted much that they might have questioned. At least one Enron director, Robert Belfer, is wealthy enough to be worth chasing. So, collectively, are the WorldCom directors, a number of whom sold their companies to WorldCom and then sold enough WorldCom shares, soon enough, to retain significant personal wealth. As cases where outside directors have reason to fear actual liability, Enron and WorldCom are as good as it is likely to get. The last word on these lawsuits won't be written soon, but the early words are encouraging for the outside directors.

Enron. The Enron directors needed bankruptcy court approval for the D&O policy to pay their defense costs. They received it. The derivative lawsuits were

83 Coffee (2003), supra note xx [NYLJ article], argues that the enhanced information flow to audit committee members under the Sarbanes-Oxley Act may make it possible for plaintiffs to claim actual knowledge of misdisclosure. This would get the plaintiffs around the proportionate liability rules, but at the cost of eliminating D&O coverage. We doubt that many plaintiffs' counsel will think this a sensible tradeoff.


85 On Robert Belfer's post-Enron wealth, see Leslie Eaton & Geraldine Fabrikant, Enron Loyalty Costs N.Y. Family Billions, N.Y. TIMES, Jan. xx, 2002. Director Ronnie Chan has serious wealth in Hong Kong, but likely doesn't have significant U.S. assets or could move them offshore before trial.

86 See N.Y. Judge Signs Final Order Allowing Payment of Enron's Legal Costs, ANDREWS DELAWARE CORPORATE LITIGATION REPORTER, Jan 6, 2003.
consolidated into the bankruptcy proceeding and stayed by the bankruptcy court. There is no evidence of self-dealing by the outside directors, so the derivative suits may vanish altogether, or else be settled together with the securities claims.

Plaintiffs raised Securities Act and Exchange Act claims against the outside directors, alleged control person liability under both statutes, and raised Texas securities law claims as well. But the Exchange Act claims were dismissed for failure to plead facts giving rise to a strong inference of scienter. The only concrete facts raised by the plaintiffs involved the directors' sales of Enron shares. These sales, the court found, were too small and erratic to meet the pleading burden. The court deferred decision on the Texas law claims, allowing plaintiffs to replead, but these claims seem likely to vanish also. The Securities Act claims, in contrast, survived a motion to dismiss. Due diligence is an affirmative defense that is premature in a motion to dismiss, where the court examines only the sufficiency of the complaint.

Theoretical risk remains. The remaining Securities Act claims total roughly $1 billion, and exceed Enron's roughly $450 million D&O insurance policy. Yet these claims are a small part of a case with dozens of important defendants and nominal claims likely approaching $50 billion. It seems likely that the outside directors will be able to settle within the policy limits. Conceivably, Mr. Belfer might chip in a million or two as well.

WorldCom. The news for the outside directors is even better in WorldCom. Exchange Act claims against the audit committee members were dismissed for failure to plead facts giving rise to a strong inference of scienter. A claim against outside director Stiles Kellett, who chaired the compensation committee survived, thanks to some odd dealings (he sold WorldCom stock at an opportune time, received IPO allocations from Salomon Smith Barney, along with CEO Ebbers and CFO Sullivan, and was alleged to have received other irregular benefits from Ebbers). The other outside directors were not even charged with Exchange Act violations. Securities Act claims survive as well, because due diligence can only be raised as an affirmative defense.

After some early skirmishing over application fraud, WorldCom's primary D&O insurer agreed to cover the outside directors. Moreover, WorldCom will emerge from bankruptcy with a $750 million fund ($500 million in cash, $250 million in shares) to pay securities claims, based on a civil penalty levied by the SEC but made available to pay securities claims. Finally, under WorldCom's plan of reorganization, its directors will

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89 For news accounts viewing the Enron decision as a victory for the directors, see Kurt Eichenwald, Enron's Outside Directors Win a Round in Court, N.Y. TIMES, Mar. 14, 2003, at C6; Mary Flood, Ruling Lesses Case Against Enron's Outside Directors, HOUSTON CHRONICLE, Mar. 15, 2003, at A2.


be covered for up to $25 million in legal expenses. This, plus the SEC-derived fund, is expected to be sufficient to cover settlement of the securities claims. Indeed, an earlier version of the Plan of Reorganization called for full indemnification; this was reduced to $25 million for expenses when the SEC penalty was agreed on.92

F. Other Laws

We have thus far discussed liability under corporate, securities, and bankruptcy law. Directors can have vigilance duties and accompanying risk of nominal or actual liability under other laws as well. The principal risk areas include banking, environmental, ERISA, and workplace safety law. The claim will typically be that the directors failed to take some action they should have taken, or failed to supervise well enough to prevent the company from violating the relevant law. The claim could arise either in a private lawsuit (when a private right of action is available) or in a government suit seeking damages or a civil penalty. Indeed, in other countries, liability under corporate and securities law is often secondary, and liability under other laws is often the principal perceived risk.

We sketch here the principal risks. We focus on civil liability. Criminal sanctions usually require intent and have not yet, to our knowledge, been applied to outside directors.

Direct claims. These claims will usually be direct claims by the government or private claimants against the company, directors, or both. Directors will usually be protected by both indemnification and insurance. The risks of actual liability fall into two broad categories. First, the company may be insolvent, and thus unable to pay indemnification. If so, insurance will usually provide backup coverage, but with some risk of liability exceeding the policy limits, and some risk of a policy gap, in which this particular liability is excluded from the D&O policy, yet not adequately addressed by a risk-specific policy. For example, D&O policies commonly exclude environmental and ERISA claims, so companies need separate environmental and ERISA coverage.

Second, a court could decide that a particular liability isn't indemnifiable, similar to the SEC's view on securities law liability. However, insurance should usually provide backup coverage, subject again to the risk of a policy gap or of liability exceeding the policy limits. The director also runs a risk that the regulatory agency will not settle unless the director makes some out-of-pocket payment.93


93 For a securities law example involving inside directors, see Floyd Norris, 6 From Xerox to Pay S.E.C. $22 Million, NEW YORK TIMES, June 6, 2003, at C1 (for $22 settlement by six Xerox officers. Xerox reimburses them for $19 million and pays their legal costs; the remaining $3 million reflects fines, for which SEC rules do not permit indemnification). See also Testimony by SEC Chairman William H. Donaldson Before the Senate Committee on Banking, Housing and Urban Affairs 17 (May 7, 2003) (describing the SEC's settlement with two analysts, Henry Blodget and Jack Grubman, in which half if Blodget's $4 million
ERISA. Enron illustrates the ERISA risk. A private lawsuit, and a related suit by the Department of Labor, made failure-to-supervise allegations against all outside directors and other defendants for two Enron pension plans that held Enron shares, seeking to recover the $1.5 billion that the plans lost when Enron collapsed. Apparently, the Enron board was supposed to and did appoint a trustee (Northern Trust) for the Enron Employee Stock Ownership Plan, but Enron officials then failed to sign a contract with Northern. This left the plan without a trustee and left the plaintiffs and the Department of Labor with a barely plausible claim against the Enron directors for lack of oversight. The complaints allege that the power to appoint the trustee makes the board members ERISA fiduciaries, and that the directors breached this fiduciary duty by failing to appoint a trustee. The private lawsuit against the compensation committee members (but not the other outside directors) survived a motion to dismiss; the Department of Labor case has not yet reached this stage.94

The cases seek to stretch existing law. It is not clear that the power to appoint a trustee make the outside directors fiduciaries under ERISA, even those on the compensation committee. Nor is it clear that their failure to notice that a trustee wasn't formally hired is neglect sufficient to establish liability. But if the directors are fiduciaries, the standard of care is simple negligence.

The risk of actual liability seems small. Enron has an ERISA policy, with a $95 million limit, that covers the directors.95 The same settlement incentives that produce securities settlements within policy limits ought to operate here as well. Indeed, the ERISA plaintiffs argued to the bankruptcy judge, in an effort to persuade him to unfreeze the ERISA policy, that the policy coverage was "the only [recovery] the ERISA plaintiffs are likely to find available."96 Still, some risk exists of liability exceeding the policy limits, from a source the Enron directors never thought about.

Banking - derivative claims. Under banking law, some claims are derivative rather than direct claims, making indemnification potentially unavailable. Under federal banking law, a federally chartered bank can sue its directors for gross negligence in approving loans. This cause of action isn't affected by a § 102(b)(7) charter provision, because the federal cause of action overrides the state limit on liability.97

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95 See Texas Plaintiffs Ask Court to Put their Brand on $85M Enron ERISA Policy, CORPORATE OFFICERS AND DIRECTORS LIABILITY LITIGATION REPORTER, Apr. 8, 2002 (the $95 million coverage cited in text includes $10 million that is reserved for defense costs; if defense costs exceed this amount, the directors' costs will be covered from the base $85 million policy).

96 Id.

A solvent bank isn't likely to sue its own directors. Thus, the principal risk is for directors of an insolvent bank. The Federal Deposit Insurance Corporation (FDIC) steps into the bank's shoes and has an incentive to sue the directors if they are plausibly liable, if only to recover from the D&O policy. The suit is derivative in nature, so indemnification is available for legal expenses but not for damages, if the bank is still able to pay these expenses. The D&O policy is available to cover damages and any legal expenses that the bank can't or won't cover.

The outside directors of an insolvent bank thus face actual liability if damages plus legal expenses exceed the policy limits. This is similar to their exposure under securities law. The same settlement incentives come into play, and usually produce settlement within the policy limits. As for securities cases, the liability window is for a claim that exceeds the policy limits, for a director with enough personal wealth to be worth chasing. There may be additional risk because the FDIC's lawyers could refuse to settle and instead pursue an individual to deter future misconduct, whereas securities plaintiffs lawyers will simply try to maximize expected dollar recovery.

G. Summary

We have not exhausted the possible bases for claims against outside directors, but we believe that we have covered the main areas of concern. The bottom line: there is lots of nominal liability, primarily under securities law. There are some theoretical windows of actual liability, primarily if the company is bankrupt. Yet even for bankrupt companies, the combination of insurance and settlement incentives ensure that outside directors face only a tiny risk of actual liability. The almost total lack of cases involving actual liability of outside directors is not a matter of luck, but rather the predictable outcome of the multiple, overlapping liability-limiting factors we have discussed.

III. The Role of Reputational Sanctions and Social Norms

If actual liability doesn't do much to get outside directors to work hard, what does? Purely market-based incentives are surely important. Yet if they were sufficient, legal rules would be superfluous. We therefore explore here what role the nominal liability of outside directors may play, even without actual liability. In our view, four factors importantly affect directors' vigilance: concern for reputation; social norms, including directors' sense of professionalism; the nuisance cost of being sued; and procedural rules for board conduct, established by law and common practice. All are importantly connected with formal legal duties. Thus, they cannot be fully supplied by purely market-based institutions.

Sections A-B set the stage for our analysis by discussing outside directors' direct financial incentives and the potential for D&O insurers to monitor directors. These

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98 A few did so in the 1980s to collect on the D&O policy, but insurers have amended their policies to prevent these suits. See HATCH, OLSON & SAGALOW (2001), supra note xx, § 10. (discussing the "insured vs. insured" exception that is now standard in D&O policies).

99 Cf. James D. Cox, Private Litigation and the Deterrence of Corporate Misconduct, 60 LAW AND CONTEMPORARY PROBLEMS 1-38 (1997), at 35-36 (addressing litigation against corporate defendants generally, treating financial cost as the primary deterrent, but also mentioning reputation and nuisance cost).
sources of incentives are useful, but likely insufficient by themselves. Sections C-G
discuss softer constraints, including reputational sanctions, social norms and director
professionalism, the nuisance cost of being sued, the value of procedural rules and norms,
and the possibility that directors wrongly fear actual liability. Section H summarizes the
value and limits of these alternative source of vigilance incentives.

A. Direct Financial Incentives

The potential for market-based financial gain or loss can create vigilance
incentives. One source is ownership of the company's shares and options. For example,
Enron director Robert Belfer sold his family company to Enron in exchange for Enron
shares and then kept the shares. Most of his family fortune then went down with the
Enron ship. Most of the WorldCom outside directors held large positions in WorldCom
shares, because they joined the WorldCom board after selling their company to
WorldCom.100 Whatever led Mr. Belfer and the WorldCom directors not to see the
internal rot at Enron and WorldCom, their financial incentives were ample.

Indeed, legal and market institutions often develop in complementary ways. If
legal sanctions are weak, companies are more likely to develop market-based
substitutes.101 It may be no accident that the for outside directors to own few shares has
come to be seen as poor governance.102

To be sure, most outside directors own far fewer shares than Mr. Belfer or the
WorldCom directors. Most directors now own enough shares so that a collapse in share
price will hurt their pocketbooks at least a bit, yet have only a modest fraction of their net
worth invested in a company's shares. Limited share ownership relative to net worth
(albeit likely more than at present) may be optimal. A director with too much financial
wealth invested in a single company may be more risk-averse than shareholders would
want. This problem seems intractable. If a director owns too few shares, he has limited
incentive to be vigilant. If he owns too many shares, he may be vigilant but risk-averse.
Providing director compensation partly through stock options rather than shares can
reduce this tension, but imperfectly, because option holders' incentives can change
dramatically when share price changes.

A second source of financial incentives involves director compensation. A
company that performs poorly is more likely to be acquired or go bankrupt. Either way,
the outside directors will likely lose their positions and accompanying income stream.
This source interacts with legal rules. The increasing formal legal requirements and
informal expectations for directors have led to corresponding increases in compensation,
which now averages about $64,000 annually for a large public company, with some

100 See Floyd Norris, Board That Made Decisions in Haste with No Questioning, NEW YORK TIMES,

101 See Marcel Kahan and Edward B. Rock, How I Learned to Stop Worrying and Love the Pill:

102 See, e.g., Sanjai Bhagat, Dennis C. Carey & Charles M. Elson, Director Ownership, Corporate
Performance, and Management Turnover, 54 BUSINESS LAWYER 885-919 (1999); Charles M. Elson and
Robert B. Thompson, Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the
Promise of Proprietary Incentives, 96 NORTHWESTERN UNIVERSITY LAW REVIEW 579 (2002).
companies over $100,000 annually.\textsuperscript{103} The present value of expected future director compensation is likely 5-10 times annual compensation, depending on the director's age and tenure.

Unfortunately, the incentive effect of direct director compensation is ambiguous. A director can lose this income stream by being too lax, but can also place this income stream at risk by being vigilant and annoying the CEO or other directors. Moreover, we want outside directors to be willing to resign their positions when the company does something they strongly disagree with, especially in situations involving aggressive accounting, conflict of interest, or other ethical overtones. This makes it unclear whether higher compensation, at the margin, would enhance or weaken directors' vigilance incentives.

Given the uncertain relationship between ongoing compensation and incentives, a promising structure might involve a large up-front grant of restricted stock, options, or both, to be held until the director leaves the board, plus modest annual compensation. Yet this remains an uncommon pattern.

Indeed, share and option ownership by outside directors remains modest. We lack good current data, but a study by Bhagat, Carey and Elson found that in 1993, the median director of a large firm (S&P 500 size) held shares worth $108,000, and options worth an additional $45,000. This data includes inside directors, who usually own more than outside directors. Thus, it overstates the median ownership by outside directors.\textsuperscript{104} This is a fraction of the present value of expected future direct compensation. Thus, it seems likely that direct market-based financial incentives often will not provide strong vigilance incentives.

B. Monitoring By D&O Insurers

A second potential source of market incentives for outside directors to act properly is risk monitoring by D&O insurers. If better-governed companies face lower risk of nominal liability, then companies should invest in governance to reduce their premiums. Insurers can advise them on how to do so. And if outside directors care about the company's D&O cost, they should be willing to be vigilant and otherwise improve the firm's governance.\textsuperscript{105}

Unfortunately, there are problems with both parts of this syllogism. First, D&O insurers routinely advise clients that securities litigation risk (the principal risk that most companies face) is not significantly affected by a firm's governance practices -- at least those practices that insurers can measure, such as the identity and background of board members, the proportion of independent directors, the existence of board committees and the like. The firm's industry, share price volatility, and trading volume matter;

\textsuperscript{103} See Tough at the Top: A Survey of Corporate Leadership, ECONOMIST, ECONOMIST, Oct. 25, 2003, at 21, 22 (citing director compensation results from a Korn Ferry survey).

\textsuperscript{104} See Bhagat, Carey & Elson (1999), supra, note xx, Table 5.

\textsuperscript{105} See Cox (1997), supra note xx, at 29-35. Cox offers a more optimistic view than we do about both the deterrent effect of D&O insurance cost and the insurer's screening ability.
governance measures don't, at least not much. To be sure, a study of Canadian firms by John Core finds evidence that D&O premia correlate with "excess" CEO compensation (CEO compensation higher than that at other similar firms), which is a plausible proxy for poor board functioning in general. We have also heard anecdotal evidence that insurers press for governance changes as part of contractual negotiations over coverage limits and rates. However, these efforts appear to be primarily at the low-governance-quality end of the spectrum.

Second, D&O cost affects outside directors' incentives only indirectly, by affecting the firm's profits. This takes us back to the direct financial incentives discussed in Section A. Moreover, D&O insurance cost has only a modest effect on the firm's overall profitability. The variance in that cost based on governance would have an even smaller effect.

In short, it seems likely direct financial incentives often won't be adequate to ensure director vigilance. We therefore turn in the rest of this Part to partly or mostly nonfinancial incentives.

C. Director Concern for Reputation

A key element of directors' incentives to be vigilant is their concern for their own reputation. Much of the information on reputation is delivered by a vigorous financial press, eager to report on board missteps. Reputational risk has financial implications, including loss of future directorship or other business opportunities. But an important component is nonfinancial (what do your friends think of you, perhaps even what you think of yourself).

Like share ownership, reputation offers both gains if the company does well and losses. has both a positive and a negative side. The financial press reports on successes as well as failures; on good boards and well-run companies as well as bad ones. Directors can gain prestige, and perhaps other opportunities, if their company performs well or the board responds promptly to management problems. Other things equal, that makes reputation a more symmetric and therefore better source of incentives than actual liability, much as share ownership offers more symmetric incentives than option ownership.

1. Sources of Reputational Sanctions

Reputational gains or losses from serving as a director can partly, perhaps mostly, occur independent of legal duties or nominal liability. However, formal duties and nominal liability interact with reputational sanctions. Publicity risk is correlated with being sued. Adverse publicity can be reinforced by losing a lawsuit, a legal decision that criticizes the directors' conduct, or press quotes from experts who explain the legal duties that the directors may have violated.

106 See, e.g., Jonathan Dickey, Powerpoint Slides for Directors' Consortium session on D&O Insurance, Aug. 20, 2003 (Stanford, California), at 3 ("no underwriting credit [is] being extended for good corporate governance").

A second source of reputational risk is direct government enforcement. Since 1990, the SEC has had the power to seek a court order barring someone who has committed securities fraud from serving as an officer or director of a public company "if the person's conduct demonstrates unfitness to serve as an officer or director of [a public company]." The SEC can also claim that an outside director violated Rule 10b-5 by recklessly ignoring signs of financial fraud, and seek an injunction against future violations, a civil penalty, or both. The schedule of permissible fines is complex, but a director's likely maximum exposure is $100,000 per offense. This is low enough so that the director's loss is primarily reputational rather than financial. Since 2002, the SEC has new, as yet unused power to impose a cease and desist order against future violations and an officer and director bar through administrative proceedings, instead of seeking a court order. The legal standard is the same as for a court order, and the SEC's order can be appealed to the federal appeals courts.

Finally, the SEC has occasionally issued reports concluding that outside directors didn't meet their obligations under the securities laws, without seeking formal sanctions. These are a pure exercise in public shaming, intended to dissuade other directors from placing themselves in a position to be similarly criticized.

Formal SEC power is one thing, using it is another. The SEC has sought bars against persons serving as officers and directors rarely, and only against insiders who have committed intentional fraud. Even then, the courts will only impose a bar if the SEC can show a likelihood that the misconduct will be repeated. This might be hard to show for an outside director whose misconduct reflects neglect rather than intent.

SEC reports criticizing outside directors are also rare. There were several in the mid-1970s, but only two in the last 25 years. The most recent involved the board of

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110 The highest category of fines is for a violation involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," which results in a "significant risk of substantial losses to other persons." The maximum fine for this category is the greater of $100,000 per offense or the director's pecuniary gain as a result of the violation. An outside director who acts in good faith usually won't have pecuniary gain. Securities Act § 20(d)(2)(C), 15 U.S.C. § 77t(d)(2)(C) (200x); Exchange Act § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (200x).


112 For citations to the principal cases, see X LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4914 (3d ed. 1993).

113 See SEC v. Patel, 61 F.3d 137 (2d Cir. 1995) (reversing district court's approval of lifetime director-officer ban against an officer-director-founder because the court did not explain why repeat violations were likely without the ban); Jayne W. Barnard, When is a Corporate Executive "Substantially Unfit to Serve"?, 70 NORTH CAROLINA LAW REVIEW 1489-1522 (1992).

Cooper Industries in 1994 (for their failure to respond aggressively to evidence of criminal misconduct by corporate officers) and two outside directors of W.R. Grace in 1997 (principally for not ensuring disclosure of a former CEO's retirement benefits). The SEC was criticized for the Grace report, including a dissent by Commissioner Wallman, for its apparent opinion that outside directors couldn't safely rely on disclosure decisions made by counsel.

In 2003, for the first time, the SEC brought and settled an administrative cease-and-desist proceeding against an outside director who ignored strong warning signs of financial fraud. It also brought a court action against a second director of the same company, Chancellor Corp., claiming that the director "recklessly signed [misleading financial statements] and took no care to ensure their accuracy," and seeking an injunction against future securities law violations. The SEC likely brought this court action because the outside director refused to consent to a cease and desist order. The SEC has yet to seek a penalty against an outside director. It will be some time before we know how active, or how successful, the SEC will be in pursuing these sorts of reputational sanctions against outside directors.

2. Evidence on the Importance of Reputation

There is no direct way to measure the importance of reputation as both a reason why directors serve and an incentive for them to be vigilant. Thus, we are restricted to various indirect measures. One question on which some data exists is how reputation affects a director's prospects of becoming a director at another firm. Stuart Gilson reports that directors of bankrupt firms often resign and post-bankruptcy hold significantly fewer

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116 In addition to Commissioner Wallman's dissent, see Bruce A. Hiler & Ira H. Raphaelson, When Reasonable Reliance Isn't Enough: The Evolving Standards for Board Oversight, INSIGHTS, Jan. 1998, at 2 (Mr. Hiler is a former SEC enforcement division attorney).

positions on other companies' boards. A similar effect seems likely for firms that undergo scandals of various sorts, but avoid bankruptcy. More subtly, Coles and Hoi report that directors of Pennsylvania firms which opted out of some or all of the extreme Pennsylvania antitakeover law got more directorships at other firms over the next 3 years than directors of firms that did not opt out.

One can also ask why directors agree to serve. Important element include the prestige from this high-visibility position, and the opportunity for contacts with other powerful people. Directors generally want to serve on boards of well-run companies, and boards with high-profile directors. They shun the boards of troubled companies.

Beyond this admittedly sketchy data, we can offer only anecdotes. One published anecdote is William Sahlman's famous 1990 article, Why Sane People Shouldn't Serve on Public Boards. Sahlman cites three main reasons for not serving, all flowing from lawsuit risk. In order of importance, they are harm to reputation, the time drain and "hassle" of a lawsuit, and financial risk. He complains about "frivolous lawsuits, which sap valuable time from directors and damage reputations regardless of blame." Sahlman also cites financial risk, but dismisses director protection statutes like § 102(b)(7), as addressing "only the financial risk," not the risk to reputation or time. David Skeel collects other examples of public shaming of corporate boards by activist shareholders and the business press. Finally, we can offer our own effort to ask many directors and lawyers why lawsuits affect outside directors' incentives, given that outside directors so rarely face actual liability. Concern for reputation is a common answer.

D. Cultural Norms and Professionalism

Vigilance duties can also form the basis for social norms. Most directors are successful, proud professionals, who want to do a good job and in so doing, reinforce their sense of self-worth. Consistent with this view, surveys report that "opportunity to learn" and "challenge as a director" rank high, and compensation ranks low, as reasons for serving. Outside directors aren't in it for the money, or so they say. These


122 David A. Skeel, Jr., Shaming in Corporate Law, 149 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1811-1868 (2001); see also James D. Cox, The Social Meaning of Shareholder Suits, 65 BROOKLYN LAW REVIEW 3-45 (1999).

statements are self-serving, but nonetheless often right. For many directors, the
cost of their time exceeds their compensation, even without the
accompanying financial and nonfinancial legal risks.

Board meetings ensure that directors meet regularly with other directors as a kind
of mixed business-social group, which provides a good setting for reinforcing
professional norms. Directors who serve on more than one board can propagate norms
from one company to another. So can magazines aimed at directors, news stories in the
financial press, director training sessions, even lawyers' advice. In short, the elements are
in place for strong propagation of behavior norms.

These norms interact with law and with reputational sanctions (which themselves
interact with law). Formal legal duties can help to define what the norms are. Counsel
can explain the legal duties. Reputational sanctions for breaching the norms further
reinforces them.

Nominal liability can help a director who wants to do the right thing to persuade
fellows to do likewise. So can even a bit of actual liability risk. A director can
use liability as a nonconfrontational reason to oppose a dodgy action proposed by
management. ("I'd like to do this, John, but it's just too risky.") Nor can the managers
simply respond "don't worry about liability, you are insured and indemnified." Partly this
response lacks rhetorical force. Partly the outside directors will sensibly respond -- but
what if insurance runs out and the firm can't or won't indemnify me. What about my
reputation? Partly this response raises the specter of liability for bad faith conduct.

E. The Nuisance Cost of Being Sued

A further incentive for vigilance is simply the nuisance cost of being sued, and
especially of being deposed. The deposition itself is an unpleasant, full day, sometimes
more, often plus travel. Even minimal preparation takes a second day; discovery requests
are a further nuisance. Directors' aversion to being deposed interacts with actual liability
risk to oneself or fellow directors. Even a small risk of actual liability for oneself or
others, which can be affected by what one says at deposition, makes the deposition highly
stressful, because directors fear saying the wrong thing. It also interacts with reputational
concerns, as directors fear saying something embarrassing.

For supporting evidence, we must rely principally on anecdotes. Consider, then
John Olson's lament about the litigation risk faced by audit committee members:, which
focuses on reputation risk and nuisance:

None of [the defenses against actual liability] offers effective protection against the
embarrassment, potential damage to reputation, and just plain distraction and
harassment that come when directors are sued and forced to defend themselves.124

Sahlman's article on Why Sane People Shouldn't Serve on Public Boards, discussed in
Section C, provides additional evidence. The time and hassle of a lawsuit is his second
key reason for not serving.125 A second source is the Congressional testimony,

124 John F. Olson, How to Really Make Audit Committees More Effective, 54 BUSINESS LAWYER
1097-1111 (1999), at 1104.

125 See Sahlman (1990), supra note xx.
self-serving to be sure, of executives supporting the Private Securities Litigation Reform Act. They repeatedly mention the time cost of being sued and deposed.\textsuperscript{126} Outside directors presumably feel similarly.

**F. Procedural Rules and Norms**

A final role of nominal liability is to establish a base of procedural norms that govern how directors should behave in recurring situations. Over the last 20 years, the Delaware courts have adopted procedural rules and expectations that push companies to have a majority of outside directors, and to have conflict-prone decisions taken exclusively by unconflicted directors. The audit committee's role in reviewing a company's financial statements has steadily increased since the 1970s, a trend that was reinforced by the Sarbanes-Oxley Act. Lawyers tell directors how they are supposed to behave, and the directors, for the most part, comply.

These procedures affect conduct, both directly and through their effect on professional norms. For every case where passive outside directors approve a management self-dealing proposal, there is another where directors reject a management proposal. For every case where passive outsiders approve a freezeout of minority shareholders at a low price, there is another where active outsiders extract most of the surplus that is there to be extracted. The recent trend towards controlling shareholders taking freezeout offers directly to shareholders, instead of negotiating with a special committee of independent directors, is a sign of the success of the special committee procedure.

An odd dynamic may be at work in corporate law, where the absence of liability frees the courts to establish stricter procedures. If a breach of the rules, judged in hindsight, were enough to establish liability, which would be insurable but not indemnifiable, that would give the courts pause in creating strict rules for director conduct. Post § 102(b)(7), however, the sanction is only an injunction plus the embarrassment of being told how one should have behaved. The reduced sanctions make stronger procedures possible.\textsuperscript{127}

**G. Directors' Mistaken Fear of Actual Liability**

Finally, directors may be vigilant because they wrongly fear actual liability. The risks of being sued are high. Directors know they are insured and indemnified. But they also understand that indemnification isn't always available and that D&O insurance is complicated and possibly unreliable too. They have never thought through the settlement dynamics that push all sides to settle within the policy limits.

Directors rely on lawyers, the trade press, and D&O insurers to tell them about the risks they face. All three sources tell directors that they must be careful and vigilant and

\textsuperscript{126} See Private Litigation Under the Federal Securities Laws, Hearings before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 103rd Congress (1993).

\textsuperscript{127} For us, a case like Caremark, which announced, albeit in dictum, a director obligation to monitor the firm's legal compliance, is conceivable only because directors would not face monetary sanctions if they fail to do so vigorously enough. In re Caremark International Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).
that standards are tougher than ever. These sources often stress directors' nominal liability, not the factors that limit actual liability.

Lawyers likely exaggerate the risks. As Langevoort and Rasmussen note, doing so is "a natural by-product of professional self-interest and self-definition."\(^{128}\) Some lawyers do not distinguish between the risks faced by inside directors for intentional wrongdoing or willful blindness, and the risks faced by outside directors for lack of vigilance. Some emphasize the risks of losing in indemnification or insurance, rather than how often coverage is actually lost or how often directors actually pay anything.\(^ {129}\) Some worry about SEC power to fine directors, without mentioning that the maximum fines for good faith conduct are small, or that the SEC has never ever sought to fine an outside director for such conduct.\(^{130}\)

In writing this paper, we asked many lawyers, on both the plaintiff and defense side, about their experience. What cases did they know of where outside directors faced actual liability? A common first response was that directors face lots of risk today. When we pressed on the extent of actual, as opposed to nominal liability, a common second response was that there weren't many cases (implying that there were some), or that there were "a few" cases where directors faced actual liability. Only when we pressed for actual examples did "not many" or "a few" became no cases at all, save for *Van Gorkom* or (equivalently) "I'll have to ask my partners," plus scattered cases which turned out to involve only insiders. For defense lawyers, two cases that have merely survived a motion to dismiss (*Disney* and *Abbott Labs*) are a worrisome new trend that portends future risk.

Most outside directors are business executives. They are used to getting cautious "lawyers' advice." They likely discount the risks somewhat, and thus partly compensate for lawyers' incentives. On the other hand, the outside directors' incentives are skewed

\(^{128}\) Donald C. Langevoort & Robert K. Rasmussen, Skewing the Results: The Role of Lawyers in Transmitting Legal Rules, 5 SOUTHERN CALIFORNIA INTERDISCIPLINARY LAW JOURNAL 375-440 (1997); see Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 GEORGETOWN LAW JOURNAL 797-832 (2001), at 823-825. For an example of lawyers' pessimistic nonsense (strong words, advisedly used), see James L. Griffith & Mark J. Gundersen, Protection from Liability in the Post-Enron Era (Part II), METROPOLITAN CORPORATE COUNSEL (Jan. 2001). They complain that "there is no sure protection afforded by D&O policies. In many instances you are at the mercy of the lawyers who drafts the complaint . . . . A claim of dishonesty or intentional wrongdoing can defeat your chance for coverage."). This is simply not how D&O policies work.

\(^{129}\) Dickey et. al (2003), supra note xx, offer a good example. They carefully review the skirmishing over D&O coverage in a number of recent high-profile cases, including Adelphia, Enron, HealthSouth, Sunbeam, Tyco, and WorldCom. See id. at 22-24. The directors have now been covered on all of these cases except HealthSouth, where the dispute is not yet resolved. See Douglas McLeod, HealthSouth Woes Continue as Insurer Seeks D&O Recission, BUSINESS INSURANCE, Oct. 20, 2003. HealthSouth is not bankrupt, so the dispute is between the company and the insurers over who will pay the directors' legal fees and damages, not whether someone will pay. The authors, however, draw the ominous lesson that "just because your company has a D&O insurance policy in place, that does not necessarily mean the coverage will be there to provide protection for you". Id. at 3.

\(^{130}\) See, e.g., Evelyn Cruz Sroufe & Michael Marron, Why Corporate Lawyers Lose Sleep: The Impact of Some Recent Cases on Counseling Boards of Directors, in R. FRANKLIN BALOTTI ET. AL. EDs. (2003), supra note xx at 51, 53.
enormously toward risk aversion. The directors face unknown but potentially bankrupting liability risk. Their upside is modest financial and reputational gains. On balance, risk aversion likely outweighs discounting, leading the directors to take the lawyers' exaggeration and exaggerate it further.

D&O insurers are also likely to exaggerate risk, the better to sell strong coverage. As far back as 1968, Joseph Bishop remarked on "the aggressive and imaginative propaganda of underwriters pushing [D&O] insurance."131 The insurers' tactics have become more sophisticated. They can offer data on the likelihood that a company will be sued in the next five years, even if well-governed, and the likely size of damage claims. But they still have an incentive to exaggerate the risk of nominal liability -- and of actual liability if a director isn't insured. When these warnings are coupled with the complexity of D&O insurance, and with lawyers' warnings about the exceptions to D&O coverage, directors likely hear the message that risk is pervasive and D&O insurance is incomplete protection.

In this story, director vigilance is a house built on the sand of director ignorance. Directors' misplaced fear of actual liability then reinforces professional norms of conduct. These norms would also weaken if directors were better informed. Overall legal incentives to be vigilant (and risk-averse) would then be larger than our story supposes.

This director-error story is surely partly right. Yet one should not overstate directors' fear of actual liability. When asked in surveys if they worry about liability, most answer yes. But only a minority worry a lot.132 When directors are asked why they turn down additional board positions, liability risk is one factor, but generally not the most important factor. In any case, the surveys do not distinguish between fear of being sued, being found nominally liable, and being found actually liable.133 Most outside directors, even those with significant wealth, do not shield assets through the various asset-protection trusts that are now available both offshore and onshore.134 And companies do not routinely offer advice on such trusts to directors -- as they might if the risk were higher.

H. Summary

In sum, what we can call "soft" incentives, with sources in concern for reputation, sense professionalism, director culture, the nuisance cost of being sued, and the substantive effects of procedural rules, contribute importantly to director vigilance.

131 Bishop (1968), supra note xx, at 1078.

132 For example, a 2002 survey by McKinsey found that 22% of respondents felt "very much", and 62% felt "somewhat" that the faced "a significant risk of being held personally liable". McKinsey & Co., The Need for Informed Change in the Boardroom (May 2002).

133 See LORSCH & MACIVER (1989), supra note xx, at 24-26. The Lorsch and MacIver survey data is from the late 1980s, which was a period of heightened director fear of liability in the wake of Van Gorkom. The more recent Korn/Ferry surveys cited in note 3 supra suggest that directors are worried about liability, but do not provide a comparative ranking of risks [need to confirm when get full 2003 Korn/Ferry].

134 For example a recent article on asset protection trusts mentions doctors and executives as among those likely to create such trusts, but not outside directors. See Rachel Emma Silverman, Litigation Boom Spurs Efforts to Shield Assets, WALL STREET JOURNAL, Oct. 14, 2003, at D1.
Nominal liability, in turn, contributes importantly to these soft incentives, even without actual liability. Indeed, the lack of actual liability may foster the development of strong procedural rules and norms.

These soft incentives are imperfect. But so too is the threat of actual liability. Any assessment of the overall effectiveness of the U.S. system for encouraging directors to be vigilant would be radically incomplete without recognizing that actual liability is a part -- likely a small part -- of a larger whole.

In arguing that nominal liability supports soft incentives, we do not intend to suggest that the U.S. level of nominal liability is optimal. The PSLRA was expected to reduce the number of suits but turned out not to. The conventional non-U.S. wisdom is that the U.S. has far too many lawsuits -- and not only against directors. This might be right. We could retain significant soft incentives with many fewer lawsuits, partly because with fewer suits, the reputational effect of each would increase. Today, shareholders see many corporate and securities suits as providing mostly noise rather than a signal of management or director quality.135

Moreover, the current level of corporate and securities litigation is expensive. The damages are mostly a wealth transfer from some investors to others. But payments to plaintiffs' and defense counsel are a net cost, as are the transaction costs of D&O insurance. A crude estimate of that cost might be ~$5 billion per year. It seems plausible to us -- though unprovable one way or the other -- that we could get similar soft incentives with, say, half of the current number of lawsuits.

IV. Implications

Outside directors face a tiny risk of actual liability for good faith conduct. This weakens the vigilance incentives that legal liability is thought to provide. Direct market incentives are also limited. The soft sanctions discussed above surely help, but vigilance incentives could well remain suboptimal. Commentators sometimes lament the weak direct sanctions against directors, and propose to increase them.

We address briefly in this Part several facets of these proposals. In Section A, we ask whether it is realistically possible to expose outside directors to a meaningful risk of actual liability. We argue that powerful political and market forces stand in the way. Section B then sketches an argument for why a tiny bit of actual liability might be sensible policy.

These sections are only sketches. We leave fuller analysis to future work, which will build both on this paper and on our companion paper, *Outside Director Liability Across Countries*, which studies the liability of outside directors of public companies in three common law Australia, Canada, and the United Kingdom) and three civil law

(France, Germany, and Japan) countries. Section C argues that the differences in nominal liability between corporate law and securities law are hard to justify. Section D discusses implications of our analysis for emerging markets that are considering adopting liability rules similar to those in the United States.

A. Is More Liability Risk Possible?

Suppose we wanted to expose outside directors to a meaningful risk of actual liability. Could we? It is difficult to see how meaningful risk would emerge from any plausible legal reform, given the powerful mediating effect of the three I's. To illustrate the obstacles, we consider "capped liability" proposals, which would cap directors' liability in various ways. For example, New York requires company-paid D&O insurance to include a minimum deductible and copayment. This could leave the director of a large company paying a (trivial) maximum of $10,000 out-of-pocket. But New York also lets a company eliminate duty of care liability in its charter, permits full indemnification for securities and other direct claims, and doesn't limit private insurance. Virginia caps corporate law damages for non willful conduct at the greater of $100,000 or one-year's compensation, but lets a company eliminate duty of care liability in its charter, and permits full insurability and indemnification for both direct and derivative claims. The American Law Institute's Principles of Corporate Governance recommends that charter provisions be allowed to reduce duty of care liability only to the director's annual compensation from the corporation, not to zero. However, the ALI Principles of Corporate Governance would let a company buy D&O insurance without a deductible or copayment, and sometimes let them indemnify the director as well. On the securities side, the ALI's proposed Federal Securities Code would have limited damages and costs payable by an individual defendant to $100,000 for Exchange Act filings but would not have capped Securities Act liability. The Federal Securities Code ducks the question of indemnification and does not limit insurance. Similar academic proposals exist as well.

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137 See NEW YORK BUSINESS CORPORATION LAW § 726(a)(3) (200x) (insurance contract must provide for a deductible and copayment acceptable to the superintendent of insurance); NEW YORK CODES RULES AND REGULATIONS title 11, part 72 (2003) (for a nonindemnifiable claim against a director of a company with assets over $20 million, the director must pay a deductible of $5,000, plus coinsurance of 0.5% of the first $1 million of damages).
140 See ALI PRINCIPLES OF CORPORATE GOVERNANCE (1994), supra note xx, § 7.19 (199x).
141 For the liability cap, see AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE § 1708(c) and comment 1 (1980); David S. Ruder, Francis M. Wheat & Louis Loss, Standards of Conduct under the Federal Securities Acts, 27 BUSINESS LAWYER 75-93 (Feb. 1972 special issue), at 88-90 (remarks of Prof. Loss). On indemnification and insurance, see FEDERAL SECURITIES CODE § 1724(e) and comments 4-5, 7.
142 See Alfred F. Conard, A Behavioral Analysis of Directors' Liability for Negligence, 1972 DUKE LAW JOURNAL 895-919, at 913-915 (proposing to cap directors' negligence-based liability at one year's aftertax compensation and ban indemnification and insurance); Bishop (1968), supra note xx, at 1091-1094.
None of these laws and proposals create meaningful exposure to actual liability. Moreover, constructing a tougher regime that would create meaningful exposure is fraught with difficulty. Imagine a strengthened variant of the proposal in the *ALI Principles of Corporate Governance*, in which outside directors of public companies are liable for damages up to 5 times their annual pretax compensation from the company, or roughly $300,000 for a typical outside director of a large public company. This seems about as high a damage level as one could reasonably impose, without inducing too much risk aversion or too little willingness to serve. To enhance willingness to serve, one could apply further caps (say the lowest of lifetime director compensation from the company, 5 times annual compensation, or 10% of the director's net worth). This cap would apply to liability for non-self-interested conduct under all sources of law. The company could neither indemnify directors nor insure them against this level of liability, nor could they buy private insurance. We would permit indemnification and insurance for legal expenses, lest a director who breached no duty be bankrupted by the effort to defend himself.

This intrusive regulation has multiple problems. Here are some of the major issues that occur to us:

- What is the justification for barring directors from buying insurance, but not others in arguably similar situations of trust and responsibility (trustees, lawyers, physicians)?

- Why should we bar a company or insurer, which is liable for legal expenses that can easily reach $10 million for a case that goes to trial, from settling a case against a director for a fraction of that amount, which the company or insurer couldn't do under this system, because it couldn't force the director to settle?

- Should we allow settlements with all funds coming from the company or insurer, say with the ostensible justification of limiting legal expense? This is a case of damned if you do, and damned if you don't. If such settlements are permitted, this would vitiate the goal of creating meaningful actual liability. If they are not permitted, we would face other problems, including disguised side payments, designed to reach settlement and save on legal fees (the director pays a modest amount; the company reimburses the director indirectly, through compensation for future services).

- Directors would face fiduciary duty issues. Can a director refuse to pay $100,000 to settle a case, and thus force the company, directly or through insurance, to spend $10 million in defense costs?

- A capped liability rule would have to be adopted at the federal level to be effective. It would thus federalize important aspects of state corporate law, and forego the benefits of state experimentation.

- Are we confident enough in the policy judgment that mandatory limits on insurance and indemnification are desirable to override the imperfect inference that current indemnification and insurance practice is tolerably efficient, or it wouldn't be so dominant in the market?

But let us pass on these policy questions and assume such a law is adopted. It's hard to see why anyone would sue. A recovery of $300,000 (or even 5-10 times that if proposing to ban indemnification and insurance against directors' liability for conduct worse than simple negligence).
there are a number of defendants) isn't enough to interest a plaintiffs' law firm, which could recover only a fraction of this amount in fees. Thus, we would need a way to pay plaintiffs' legal fees for successful suits even if damages are minimal, as a bounty for lawyers to bring these cases. But it seems decidedly odd to pay (say) $5 million to plaintiffs' counsel, and force the defense to spend another $10 million, all to pursue a $250,000-$1,000,000 claim. Moreover, who would police how much plaintiffs' counsel spent? For all the weaknesses of the current system, in which plaintiffs' counsel earns a fraction of the class recovery, their fees are at least tied to something, in some loosely rational way.

Moreover, the bounty would presumably have to be available only if the plaintiffs win at trial, not for a settlement. Otherwise, plaintiffs' counsel will have strong incentives to settle before trial for a minimal dollar recovery, lest they lose at trial and thus lose any recovery. Defendant directors and companies will also happily settle for nominal damages before trial, to reduce both legal fees and the risk of an adverse verdict. A likely outcome would be a large payment of legal fees to plaintiffs' counsel, and a tiny payment by the director (say a fraction of one year's compensation). Investors will indirectly pay both sides' legal expenses, without the actual liability that supposedly justifies the expense. If we force cases to trial, we will also force a fair number of innocent outside directors to undergo the serious unpleasantness and time cost of a trial. Should we compensate them too? Whether we do or not, this risk will increase director willingness to risk-aversion or willingness to serve.

Another troubling feature is that such a bounty would likely have to be available only for, or at least be much larger for, suits against outside directors. Otherwise, plaintiffs' counsel will pick the low-hanging fruit and sue only inside directors. Insiders' culpability is usually easier to show, and damages will be far higher because executives are paid far more than outside directors. Suppose then that the bounty is available only for suits against outside directors. If plaintiffs' counsel sue only the outside directors, they will face dicey legal ethics issues, because suing outside directors promises higher legal fees while suing insiders promises higher damages. Some plaintiffs would sue outside directors for not catching the insiders' misdeeds while leaving the culpable insiders untouched, surely an odd result. Meanwhile, suing both insiders and outsiders would require arbitrary cost-allocation decisions, in separating legal work into bounty-eligible and ineligible components.

But onward. Suppose that we provide bounties only for suits against outside directors, and force cases to trial. We would have still other problems. We'd have to multiply the legal fees for successful cases to offset the risk of recovering nothing if the plaintiff loses. Say that of every dollar or hour invested by plaintiffs' counsel, 1/3 is for preliminary investigations or complaints that are then abandoned, while the other 2/3 is for cases that go to trial, and that plaintiffs win half of the tried cases. Then we would have to require a losing defendant to pay plaintiffs $15 million in legal fees, even though their time charges are only a third of that. The company or insurer of a losing director(s) would now pay $25 million in combined fees, to take a $250,000-$1,000,000 case to trial.

How mandatory trials would work if there are multiple defendants is entirely unclear. We would have tough allocation issues if the plaintiffs sue six directors, and win damages against two of them. And the whole system would collapse if a company hired
outside directors without serious personal wealth, did not indemnify its outside directors for legal expenses beyond the mandatory indemnification required by corporate law, bought either no D\&O coverage or a policy with low limits, and trusted that no one would then bother to sue its directors.

This dog, in short, won't hunt. We would build a highly complex system, that would require extensive regulatory oversight and tweaking to work at all. This complex system would surely create perverse incentives the designers never anticipated, and would be vulnerable to subversion and side payments. These problems arise because the system is, at its core, an effort to force plaintiffs to spend huge dollars on legal expenses to sue outside directors, and companies to pay huge dollars to defend these suits, for a trivial dollar recovery.

We have considered here only one family of possible efforts to create meaningful risk of actual liability. But many elements of our analysis will generalize to other variations. Any increase in actual liability will have to be modest, lest directors be dissuaded from serving or become too risk-averse. Any reform will have to overcome the three I's and the market forces that support them. This will demand complex, intrusive regulation. Like any market-displacing regulation, such a system will foster evasion by companies, plaintiffs, and defendants who want to reach a mutually agreeable settlement. It will also surely create perverse incentives, which will be difficult to anticipate in advance. The regulation would have to be federal to be effective, which will make it hard to revise over time in light of experience. One has to wonder whether the effort is worthwhile, given the modest deterrence benefits to be gained from a modest amount of additional liability.

Moreover, such an effort has no natural political supporters and would face strong political opposition from plaintiffs' counsel, defense counsel, management, and directors. The last case of actual liability, in Smith v. Van Gorkom (1985), produced an outcry from directors and a legislative response. Before that, the basic indemnification statutes and the practice of purchasing D\&O insurance were legislative and market responses to the initial emergence of apparent risk in the 1960s, largely in response to the emergence of securities fraud cases.\textsuperscript{143} Any resulting legislation would likely be narrow and exception-ridden, which could leave us with the costs of a complex regulatory structure, but perhaps few of the benefits. The New York, Virginia, \textit{ALI Principles of Corporate Governance}, and Federal Securities Code examples discussed above show how easily loopholes can gut a proposal of real-world force.

\textbf{B. The Policy Logic of Tiny Liability Risk}

We argued in Section \textit{A} that it would be extremely hard to greatly expand the window of actual liability. We suggest here that there may be policy logic to a barely open liability window. We first develop some reasons why the optimal level of outside

\textsuperscript{143} The basic Delaware and Model Business Corporation Act provisions on indemnification and D\&O insurance were adopted in 1967; New York's provisions were adopted in 1963. On these amendments and the director outcry that produced them, see Johnston (1978), \textit{supra} note xx, at 1995-2005; Joseph Bishop, \textit{New Cure for an Old Ailment: Insurance Against Directors' and Officers' Liability}, 22 \textit{Business Lawyer} 92-114 (1966); Bishop (1968), \textit{supra} note xx.
director vigilance may be less than is commonly supposed. We next consider why directors can have significant vigilance incentives even with zero or very low risk of actual liability.

We have neither data nor a model to offer. Still, our analysis suggests that a tiny risk of actual liability may provide a sensible balance among the multiple goals of inducing directors to be optimally diligent, capturing the vigilance benefits from making directors aware of potential liability for misconduct, yet not wanting directors to be overly risk averse, not wanting good candidates to decline to become directors, and not wanting directors to resign their positions at the first sign of trouble.

1. Does Minimal Actual Liability Risk Produce Suboptimal Vigilance?

Outside directors are part-timers. There are good reasons for this. A principal reason is that the best overseers of corporate action may well be businesspeople in the prime of their own careers, for whom running a business is a more valuable activity than overseeing someone else doing so. These directors' time is precious. If being an outside director demands too much time, they will refuse to serve, or their own boards will deny them permission to serve.

Moreover, the experience needed to oversee effectively will often come only from one's own experience. To be sure, many directors are retired from business careers, but retirement correlates with increased age, reduced ability, and reduced knowledge of the current business environment. Indeed, governance recommendations often include a retirement age of 70 or so, not much over the age when outside directors are likely to retire from their primary occupations.

A greater time commitment means that the best candidates will serve on fewer boards -- a trend we already observe.\(^{144}\) Most governance commentators applaud this trend. We are not so sure. The wisdom to direct effectively may come partly from one's own business career, but partly from experience on other boards. A director who serves on one board and spends 200 hours per year, may not be more effective than a director who spends 100 hours on each of two boards, but brings to each the experience gained on the other.

Greater time commitment will require higher pay. This too, is of uncertain benefit. Higher pay makes it more likely that a director will care enough about losing this compensation to think twice when facing a choice between resigning and going along with a questionable decision. A director who has no (or fewer) other board positions loses diversification of his future directorship opportunities, which could increase the disincentive to rock the boat. A retired director may be especially reluctant to give up his only board seat, lest he be left with nothing productive to do, or to tell his friends about.

Greater vigilance also means more frequent and longer board meetings, more reports to the board from company officers, more officer time spent preparing reports and attending board meetings, more cautious decisions (since outside directors' incentives are skewed, likely inevitably, against taking large risks), slower decisions, and more money invested in legal advice and internal oversight mechanisms.

\(^{144}\) [data on declining number of board seats to come]
Some outside directors will serve on key committees, especially the audit committee, whose role has been steadily enhanced over time, and notably so by the Sarbanes-Oxley Act. Some will chair committees. As boards shrink, partly in response to beliefs about optimal governance and partly because growing time demands make it harder for companies to find suitable directors, the committee workload of each outside director grows.

In short, enhanced vigilance means more time spent on each board, more compensation, fewer other board positions, slower and more cautious decisions, and more board-derived expense. Up to some unquantifiable point, these are good things. Beyond that point, they are not. The optimal level of overall vigilance will likely be larger for big companies than for small ones. Yet at the same time the optimal level of attention to an issue of given dollar size will likely be larger for small companies than for large ones. Yet legal rules are rarely flexible enough to permit less overall vigilance at smaller companies, or less vigilance at big companies about items that are large in dollars yet small relative to company size -- such as Michael Ovitz' $140 million severance package from Disney. Given the current pressures and time demands on outside directors in general, and audit committee members in particular, it not obvious how many public companies suffer from suboptimal outside director vigilance, despite the current near-absence of actual liability risk.

2. Vigilance Incentives Under Different Levels of Actual Liability Risk

We consider in this subsection how different amounts of nominal and actual liability are likely to affect director incentives. We begin with the extreme case of zero nominal actual liability.

Zero liability might be hard to achieve, even if we wanted to. As risk declines toward zero, directors' incentives to settle may recede; so will their willingness to insist that the company buy D&O insurance without deductibles, copayments, or loopholes. There will always be extreme cases that tempt judges or regulators to invent a way around liability bars or tempt insurers to deny coverage. The Disney and Abbott Labs cases show this process in the courts; the application fraud disputes show it in the D&O marketplace. Thus, some risk will likely creep back in through the back door.

Vigilance incentives would exist even if directors had a rock-solid guarantee against nominal or actual liability for good faith conduct, such as section 102(b)(7) was arguably intended to provide for corporate law claims. Share ownership and important parts of the soft constraints we discussed in Part III would remain as sources of incentives.

Moreover, firms might revamp their director compensation to compensate for the lack of nominal or actual liability. Director compensation involves complex tradeoffs. Greater firm-paid share ownership means greater cost to the firm, greater incentives for directors to be vigilant, but could also lead directors to be risk-averse if they own too many shares. Moreover, directors have vastly different background wealth. Share ownership amply incents one director may be trivial for another.

At the same time, when we move from zero liability to our actual system, with substantial nominal liability but near-zero actual liability, vigilance incentives are likely
to improve significantly, due to the interaction between nominal liability and vigilance incentives discussed in Part III.

Imagine beginning with optimal outside director compensation and zero liability, and adding some increment of actual liability to investors. This liability provides skewed incentives. The director gains no incentive to increase firm value; only a large incentive to avoid downside risk. In effect, the law obligates directors to sell a kind of put option to investors. This makes directors, like any put option sellers, more risk-averse. Companies will also have to pay the put option's expected cost by increasing the director's other compensation. They may decide to compensate directors partly with call options rather than shares, to offset the risk-aversion created by the liability put option. It is not apparent that a compensation package that includes a liability put option is better than one that does not. Thus, the principal value of actual liability may be for companies that otherwise wouldn't develop sensible director compensation.

Next imagine increasing the level of actual liability risk to well above current levels -- a larger implicit put option, sold by outside directors to shareholders, but paid for by the shareholders ex ante through higher director compensation. We will induce more effort -- but that may not be an improvement, if effort levels are already adequate on average. We will induce more risk aversion -- which is unlikely to be optimal if director compensation schemes are sensibly designed. We will likely dissuade wealthy candidates from serving. Yet they possess one key independence attribute -- they don't mind the loss of compensation from resigning. We may, to some extent, dissuade good candidates from serving generally. Directors will be more likely resign, perhaps en masse, when a company gets into trouble -- hardly a good outcome. Large outside shareholders would have greater reason not to put their own nominees on company boards, thus weakening one source of monitoring.

Moreover, investors are not clamoring for greater outside director liability. They do not protest indemnification bylaws and zero-deductible D&O policies. They routinely approve section 102(b)(7) provisions. To be sure, the power of this inference is limited. Consider section 102(b)(7) provisions. There is some evidence of an adverse price effect from adoption of these provisions, even if not enough to dissuade shareholders from approving them. 145 Also, directors offer shareholders only the choice between eliminating liability to the maximum extent permitted by section 102(b)(7) and not limiting liability at all. Capped liability might be optimal, but shareholders are not given this option. Still, investor acceptance of indemnification, insurance, and 102(b)(7) provisions provides some evidence that investors are comfortable with a low level of actual liability risk.

In the end, actual liability may provide a net benefit for the minority of companies where directors are miscompensated, meet too seldom, and work too little. But it will likely have a net cost for companies where directors are sufficiently motivated already. We do not know how to estimate the benefits or costs of such a move. But can say that there are not obvious social gains from significantly increasing outside directors' actual

liability. That, coupled with the extraordinary difficulty of doing so (Section 4), may be sufficient reason not to try.

In suggesting that a tiny bit of actual liability could be optimal, we have ignored the details of how that liability risk arises -- including the body of law, the standard of care, whether liability is capped, etc. In our view, directors respond to the perception of some risk, somewhere, much more than to the details of how risk arises. The basic question that an outside director has to ask is likely to be at a high level of generality: Am I at risk from for outcomes not fully in my control? They do not know, or ask, about the different levels of risk under, say, the Securities Act versus the Exchange Act, or corporate versus securities law.

C. Corporate Versus Securities Liability: Does the Pattern Make Sense?

We have suggested above that the details of where directors are nominally or actually liable are likely of second-order importance. Still, if one looks with care at our current liability rules and practices, they reflect some hard-to-reconcile policy choices. We focus here on the differences between corporate and securities law, to illustrate the problems that emerge when one looks across different bodies of law.

Putting the three I's aside, corporate law policy analysis, embodied in the business judgment rule, section 102(b)(7), procedural limits on derivative suits, and permissive indemnification and insurance provisions, supports protecting directors from liability for good faith conduct. The principal reasons include: liability will chill directors from taking risks, even good risks; liability will discourage good directors from serving; even expert Delaware judges aren't good at judging in hindsight whether directors acted sensibly or not; the risk of loss due to directors' good faith mistakes or omissions isn't different in kind from other investment risks; and this risk is of a type that shareholders can reasonably evaluate and accept, and protect against by diversifying.

In contrast, securities law imposes liability on outside directors for negligent (for public offerings) or reckless (for losses from market trading) failure to ensure proper disclosure. Unlike corporate law, companies cannot limit this liability in their charters. Moreover, the SEC views indemnification for negligent conduct as contrary to public policy (the courts' views are unknown); and we trust directors' fates to the hindsight-biased judgment of randomly chosen juries.

Yet the policy concerns that underlie corporate law's limits on nominal and actual liability largely apply to securities cases as well. The magnitude of harm is similar. So is the potential for investors to protect themselves by diversifying, the factors that foster director vigilance even without liability, and the reasons to worry that actual liability will make directors risk-averse or unwilling to serve.

Thus, for both nominal and actual liability, there is an unresolved tension between corporate and securities law. For nominal liability, it is hard not to conclude either that corporate law provides too little or securities law provides too much. For actual liability, the SEC's stance against indemnification even for negligence-based Securities Act liability is highly dubious. No sane outside director would willingly face actual liability on this basis, especially when negligence is determined in hindsight by a lay jury. Yet that is the outcome the SEC appears to want. It is only because securities cases
universally settle, D&O insurance is universally purchased, and settlement occurs with
the company as primary obligor or else within policy limits, that the SEC's policy remains
untested. It is only, we believe, because the SEC's policy remains untested that it survives.
The outcry from companies and directors would be enormous if it were applied.

The outcome -- a longstanding, loony, yet untested SEC policy -- is circular in an
important way. The policy increases the pressure for directors to settle by increasing the
risk of actual liability if a case goes to trial. This settlement pressure helps to ensure that
the policy is never tested, which then permits it to survive.

Moreover, actual liability in securities cases emerges only if the firm is bankrupt,
a low-probability event that is largely not under outside directors' control. This
perversely encourages directors to flee a firm at the first sign of financial weakness and
gives new directors an incentive not to join such a board, perhaps reinforcing its troubles.
These incentives are reinforced by the risk of reputational harm from having served on
the board of a bankrupt company.

If one could build a system of outside director liability from scratch, we would
likely want similar standards of care across corporate duty of care, Securities Act, and
Exchange Act liability. There are, to be sure, differences among these three areas that
might suggest a need for somewhat different liability standards. For example, public
offerings involve a greater risk of capital misallocation than market trading. But these
differences seem second order, especially since most directors will be only weakly aware
of any gradations that the law creates. Most likely, that common standard would be much
closer to the extreme neglect standard that is loosely embodied in the business judgment
rule or the severe recklessness (approaching conscious awareness) that is roughly the
Exchange Act standard today, than to the simple negligence standard of the Securities
Act.

D. Implications for Emerging Markets

Outside the United States, company law reform proposals often include
transplanting American fiduciary duty rules, often together with enforcement
mechanisms such as derivative and class action suits. These rules are seen abroad as
important to the perceived success of U.S. corporate governance (notwithstanding Enron
and the like). We speculate briefly here as to the likely impact of these rules in other legal
and economic environments.

Our analysis of director incentives -- including the small role of actual liability
and the complex, indirect role of nominal liability -- suggests caution in assuming that a
transplant will work well. To begin with, the top U.S. corporate governance issue is
motivating directors to be vigilant in ensuring good management decisions and, to a
lesser extent, good financial disclosure. Good disclosure is policed primarily through
disclosure rules, active analysts, and accountant and investment banker liability. Insider
self-dealing is uncommon, thanks to courts that vigorously attend to duty-of-loyalty
violations, criminal prosecutors with the skill to pursue complex insider trading and other
self-dealing cases, and strong cultural norms against insider self-dealing. In most of the

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world, in contrast, the dominant concerns are financial disclosure and controlling self-dealing. U.S. concern over outside director vigilance may seem like a high-class problem to have. Different concerns may call for different legal responses.

If, despite these differences, other countries adopt U.S.-style director duties, one wonders whether they will also adopt our rules that foster nominal liability while limiting actual liability. If not, they are adopting a very different regime. Conversely, if other countries limit actual liability in the American manner, they may lack the institutions that, in the US, produce vigilance despite the low risk of actual liability? For example, the power of reputational sanctions depends on overall cultural norms in which insiders stealing from companies is really bad behavior, and outsiders allowing the theft is moderately bad. Reputational constraints will be far weaker in a country (Brazil, say, or so we have been told) where controlling shareholders expect to extract large private benefits from controlled companies and aren't ashamed to disclose their self-dealing to their friends. Reputation will also be a weaker constraint in a country with a weak financial press. That might call for stronger legal constraints.

More generally, strong securities markets are fostered by a host of interconnected legal and market institutions. Legal complements include: attorney fee rules; whether the board can control derivative lawsuits; the availability of class actions; honest and competent judges; acceptance of circumstantial evidence; and reasoned written decisions by courts. Nonlegal complements include: competitive product markets, where bad business decisions can lead to failure; accounting rules and a strong accounting profession; some legal liability for accountants and investment bankers; a vigorous business press; and a cohort of potential independent directors with reputations worth preserving. In the United States, these complementary institutions contribute to a governance equilibrium where low levels of actual liability coexist with reasonable levels of director vigilance. For countries lacking similar complementary institutions, one should be cautious about assuming that U.S.-inspired legal rules will produce sensible outcomes.

V. Conclusion

The United States has, almost unnoticed and unintended, developed a system in which outside directors face extensive nominal liability, but nearly zero actual liability. Both market and political forces make the near-absence of actual liability a stable solution, almost irrespective of the nominal liability rules.

This system appears odd. It becomes even odder if one focuses on the details of where actual liability risk is present or absent. But it is not crazy. The limited deterrence provided by actual liability is supplemented by market incentives and by reputation and other soft incentives, which in turn are reinforced by nominal liability. We may have a sensible level of both actual liability and director vigilance, without creating in directors too much risk-aversion or unwillingness to serve.

The stable and perhaps sensible nature of this outcome is reinforced by the comparative analysis that we undertake in our companion paper. The United States has far more nominal corporate and securities liability than any other country. Yet other developed countries, though they have far less nominal liability, and often have it in different areas of law, have similar levels of actual director liability -- almost but not quite none. As we discuss in the companion paper, this is no accident.

A subtheme of this paper is that the actual and nominal liability of outside and inside directors should be analyzed separately. The policy factors that justify very low actual liability risk for outside directors weaken for insiders. Not accidentally, insiders' exposure to actual liability is greater -- though still small. Whether insiders face a sensible level of actual liability risk is a fruitful topic for future research.

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