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Rewarding Outside Directors

Law Working Paper N° 085/2007
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Assaf Hamdani
Bar Ilan University and ECGI
Reinier Kraakman
Harvard Law School and ECGI

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Abstract

While they often rely on the threat of penalties to produce deterrence, legal systems rarely use the promise of rewards. In this Paper, we consider the use of rewards to motivate director vigilance. Measures to enhance director liability are commonly perceived to be too costly. We, however, demonstrate that properly designed reward regimes could match the behavioral incentives offered by negligence-based liability regimes but with significantly lower costs. We further argue that the market itself cannot implement such a regime in the form of equity compensation for directors. We conclude by providing preliminary sketches of two alternative reward regimes. While this paper focuses on outside directors, the implications of our analysis extend to other gatekeepers as well.

Keywords: independent directors, liability, gatekeepers

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Assaf Hamdani
Bar Ilan University - Faculty of Law
Faculty of Law
Ramat Gan 52900 52900
Israel
e-mail: hamdana@mail.biu.ac.il

Reinier Kraakman
Harvard Law School
1575 Massachusetts
Hauser 406
Cambridge, MA 02138
United States
phone: 617-496-3586, fax: 617-496-6118
e-mail: kraakman@law.harvard.edu

*Corresponding Author

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Assaf Hamdani
Reinier Kraakman

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REWARDING OUTSIDE DIRECTORS

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I. Introduction

The proper role of legal sanctions in motivating directorial oversight is one of the most difficult issues in corporate governance. On one hand, the law has long been reluctant to hold directors effectively liable for negligently supervising managers. Indeed, U.S. corporate law goes far to insulate directors from such liability because, it is said, directors would otherwise hesitate to serve or would become overly risk averse. On the other hand, the law has also been reluctant to give directors a free pass for all misconduct short of intentional wrongdoing—presumably because lawmakers fear that doing so would leave dangerously little incentive for boards to monitor management. As might be expected, moreover, the tension between distrusting boards and fearing liability has stimulated awkward doctrine and a considerable literature about the costs and benefits of liability in the complex setting of the boardroom.[1]

1. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004); Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of*

This paper adds to that literature obliquely. We do not attempt to assess the optimal level of liability in the boardroom. Instead, we look beyond the traditional debate over the desirable scope of liability to explore a logical alternative: namely, the possibility of employing rewards to motivate directors.

The law conventionally relies on sanctions rather than rewards to motivate behavior. Among the many plausible reasons for this asymmetry are the lower intrinsic costs of penalties, greater ease of administration, law's characteristic task of enforcing minimal—rather than exceptional—behavioral norms, and a deep-rooted public sentiment that compliance with the law is a duty rather than a compensable service.[2] As legal mandates shade into the fine-tuned regulation of markets and complex organizations, however, the difference between the law's objectives and those of a private employer or principal begin to shrink. One class of examples includes so-called "gatekeepers"—parties such as accountants, lawyers, underwriters and outside directors, who, although not primary wrongdoers, may be able to prevent misconduct at little cost by virtue of their institutional positions.[3]

Two factors make penalizing gatekeepers—including outside directors—especially costly. First, liability may make gatekeepers overly risk averse, particularly since they act on behalf of third parties and therefore do not bear the full costs of taking precautionary measures or making conservative decisions.[4] The second is that if, for institutional reasons, the market fails to respond flexibly to gatekeeper liability, this liability may not only make gatekeepers excessively risk averse and their services more costly, but it may also lead to an exodus of talented professionals.[5] Thus, to the extent that the law attempts to enlist

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Corporate Directors and Officers, 77 YALE L.J. 1078 (1968); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality,* 39 BUS. LAW. 1477 (1984).

2. Scholars have studied the use of rewards to motivate law enforcement. *See* Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1 (1974); William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975); A. Mitchell Polinsky & Steven Shavell, *Corruption and Optimal Law Enforcement*, 81 J. PUB. ECON. 1 (2001); *see also* J. Falkinger & H. Walther, *Rewards versus Penalties: On a New Policy Against Tax Evasion*, 19 PUB. FIN. Q. 67 (1991) (developing a model for using rewards to induce tax compliance). An analytically related topic is employers' use of bonuses and so-called efficiency wages to motivate their employees. *See, e.g.*, Gerrit De Geest et al., *The Intrinsic Inferiority of Efficiency Wages to Conditional Bonuses and Punitive Damages* (George Mason Univ. Law & Econ., Research Paper Series No. 4-10, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=508702.

3. *See* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining "gatekeepers" as private parties "who are able to disrupt misconduct by withholding their cooperation from wrongdoers").

4. *See* Assaf Hamdani, *Who's Liable for Cyberwrongs?*, 87 CORNELL L. REV. 901 (2002) (exploring the implications of this feature for the liability of internet service providers).

5. *See infra* Section III.B.

gatekeepers as "cops on the beat," lawmakers face challenges similar to those faced by principals of highly skilled agents. The law's objective is no longer to enforce minimal standards of behavior. It is, instead, to secure the cooperation of sophisticated actors whose knowledge of local circumstances typically far exceeds that of enforcement officials. It follows that the advantages of penalties over rewards are less clear-cut for gatekeepers than for primary wrongdoers.

The law currently employs liability to motivate some—but not all—gatekeepers. For example, auditors, who have an explicit monitoring methodology, are often held liable for negligence,[6] while directors, whose responsibilities are far less clear-cut, are seldom held liable for negligent oversight.[7] As we discuss below, one reason that directors escape liability is that directorial negligence is peculiarly difficult to identify with confidence (i.e., the legal error rate is likely to be high). Another contributing factor is that a dense latticework of contractual risk-shifting devices—such as insurance, indemnification, and exculpatory charter provisions—insulates directors from what little liability the law does impose.[8] Given these barriers to directorial liability, this paper asks whether rewards might be a more workable substitute. Put differently, assuming that legal intervention is required to improve directorial oversight,[9] we consider whether rewards can outperform liability in incentivizing directors.

Much of our analysis is a comparison of two possible legal regimes: a negligence regime in which outside directors face personal liability for failure to reasonably monitor top management, and a "reverse negligence" regime in which directors are rewarded for satisfactorily discharging their monitoring obligations. Both regimes stand in sharp contrast to the status quo, in which, despite widespread belief to

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6. *See* Robert J. Haft & Michele H. Hudson, LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS, § 5 (2006–2007 ed.).

7. *See* Bernard Black et al., *Liability Risk for Outside Directors: a Cross-Border Analysis*, 11 EUR. FIN. MGMT. 153 (2005) (a comparative study finding that outside directors very rarely bear out-of-pocket liability for failure to monitor management).

8. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1077–94 (2006) (analyzing in-depth the insulating effect of D&O insurance and indemnification).

9. For the position that no legal intervention is required, see Lynn A. Stout, *On the Proper Motives of the Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1 (2003) and Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001). Others believe that given the cost of expanding directors' liability and the existence of market incentive for directorial oversight directors should face only a minimal risk of out-of-pocket liability. *See, e.g.*, Bernard Black et al., *Outside Director Liability: A Policy Analysis*, 162 J. INST. & TH. ECON. 5 (2006).

the contrary, directors actually face very little pressure from liability (or rewards).[10] We compare these regimes in order to isolate their common problems and, more importantly, to locate the points at which their costs and benefits diverge. The liability regime we select is the familiar proposal to hold directors personally liable for negligent monitoring. By contrast, the reward regime we outline is a decidedly unfamiliar proposal to reward directors who demonstrate that they did not discharge their monitoring obligations negligently. We argue here that this reward regime answers several of the most troubling drawbacks of its liability counterpart. Given the novelty of our reverse negligence regime, we do not expect it to find immediate acceptance. We do believe, however, that it can yield important insight into the legal gatekeeper strategy, and also suggest less ambitious reforms that hold promise for improving directorial monitoring of senior managers.

One more qualification. The hypothetical reward regime that we consider is almost—but not quite—the mirror image of a negligence regime. A negligence regime imposes liability contingent upon the occurrence of a triggering event (i.e., harm), followed by an ex post determination that the harm resulted from the failure of an actor to perform her legal duty (i.e., behave reasonably). The mirror image of such a regime would make a reward contingent on the absence of harm over a period of time, and an ex post determination that this absence was "caused" by an actor's faithful performance of her legal duties. For reasons that we develop below, however, establishing that harm failed to occur because directors monitored adequately (or merely establishing that directors did monitor adequately over a lengthy period) is an impossible task. Therefore, instead of framing the absence of harm as a triggering event for possible awards, we look to the occurrence of harm just as a negligence regime does. Under our regime of reverse negligence, directors are rewarded if, after the occurrence of harm (or one of its correlates), they are found to have monitored reasonably, even if they failed to prevent harm. In other words, we would not require directors to prevent harm to become eligible for rewards, because we expect heightened monitoring itself to act as a deterrent against managerial misconduct, even when it falls short of preventing harm in particular cases.

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10. *See infra* Section III.A.

The resemblance of rewards to compensation raises a threshold issue that we must address at the outset. A large body of literature on directorial compensation parallels the literature on directorial liability (although the two rarely intersect).[11] A principal theme of the compensation literature is that directors ought to be paid in equity—options or restricted stock—like senior managers, and for much the same reason: to align their financial interests with those of shareholders. Put more strongly, many commentators view equity compensation as the principal answer to the board's incentive problems,[12] and some might argue that firms can automatically induce effective monitoring by implementing the right sort of high-powered equity compensation in the boardroom. We disagree for reasons that we elaborate in Part II.[13]

Our discussion is organized as follows. Part II demonstrates the limitations of equity compensation as a means of inducing directorial monitoring, however salubrious its effects might otherwise be. Part III then expands on the limitations and costs of negligence-based liability as a device for motivating directorial monitoring. Part IV introduces the reverse negligence regime and uses it to offer our core analytical comparison of rewards and liability as incentive devices for outside directors. Part V considers the potential costs of reward regimes and explores the mechanisms for addressing such costs. This Part also explains why we neither recommend adoption of a reward regime of the same broad scope as a negligence regime, nor expect such a regime to be adopted any time soon. Part VI applies the insights that follow from comparing liability and rewards to frame two more modest corporate governance

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11. *See* Eric Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation* (Univ. of S. Cal. Law and Econ., Research Paper Series No. 04-7, 2004) (corporate governance arrangements, executive compensation, and shareholder litigation are all substitutes for incentivizing managers), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=536963.

12. *See, e.g.*, Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 689–92 (1995) (paying directors in stock will "incentivize outside directors in the large public corporation to eschew their traditional passivity"); Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 864–65 (1993) (encouraging directors to hold substantial equity interests would provide better oversight incentives); Wei Shen, *Improve Board Effectiveness: the Need for Incentives*, 16 BRIT. J. MGMT. S81, S86 (2005) (stating that to improve board effectiveness, directors should be compensated primarily with company stock and be required to buy a significant amount of company stock upon joining the board).

13. In certain cases, equity pay may be a useful device for motivating lower-level employees to engage in peer-monitoring. *See* Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock Ownership Plans*, MICH. L. REV (forthcoming 2007).

reforms that merit closer study. Finally, Part VII comments briefly on the extension of reward regimes to other classes of gatekeepers in corporate and securities law.

II. Equity Compensation as a Reward Mechanism

We begin with a threshold question: why should the law motivate directors to monitor, given that public companies already voluntarily "reward" their directors with equity compensation? One might suppose that by aligning the interests of directors and shareholders, equity pay already motivates directors to monitor management closely.[14] Better still, equity pay is self-executing, so no procedures are necessary to determine whether directors are eligible for rewards. This reasoning may partly explain the increasing popularity of equity pay for directors,[15] and why it has found favor with a broad spectrum of observers, ranging from institutional investors[16] to economists,[17] lawyers,[18] and even the Delaware Supreme Court.[19]

Although we are agnostic about the general merits of equity pay for directors, we are certain that it cannot substitute for direct monitoring incentives. Options and restricted stock may encourage outside

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14. At the same time, one could worry that equity pay for directors aligns their interest with—and thus reduces their likelihood of policing—the CEOs who themselves receive hefty stock-based compensation. If equity-based compensation worked for outside directors, it would be expected to work also in the case of CEOs. *But see infra* note 30 (discussing plausible differences between CEOs and outside directors)

15. *See* David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281 (2004).

16. *See, e.g., id.* at 2282 (tying directors' pay to stock performance is a frequent goal of institutional investors' corporate governance initiatives).

17. For empirical research finding that equity pay enhances firm value, see David A. Becher et al., *Incentive Compensation for Bank Directors: The Impact of Deregulation*, 78 J. BUS. 1753 (2005) (showing that banks utilizing a high degree, equity-based director compensation exhibit higher performance and growth); Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999) (finding some correlation between the dollar value of director equity-holdings and CEO turnover); and Tod Perry, *Incentive Compensation for Outside Directors and CEO Turnover* (July 1999) (demonstrating that equity-based director compensation is associated with better director monitoring and CEO turnover following poor performance), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236033. For research casting doubt on the benefits of equity pay for directors, see Mason Gerety et al., *Do Shareholders Benefit from the Adoption of Incentive Pay for Directors?*, 30 FIN. MGMT. 45 (2001) (showing that the adoption of director incentive plans do not affect share price) and Nikos Vafeas, *Operating Performance around the Adoption of Director Incentive Plans*, 68 ECON. LETTERS 185 (2000) (finding that the adoption of director incentive plans does not affect firms' operating performance).

18. *See* Charles M. Elson & Robert B. Thompson, Van Gorkom's *Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 587–89 (2002) (arguing that the judicial application of the duty of care should be tailored to the level of equity ownership by outside directors).

19. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1380–81 (Del. 1995) (holding that directors who hold substantial equity stakes in a target corporation may not be presumed to vote against their economic interests as stockholders). For an analysis, see J. Travis Laster, *Exorcizing the Omnipresent Specter: The Impact of Substantial Equity Ownership by Outside Directors on* Unocal *Analysis*, 55 BUS. LAW. 109 (1999).

directors to advise management competently and participate meaningfully in the formulation of firm strategy.[20] But directors also have a duty to protect investors against managerial misconduct including, inter alia, attempts to manipulate financial data and inflate share prices.[21] Equity pay does not support this duty for two reasons. First, it sometimes gives an affirmative incentive to overlook wrongdoing. Second, to the extent that management influences the tenure of directors, generous compensation of any sort, including equity pay, can compromise directorial independence.[22]

Consider first why equity pay might perversely encourage directors (and other market gatekeepers)[23] to overlook wrongdoing. In the short run, equity holdings reduce a director's incentive to uncover and disclose wrongdoing because doing so will normally depress share price.[24] Companies that restate their financial statements, for example, lose on average roughly ten percent of their market value,[25] which suggests that directors with significant shareholdings will not be eager to report bad news.[26] In

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20. Indeed, studies finding a correlation between incentive director pay and corporate performance typically focus on the business role of directors. *See* Stephen Bryan & April Klein, *Non-Management Director Options, Board Characteristics, and Future Firm Investments and Performance,* (N.Y. Univ. Law & Econ., Research Paper Series No. 04-009, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=550506; Yermack, *supra* note 15. *But see* Bhagat et al., *supra* note 17.

21. Michael Jensen argues that one of the principal agency problems characterizing public companies is that markets overvalue their shares. *See generally* Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5 (2005).

22. Our analysis should be distinguished from the ongoing scholarly debate over whether some forms of incentive pay are superior to others in aligning management incentives with those of shareholders. Some economists argue that CEO stock options—but not restricted stock or bonuses—are likely to encourage misreporting. *See e.g.*, Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON**.** 35 (2006). Others posit that restricted stocks are more likely than stock options to encourage earning management. *See, e.g.*, Ohad Kadan & Jun Yang, *Executive Stock Options and Earning Management: A Theoretical and Empirical Analysis* (Am. Fin. Ass'n, 2006 Boston Meetings Paper, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=615881. Our claim is more ambitious in scope. We argue that all forms of equity pay are likely to fail in providing directors with adequate monitoring incentives.

23. Here we include auditors and attorneys. *See, e.g.*, Sankar De & Pradyot K. Sen, *Is Auditor Moral Hazard the Only Reason to Ban Contingent Fees for Audit Services?*, 1 INT. J. AUDIT**.** 175 (1997); Ronald A. Dye et al., *Contingent Fees for Audit Firms*, 28 J. ACCT. RES. 239 (1990).

24. This perverse incentive also can operate *before* misconduct occurs by discouraging measures that prevent some misconduct while increasing the probability that residual misconduct is detected or reported ex post. *See* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994). Thus, a board preoccupied with share price might eschew a particular control on accounting fraud if it appeared that the fraud might occur nonetheless and the control would almost certainly detect the fraud if it did occur.

25. U.S. GEN. ACCT. OFF., FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES GAO-03-138, at 5 (October 2002) (finding an average decline of ten percent); Zoe-Vonna Palmrose et al., *Determinants of Market Reactions to Restatement Announcements*, 37 J. ACCT. & ECON. 59, 60 (2004) (finding an average decline of nine point two percent).

26. Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 577 (2003) (positing that equity-based compensation is unlikely to provide incentives for directors to identify and disclose evidence of misconduct);

addition, recent corporate debacles have typically involved fraudulent financial reporting.[27] Directors—and especially members of the audit committee—have a particular obligation to take corrective measures upon discovering problems of inaccurate disclosure,[28] which makes the link between the market price of the company's stock and director wealth especially problematic. As a recent paper notes: "A compensation structure in which the payout is contingent on reported earnings cannot simultaneously incentiv[ize] the managers to maximize profits and to report those profits honestly."[29] This intuition is supported by the large empirical literature that documents a relationship between equity pay and the incidence of accounting fraud and illicit earnings management.[30]

To be sure, imposing lengthy holding periods on directors mitigates the incentive problems attending equity pay when financial misstatements are modest and firms are solvent. But holding periods do not eliminate the problem. We often wish to motivate directors to take actions that will decrease share price without offering any prospect of an offsetting future increase in share price. For example, directors (or auditors) have a duty to the market to restate the misleading financial results even if, as often happens,

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see also Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1242 (2002) ("[S]tock-based director compensation may . . . increase . . . ambivalence about uncovering embarrassing facts that will reduce the share price.").

27. See John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REV. ECON. POL'Y. 198, 200-01 (2005) (discussing the widespread fraud evidenced by the increase in financial restatements in the United States in the late 1990s).

28. *See generally* Hillary A. Sale, *Independent Directors as Securities Monitors*, 61 BUS. LAW. (forthcoming 2006) (arguing that all directors should be fully aware of company statements and sufficiently engaged and active to question and correct inadequate disclosures), *available at* http://ssrn.com/abstract=900458.

29. Keith J. Crocker & Joel Slemrod, *The Economics of Earning Manipulation and Managerial Compensation*, 22 (Feb. 3, 2005), http://irm.wharton.upenn.edu/S05-Crocker.pdf. *See also* Susan R. Curtis, *Incentive Pay, Fraud, and Self-Reported Performance Measures*, (Mar. 8, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=682125; Jensen, supra note 21, at 14–15 (equity-based compensation cannot solve the agency problems arising from overvalued equity).

30. For recent examples, see Merle Erickson et al., *Is There a Link Between Executive Equity Incentives and Accounting Fraud?*, 44 J. ACCT. RES. 113 (2006) and Shane A. Johnson et al., *Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter*, (June 13, 2006) (presented at the European Finance Association 2006 Zurich Meetings), http://ssrn.com/abstract=395960.

Although research has thus far focused on incentive pay for executives, the insights seem to extend to directors as well. One plausible difference is that equity pay is substantially higher for senior executives than for directors, thereby making it less likely for directors to sell stock for risk-diversification purposes. *See* Eli Ofek & David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 J. FIN. 1367, 1369-70 (2000) (equity-based compensation encourages fraud since it makes executives sell stock to diversify risk).

bankruptcy is likely to follow a serious financial restatement.[31] In this case, equity pay cuts in precisely the wrong direction. And the problem is not that directors have a short-term focus. Rather, the problem is that by diligently performing their gatekeeping duties, directors must automatically—and permanently—destroy the value of their shareholdings.[32]

Even when equity compensation does not create perverse incentives, rich equity pay—indeed, rich compensation of any sort—compromises directorial independence by increasing the opportunity costs of leaving the board. Conventional wisdom has it that directors who openly spar with CEOs are often eased off the board.[33] Thus, we must expect well-paid directors to hesitate before pushing too hard.[34] Even if a self-interested director were certain to increase the value of her own company shares by challenging management, she might still refrain from doing so to safeguard her "flow" of compensation during additional years of service on the board. Of course, the pressure on outspoken directors may be more nuanced today than it was in the past as a result of the new exchange listing requirements that assign nomination responsibilities to independent directors.[35] But these new requirements are unlikely to have entirely eliminated management's influence over the names on next year's company slate of board

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31. *See* Zoe-Vonna Palmrose & Susan Scholz, *The Circumstances and Legal Consequences of Non-GAAP Reporting: Evidence from Restatements*, 21 CONTEMP. ACCT. RES. 139, 145 (2004) (companies with substantial restatements have higher frequencies of a subsequent bankruptcy or delisting).

32. In some cases, this problem might be solved by modifying the prohibition against insider trading to allow outside directors to trade on bad news for a brief period of time if they later disclose it. Kristoffel R. Grechenig, *The Marginal Incentive of Insider Trading: An Economic Reinterpretation of the Case Law*, 37. U. MEM. L. REV. (forthcoming 2006) (manuscript at 6–11, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=883642); Jonathan Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistle-blowing and Insider Trading*, MICH. L. REV. (forthcoming 2007).

33. *See, e.g.*, Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 293 (2004) ("[A] board member who takes the initiative to seek change but fails to gain a consensus will lose power and probably not last long on the board.").

34. This problem is generic to gatekeeper schemes, which often rely on gatekeepers who are hired by those they are under an obligation to monitor. *See, e.g.*, John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403, 1406-07 (2002) (auditors); Poonam Puri, *Taking Stock of Taking Stock*, 87 CORNELL L. REV. 99, 152–53 (2001) (attorneys).

35. *See* Order Approving NYSE and NASDAQ Proposed Rule Changes Relating to Corporate Governance Requirements, 68 Fed. Reg. 64,154 (Nov. 12, 2003); Order Approving AmEx Proposed Rule Changes Relating to Enhanced Corporate Governance Requirements Applicable to Listed Companies, 68 Fed. Reg. 68,432 (Dec. 8, 2003).

nominees.[36] Thus, as long as CEOs exert influence over the appointment and tenure of "their" directors, conventional forms of compensation will provide insufficient oversight incentives.[37]

III. The Limits of Directorial Liability

Given that equity compensation does not provide directors with focused monitoring incentives, we now turn to the possibility of legal intervention—first in the form of a traditional negligence regime and then in the form of its mirror image, a reverse negligence regime. We take it as a given that a negligence regime could supply directors with high-powered legal incentives to monitor senior management. The principal objection to such a regime is that it is likely to be too costly. The best evidence for such substantial costs is that the law either in the U.S. or anywhere else very rarely imposes liability on directors for failure to monitor management.[38] The best evidence that the question is a close one, however, is that there are exceptions and ambiguities that leave open the possibility of liability in exceptional circumstances.

A. *The (Very Limited) Scope of Negligence-Based Liability*

Under U.S. law, directors enjoy protection from liability for failing to detect misconduct—or for failing to attend to other aspects of company business—on two levels: the level of substantive law and the level of private risk-shifting devices authorized by law.

Consider first a thumbnail sketch of director liability under substantive law. Under state law, the principal fiduciary duty governing disinterested directors is the duty of care;[39] that is, the injunction that 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."[40] In the aptly-named Caremark decision, the

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36. Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot,* 59 BUS. LAW. 43, 49 (2003).

37. Lucian Bebchuk & Jesse Fried**,** PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 25–27 (2004) (positing that compensation is a limited solution as long as nomination is not determined by shareholders).

38. Black et al., *supra* note 8, at 155, 162–63.

39. There is some uncertainty concerning the extent to which disinterested directors have an independent duty of good faith under Delaware law. For a comprehensive analysis, see Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004).

40. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 4.01 (1992); *see also* MODEL BUS. CORP. ACT § 8.30(b) (1984).

Delaware Chancellor held that the director's duty of care encompasses an oversight function.[41] This includes a duty to ensure that appropriate "information and reporting systems" exist to provide the board of directors with accurate and adequate information to assess corporate compliance with legal requirements.[42] The duty of care is qualified, however, by the so-called business judgment rule, which bars courts from inquiring into the content of the board's business decisions.[43] As a result, it is seldom possible to challenge a board's decisionmaking except when, as a result of gross negligence or bad faith, the protections of the business judgment rule do not attach. Directors only face a risk of personal liability under state corporate law if the board is grossly negligent in its procedures—i.e., by dealing with obviously important matters in a cursory fashion—[44]or if the failure to question obvious wrongdoing is so blatant as to suggest intentionality and bad faith.[45] Some commentators believe that this procedural focus is desirable,[46] while others do not.[47] But what is important for our purposes is that directors currently face very little risk of liability for negligent oversight.

Federal law is equally reticent to impose personal liability for oversight failure on directors. The principal exception to this rule is Section 11 of the Securities Act of 1933[48] which holds directors to a negligence-type standard in connection with misrepresentations in the prospectus accompanying public

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41. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968–70 (Del. Ch. 1996).

42. The jurisprudence concerning directors' oversight duty is still in its infancy, and there are no clear standards prescribing what type of monitoring directors have to undertake in order to discharge these duties. *See, e.g.*, Charles M. Elson & Christopher L. Gyves, In Re Caremark: *Good Intentions, Unintended Consequences*, 39 WAKE FOREST L. REV. 691, 701 (2004) (arguing that the *Caremark* decision leaves unclear exactly what directors would need to do to meet their oversight duties); Jack B. Jacobs, *The Delaware Supreme Court: Looking to the Future*, 8 MERGERS & ACQUISITIONS L. 2 (2004) (noting that Delaware law concerning the board's obligation to oversee management is "developed hardly at all").

43. *See* E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. PENN. L. REV. 1399, 1421–1428 (2005).

44. *See Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

45. *In re Emerging Commc'ns, Inc. S'holders Litig.*, 2004 WL 1305745, at *40 (Del. Ch. June 30, 2004).

46. *See, e.g.*, Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002) (offering an altruism-based justification for the process-oriented nature of the business judgment rule); Rock & Wachter, *supra* note 9.

47. *See* Fisch & Gentile, *supra* note 26, at 567 ("So long as adherence to procedural standards, coupled with the retention of outside professionals, is sufficient to insulate directors from personal accountability, there is little reason to expect directors to monitor management closely.").

48. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000)).

offerings of securities.[49] By contrast, directors are liable under the Securities Exchange Act of 1934[50] only if they are shown to have acted with "scienter," i.e., engaged in knowing misconduct.[51] In this regard, it is instructive to note the federal response to reports about the role of director passivity in facilitating financial debacles at Enron, Worldcom, and other companies that fell victim to financial fraud in the early years of the decade.[52] The Enron scandals sparked numerous demands that directors be subject to negligence-based liability for failure to exercise proper vigilance.[53] But the federal response—the Sarbanes Oxley Act and the regulations in its aftermath—did not expand director liability. Instead, these reforms focused on regulating board independence and assigning increasing responsibilities to specialized committees, such as the audit committee.[54] In particular, very little in the new regulations addresses the scope of directors' oversight obligations.[55] To the contrary, the SEC has refused to prescribe the manner in which members of the audit committee should execute their oversight responsibilities.[56]

In addition to state and federal substantive law, state law authorizes a second level of legal insulation for corporate directors through a variety of private risk-shifting devices. Delaware law, for example, explicitly endorses permissive indemnification and insurance of virtually all directorial liability costs that do not result from fraud or similar intentional wrongdoing.[57] Moreover, all states now authorize

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49. *See* Sale, *supra* note 28, at 18.

50. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)).

51. *See* Sale, *supra* note 28, at 17; *see also* Suraj Srinivasan, *Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members*, 43 J. ACCT. RES. 291, 294 (2005) (finding that outside directors of companies that restated their financials face little discipline through SEC action or private litigation).

52. *See* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003) (describing director passivity at Enron); David S. Hilzenrath, 'The company's directors were all too often a passive rubber stamp for management and especially Mr. Ebbers.': *How a Distinguished Roster of Board Members Failed to Detect Company's Problems*, WASH POST**,** June 16, 2003, at E1 (describing findings concerning director conduct at WorldCom); Floyd Norris, *Ebbers and Passive Directors Blamed for WorldCom Woes: Board That Made Decisions in Haste With No Questioning*, N.Y. TIMES**,** June 10, 2003, at C1 (same).

53. *See, e.g.*, Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393 (2005).

54. *Id.* at 400–05.

55. *See* Fisch & Gentile, *supra* note 26, at 572 (explaining that it is unclear to what extent members of the audit committee are responsible for making independent assessments of the quality of issuers' internal controls, financial statements, and financial reports).

56. *See* Standards Relating To Listed Company Audit Committees, 68 Fed. Reg. 18,788, 18,796 (Apr. 16, 2003) (to be codified at 17 C.F.R. pt. 228, 229, 240, 249, 274) ("[T]hese specific decisions regarding the execution of the audit committee's oversight responsibilities, as well as decisions regarding the extent of desired involvement by the audit committee, are best left to the discretion of the audit committee . . . .").

57. DEL. CODE ANN**.** tit. 8, § 145(a), (g) (2005) (indemnification and insurance).

companies to adopt charter provisions that exculpate directors from monetary liability for breaching the duty of care.[58] Finally, the frequent settlement of derivative litigation and class actions against directors—the chief mechanisms for enforcing the directors' monitoring obligations—assures that only a tiny percentage of cases are ever adjudicated. The vast majority of lawsuits are either dismissed or settled—with the companies and their insurers picking up the tabs.[59] The bottom line is that directors almost never bear out-of-pocket liability expenses.[60]

B. *The Costs of Negligence-Based Liability*

The principal policy argument against director liability for faulty monitoring is that the costs outweigh the benefits, largely because such a regime would have high error rates.[61] The courts would frequently err in deciding in hindsight whether directors acted reasonably,[62] and plaintiffs' lawyers would multiply the errors by pursuing actions against directors with little genuine regard for the merits.[63] A high error rate, in turn, would impose significant risk-bearing costs on directors.[64] At a minimum, directors would demand insurance against negligence-based liability risk or compensation for bearing it. It follows that if out-of-pocket negligence-based liability became common, Director and Officer ("D&O") insurance premiums would increase an order of magnitude, directors would receive much larger fees, or—the most likely outcome—premiums and fees would both increase significantly. But to the extent that firms were able to insure against the expected liability costs of their directors, they might blunt the incentive function of negligence-based liability. Thus, it might be necessary to consider limiting D&O insurance coverage

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58. J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 332 n.93 (2004) (noting that by 2003, all fifty states had adopted statutes enabling corporations to limit or eliminate personal liability for directors).

59. Black et al., *supra* note 8, at 158-61. The SEC may attempt to limit companies' ability to indemnify directors.

60. In the well-publicized cases of Enron and Worldcom, outside directors agreed to pay substantial amounts to settle securities class action lawsuits. On the implications of these settlements, see Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).

61. This section offers what we believe is a sensible synthesis of the prevailing objections to enhancing directorial liability. We do not necessarily endorse these objections. Rather, our goal is to lay the framework within which we can later evaluate the benefits of a reward regime.

62. *See, e.g.*, inbridge, *supra* note 1, at 114–15; Veasey with Di Guglielmo, *supra* note 43, at 1424.

63. *See, e.g.*, Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J.L. ECON. & ORG. 55 (1991).

64. It might also create perverse incentives to ignore misconduct. *See* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994).

and indemnification arrangements in order to maintain liability incentives, and it surely would be necessary to void charter provisions that insulate directors from monetary liability for breach of their duty of care.

If directors were unable to shift liability risk, however, companies would face additional costs that might far exceed the direct risk-bearing costs to their directors. One of these costs is the agency cost of risk-distorted decision making by the board, and another is a diminished pool of candidates from which to recruit new directors. Both of these costs are well known and widely discussed. The principal agency cost is the danger that negligence-based liability would induce directors to make overly cautious decisions to reduce the likelihood of a company failure for which they might be sued.[65] An ancillary concern is that directors would overinvest in compliance measures in order to reduce the likelihood that they would be held liable if a lawsuit were filed.[66] Economists have shown that negligence standards might induce defendants to be overly cautious when courts are prone to error.[67] For directors, however, this over-compliance tendency is exacerbated since the cost of directors' caution is borne by the corporation. Consider, for example, the possible losses that might follow from a board's decision to select a cautious CEO over an entrepreneurial one, or to impose a rigid, hierarchical management structure over a flexible one.

Similarly, liability creates a problem of recruitment for boards insofar as it might lead many potential directors to refuse to serve.[68] In theory, companies could always raise board fees to offset an enhanced risk of negligence-based liability. However, offering outside directors substantially higher fees

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65. Veasey with Di Guglielmo, *supra* note 43, at 1422–25 (discussing how liability might stifle risky business initiatives).

66. *See* Black et al., *supra* note 9, at 17 (explaining that boards might adopt "excessively bureaucratic procedures" as a response to a heightened liability risk).

67. *See* Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279 (1986); Louis Kaplow & Steven Shavell, *Accuracy in the Determination of Liability*, 37 J.L. & ECON 1, 2 (1994).

68. *See, e.g.*, Gordon, *supra* note 26, at 1244 (noting that measures to enhance director liability for breaching the duty of care "may have the perverse effect of discouraging board service by the well-qualified, especially for corporations facing significant business challenges"); Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 1–2 (1989) ("There are reports of directors resigning because their firms had lost insurance coverage and of individuals declining invitations to serve on boards in increasing numbers.").

might undermine their independence and further decrease their willingness to take risks.[69] Moreover, potential directors have heterogeneous assets and reputations at stake; fees set to compensate modal directors would fail to attract the wealthiest or most illustrious candidates. The concern that expanding liability would discourage the most qualified candidates from joining boards appears to have a strong influence on lawmakers, motivating them to insulate directors from liability.[70]

Finally, of course, there would be an enormous political cost to any effort to impose negligence-based liability on directors, particularly if such a reform also sought to restrict indemnification, insurance, the business judgment rule, exculpatory charter provisions, and the board's power to fund settlements with the plaintiffs' bar—in short, the entire arsenal of risk-shifting devices that are an accepted part of shareholder litigation today. There is no organized group to bear this cost, least of all corporate shareholders, who have consistently voted to eliminate directors' monetary liability for breach of the duty of care whenever the matter has been put to a shareholder vote.[71]

IV. The Benefits of Directorial Rewards

The costs of negligence-based liability for directors lead directly to the central question of this paper: namely, whether it is possible to erect a less costly reward regime that has roughly the same incentive power[72] as a traditional negligence regime? A reward regime can easily mimic the incentive features of a liability regime;[73] the critical issue is whether it can do so at less cost.

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69. *See* Black et al., *supra* note 9, at 18–19.

70. *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1162 (1990) (arguing that states that allow corporations to indemnify directors "hope to prevent an exodus of qualified directors from boards"); Gregory S. Rowland, *Earning Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 201–202 (2002) (reviewing pressures on the SEC to protect audit committee members from liability under the concern that liability would reduce ability to find qualified members).

71. *See* Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 490 (2000) ("[O]ut of one hundred 'Fortune 500' companies, ninety-eight of the stock corporations that incorporated in jurisdictions allowing for exculpatory charter provisions have adopted such provisions.").

72. To produce an equal incentive power, rewards and liability regimes may slightly differ in monetary size. For example, research shows that individuals tend to view gains and losses differently. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 279 (1979) ("The aggravation that one experiences in losing a sum of money appears to be greater than the pleasure associated with gaining the same amount."). If these findings apply to outside directors, then the reward amount will have to be adjusted upward to offset this effect.

73. Assume that it is socially desirable for directors to make an investment valued at $50 in reviewing the company's financial statements. Compare a liability regime under which directors must pay a penalty of $100 if

To answer this question, we first elaborate a reward regime—reverse negligence—that parallels negligence liability. We then explore the advantages of a reverse negligence regime as it compares with a traditional negligence regime. A reward regime of this sort would reduce error rate, alleviate the problem of distorted decisionmaking, reduce recruitment costs, and would not be subject to dilution by private risk-shifting arrangements. Reverse negligence would also facilitate the development of an informed market for directors. In the next Part, we discuss the extent to which a reward regime can be expected to produce its own costs. Throughout this discussion we will use the terms "reward regime" and "reverse negligence regime" interchangeably.[74]

A. *How a Reverse Negligence Regime Works*

Like negligence-based liability, reverse negligence builds on a civil lawsuit that turns on the reasonableness of a director's conduct. Unlike a negligence regime, however, directors would sue as plaintiffs under a reverse negligence regime, on the theory that their conduct had met or exceeded a legal standard. As we discuss below, successful suits would result in substantial awards.[75] However, directors could only bring suit in the aftermath of certain triggering events that caused—or were associated with—harm to the company. Possible triggering events might include major financial restatements,[76] settlements of shareholder suits resulting in monetary payment above a threshold amount, or the opening of investigations by the SEC.

The function of a triggering event is to ensure that a reverse negligence regime is administrable. Linking rewards to triggering events has several advantages over the alternative of inspecting board conduct periodically or randomly, even in the absence of harm. First, given the wide range of directorial

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they fail to make this investment to a reward regime under which directors are paid $100 if they do make this investment. Under the liability regime, directors will weigh the cost of $50 against their expected liability for failure to monitor—$100. Under the reward regime, directors will weigh the cost of $50 against their expected payment for adequate monitoring—$100. Both regimes, therefore, provide comparable incentives under these circumstances.

[74] Note that we do not propose to displace the existing regime of directorial liability. Rather, our analysis compares a hypothetical reverse negligence regime to a hypothetical negligence regime.

75. *See infra* Part V.B.

76. Not all financial restatements are the result of management wrongdoing. *See* Jeffrey L. Callen et al., *Accounting Restatements: Are They Always Bad News for Investors?*, J. INVESTING, Fall 2006, at 57, 57. The import of financial restatements has already received legal recognition in Section 304 of the Sarbanes-Oxley Act, which forces executive compensation give-backs after financial restatements under certain circumstances. *See* 15 U.S.C.A. § 7243(a) (2002).

responsibilities, it is difficult to specify what would amount to "adequate oversight" of management without reference to a particular risk. Vigilance is most easily observed when incipient crises reveal a director's growing awareness of her company's problems and the desire to respond appropriately. Focusing on directorial conduct in the aftermath of wrongdoing or mismanagement thus allows courts to tailor their scrutiny to specific circumstances and concrete harms. Second, subjecting all public companies to routine inspections would require costly evaluation procedures even for companies in which directors' vigilance is relatively less valuable.[77] By contrast, a triggering-event requirement limits judicial review to precisely those circumstances in which vigilance is most valuable because managerial misconduct is most likely, and the allegiance of directors to their monitoring obligations is most likely to be tested. Third, the triggering-event requirement economizes on investigation costs, since events of this magnitude will ordinarily spark inquiries into management behavior in any case.[78] And finally, allowing directors to claim rewards only in the aftermath of certain triggering events alleviates the financial burden of funding rewards.

Closely related to the issue of when to evaluate directorial conduct under a reverse negligence regime is the question of what standard of review a court should employ. A natural answer is a "reverse negligence" standard: if a negligence regime imposes liability for failing to exercise due care, a reverse negligence regime ought to reward the director who *does* take due care in monitoring management. Note that this standard does *not* imply its converse, that is, not every director who might have escaped liability under a negligence regime would be eligible for a reward under a reward regime. This is because a director seeking a reward under this regime carries the burden of affirmatively proving that her conduct

77. Directors' vigilance is valuable to the extent that it prevents management misconduct. When misconduct is unlikely—because management is honest, for example—the value of directorial oversight is relatively small.

78. More accurately, the triggering-event requirement reduces the per-company cost of evaluating directors' conduct. In contrast, total inspection costs could be reduced even without the triggering-event requirement by reducing the number of companies inspected while adjusting upward the magnitude of the reward. *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

met or exceeded a standard of reasonable vigilance. Thus, only directors who can establish their vigilance would receive a reward.[79]

Assume for the moment that lawmakers establish a reverse negligence regime as we have described it above. How does such a regime compare to a traditional negligence regime with similar incentive properties? As we explain in the remainder of this Part, the answer is that it compares quite well.

B. *Error Rates*

Take error rates first. Recall that most of the costs we attribute to a regime of negligence-based liability for outside directors arise because we (and virtually everyone else) assume that error rates would be high in the adjudication of liability suits challenging directorial conduct. This assumption is less plausible under a reverse negligence regime. Under a negligence regime, directors are likely to close ranks and stay silent to bolster the board's collective defense, while under a reverse negligence regime they have a strong incentive to produce information because they carry the burden of establishing that they complied with their legal duties. Thus, reverse negligence encourages insiders to produce first-hand accounts of boardroom behavior that are highly probative, even if sometimes self-serving.

A second reason why we expect more accuracy from a reverse negligence rule is that it does not rely on the plaintiffs' bar to initiate suits but requires outside directors themselves to bring actions to seek rewards.[80] Relying on the plaintiffs' bar to file lawsuits is not only inherently costly[81] but also opens the door to abusive suits.[82] By contrast, we expect the directors seeking rewards to behave less strategically than members of the plaintiffs' bar, partly because of reputational constraints and partly because company insiders can easily verify or dispute their accounts. In addition, actions brought by directors to obtain

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79. Of course, variations are possible as well. For example, one could imagine a "reverse gross negligence rule," under which a director would be required to prove that her conduct was not merely reasonable, but exceeded the level of vigilance normally expected of outside directors. This modification would ensure that only those directors who demonstrated exemplary vigilance would qualify for a reward. In addition, this rule would enhance the reputational benefits associated with the reward while mitigating any plausible adverse effect on the reputation of directors who failed to qualify for a reward.

80. As we explain in Part V.C below, one of the key challenges in designing reward regimes is inducing directors to file reward claims. It is thus likely that reward regimes would depend upon independent third parties to initiate reward inquiries. This might further increase the accuracy of the regime.

81. *See, e.g.*, Romano, *supra* note 63.

82. *See, e.g.*, Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 535–36 (1997) (describing the concern that class attorneys file frivolous claims solely for their settlement value).

rewards would lack certain features that encourage abusive lawsuits, such as asymmetric stakes and the prospect of obtaining significant fees.[83] Thus adjudication of rewards under a reverse negligence regime is likely to be cheaper and more accurate than adjudication of liability under a parallel negligence regime.[84]

C. *Recruitment*

Of course, a reverse negligence regime can only reduce legal error, not eliminate it. Courts will inevitably make mistakes in assessing directorial conduct, given the hindsight bias and open-ended directorial duties. A second advantage of reverse negligence, however, is that it lowers the costs of the legal errors that do occur.[85]

Consider the costs of recruiting qualified directors. As compared to a liability regime, reverse negligence substitutes the prospect of a fixed reward for the threat of penalty under a liability regime—a penalty that would vary with the assets and professional reputations of individual directors. Negligence-based liability must inevitably deter some candidates from serving on boards (in the absence of liability insurance), unless firms pay directors enough to offset the expected costs of serving for even the wealthiest and most reputable directors. By contrast, reverse negligence does not deter anyone from accepting a board seat. All directors who faithfully discharge their duties during a triggering crisis are eligible for the same reward, and directors who do not seek a reward in the wake of a crisis are not penalized on this account. Reverse negligence does not put directors' personal wealth at risk,[86] but it is also unlikely to put their reputations at risk. On the contrary, directors who qualify for rewards plausibly enhance their reputations among investors, while directors who fail to obtain rewards suffer little

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83. *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 153–54 (2004).

84. Furthermore, risk averse directors have far less incentive to sell their contingent claims on rewards than they do to protect themselves against the risk of catastrophic liability.

85. In this section, we compare a reward regime to a hypothetical liability regime undiluted by private risk-shifting arrangements. Likewise, we assume that public companies do not offer their directors compensation packages that vary by assets or reputation.

86. Reward regimes will likely reduce other components of director pay. This decrease might not equal the expected reward amount, since risk-averse directors might demand companies to increase their fixed pay amounts to offset the additional risk associated with contingent rewards.

reputational harm.[87] Thus, qualified candidates have no economic reason to avoid board seats under a reverse negligence regime, and there is even reason to expect that they might prefer to sit on the boards of risky companies, where the ex ante probability of receiving a reward is higher than elsewhere.

More generally, the reverse negligence rule might serve to foster a market for vigilant directors. It is commonly assumed that directors today are influenced as much by reputational concerns as by monetary incentives.[88] There is evidence that directors at failing companies suffer reputational penalties.[89] Yet, under existing conditions, the market for directors has little opportunity to evaluate the quality of individual directors, especially directors who exercise exceptional vigilance in the boardroom. If, for example, a board terminates the employment of the CEO of an underperforming company, the public is unlikely to discover which directors took the behind-the-scenes initiative in orchestrating a change of leadership. In contrast, a well-functioning reward regime would celebrate the achievements of just these directors. It would single out and compensate directors who demonstrated exemplary performance or who assumed a leadership role during a time of crisis for the company. In this way, a reward regime would offset the collective action problem that is inherent in a collective decisionmaking body such as a corporate board. Equally important, publication of the basis for making a monitoring award to a director would give institutional investors and other corporate outsiders information about the quality of individual directors, who might then be nominated to other boards.

D. *Decisionmaking*

After recruitment difficulties, commentators generally treat risk-averse decisionmaking as the second major cost of imposing negligence-based liability on directors when the risk of legal error is

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87. Those who cannot demonstrate by a preponderance of the evidence that they fully performed their fiduciary duties need not fear stigma. All the market learns is that that the evidence to support a reward was missing or that the director in question did not apply for a reward. *See also infra* Part V.C. (addressing the risk of affirmative findings of negligence).

88. *See, e.g.*, Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997). *But see* Renée B. Adams & Daniel Ferreira, *Do Directors Perform for Pay?* (EFA, 2004 Maastricht Meetings Paper No. 4460, 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=565942 (finding a positive link between attendance-based director fees and director attendance behavior).

89. *See* Stuart C. Gilson, *Bankruptcy, boards, banks, and blockholders: Evidence on changes in corporate ownership and control when firms default*, 27 J. FIN. ECON. 355 (1990) (explaining that directors hold fewer directorial positions after their companies undergo bankruptcy); Srinivasan, *supra* note 51 (explaining that directors of companies that restated their financials suffered labor market penalties).

significant. A reverse negligence rule significantly reduces this cost as well. Two elements of liability regimes encourage directors to be overly cautious. First, because liability typically follows a harmful event, such as a disastrous business failure or a major financial restatement, the risk of liability arising from legal error discourages directors from making decisions that would increase the company's risk profile.[90] Second, because directors escape liability by convincing a court that they acted diligently, they may overinvest in monitoring to assure that they meet the applicable due care standard.

To illustrate, consider the following example. Suppose that a company's board is asked to approve a related-party transaction, say a joint venture with the company's CFO.[91] Although the stated purpose of this transaction is to allow the company to exploit a unique business opportunity, some directors suspect that it might also be designed to allow management to manipulate the company's earnings. A negligence regime might produce two distortions. First, and more importantly,[92] the suspicious directors might persuade the board to veto the transaction without considering its potential benefits, merely because giving approval to the transaction would increase the liability exposure of the entire board. Second, if the transaction is approved, directors might excessively invest in monitoring the company's financial statements to ensure their accuracy.

Now consider the costs associated with the same example under a reverse negligence regime. Although reverse negligence does little to alleviate the ancillary problem of over-compliance,[93] it entirely eliminates the principal problem that directors might be induced to shun a valuable but risky transaction. Under a reverse negligence regime, the modest risk that the proposed transaction might give rise to earnings manipulation and a financial restatement is not a personal risk to directors at all. Indeed, our directors will earn a reward only if they approve the transaction, and it is subsequently discovered to be a

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90. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel**,** THE ECONOMIC STRUCTURE OF CORPORATE LAW 98–99 (1991).

91. This example freely draws on some of the facts underlying the Enron debacle. For a description of the Enron transactions, see William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1306–1314 (2002).

92. The opportunity cost of distorted decisionmaking for a large company would normally far exceed the cost of excessively bureaucratic procedures that the board might adopt.

93. Rewards do not put directors' reputation at risk. Instead, they offer diligent directors the prospect of receiving a fixed amount contingent on the occurrence of certain events. Since the potential benefits from caretaking are limited, directors would have a weaker incentive than under a negligence regime to exercise excessive precaution.

manipulative tool that triggers a financial restatement. Modest suspicions or concerns will lead directors to dig deeper under a reward regime, but they will not lead to the vetoing of seemingly valuable transactions or projects. Of course, one might ask whether rewards could have the opposite effect, that is, of inducing directors to make risky decisions opportunistically in order to become eligible for windfall gains.[94] We discuss this question in Part V below.

E. *Risk-shifting*

Reverse negligence offers another advantage over liability that, while not fundamental as a conceptual matter, is very important as a practical one: rewards are unlikely to trigger contractual risk-shifting devices such as liability insurance and indemnification. The usual justification for these devices—that they are necessary to recruit risk-averse directors—simply does not apply to rewards because companies and their directors lack an obvious reason to contract out of a reward regime. Indeed, attempting to do so by entering into a "reverse indemnification" contract[95] might appear suspicious, given that a reward regime does not put directors' personal wealth at risk. The upshot is that reward incentives are likely to remain undiluted whereas liability incentives are not unless risk-shifting devices are banned or regulated.

How far liability insurance and indemnification undermine deterrence is a complicated question with no clear answer.[96] However, for those who believe that these arrangements improperly dilute director oversight incentives, a regime that can incentivize directors without triggering insurance and indemnification agreements should be a welcome development. Indeed, reverse negligence should appeal even for those who believe that pervasive risk-shifting is currently necessary in order to achieve the right

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94. *Cf.* Saul Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of Affirmative Obligations*, 72 VA. L. REV. 879, 886 (1986) (suggesting that large rewards might induce potential rescuers to create a demand for their services by putting others at risk).

95. Under a reverse indemnification agreement, a director would waive rights to petition for a reward in exchange for higher fixed compensation.

96. For a comprehensive analysis of the impact of liability insurance on deterrence, see Steven Shavell, *On the Social Function and the Regulation of Liability Insurance*, 25 GENEVA PAPERS ON RISK & INS. 166 (2000).

balance of directorial liability and insulation,[97] since rewards reduce the need to rely on risk-shifting—and hence the transaction costs associated with their negotiation and subsequent triggering.[98]

V. Obstacles to a Reward Regime

We have shown thus far that a reverse negligence rule addresses many of the principal shortcomings of negligence-based liability for directors. In this Part, we consider the drawbacks of reverse negligence. We conclude that even though reverse negligence is less costly than a parallel liability regime, it is unlikely to succeed as a reform proposal. The chief reason is that reverse negligence would encounter stiff cultural and political resistance to its key elements, especially court-ordered reward payments for directors. More generally, this Part identifies the novel challenges facing policymakers seeking to devise workable reward regimes for outside directors: overcoming moral hazard problems, ensuring funding, computing award amounts, and overcoming political skepticism. The next Part uses the insights of this analysis to propose alternative reward regimes.

A. *Moral Hazard*

We have described how the triggering-event requirement in a reverse negligence regime alleviates the problem of risk-averse decisionmaking by directors, but we left open the question of whether this requirement might also induce directors to approve *excessively* risky corporate actions in order to become eligible for rewards. This concern arises when board conduct takes place over multiple time periods, including an ex ante period when misconduct can be prevented, and an ex post period when it can be detected but not longer prevented. In this case, one might argue that directors would fail to press for preventive measures ex ante but nonetheless display exemplary vigilance ex post. Put differently, the prospect of a reward for discovering misconduct might discourage its prevention. Consider again the self-dealing example discussed in Part IV, in which a vigilant director earns a reward only if the company

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97. *See, e.g.*, Black et al., *supra* note 9, at 17–19 (explaining why a tiny risk of out-of-pocket liability might be optimal); Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887 (1999) (same).

98. Some argue that the decoupling of nominal from actual liability is designed to provide the plaintiff bar with sufficient incentive to bring suits. *See* María Gutiérrez, *An economic analysis of corporate directors' fiduciary duties*, 34 RAND J. ECON. 516 (2003); Kamar, *supra* note 97. Under a reward regime, in contrast, directors will initiate reward claims and capture the entire amount of the reward.

restates its financials. This circumstance, the argument goes, would give each director an incentive to approve the suspect self-dealing transaction in the hope that she could then earn a reward by making an exemplary effort to uncover wrongdoing.

At the level of legal design, lawmakers could address this problem by making rewards contingent upon a showing of appropriate conduct in all relevant time periods, including the initial period in which misconduct might have been prevented.[99] If courts could always spot opportunistic decisionmaking ex post, directors would never engage in it. Our working assumption, however, is that courts will make errors, particularly in evaluating the open-ended obligations of directors. Given this assumption, the requirement that directors only become eligible for rewards after the occurrence of a harm-related event will inevitably create some incentive for directors to approve overly risky projects and transactions.

But if the moral hazard problem is real, its dimensions are likely to be modest. Most directors will not hope for financial scandal or criminal prosecution on their watch under any circumstances. Crises of this sort would not only adversely affect their reputations and reduce the value of their stock, but also increase their risk of personal liability, especially for directors who appeared to have consciously contributed to corporate failures. Reverse negligence would induce directors to act opportunistically only if the expected rewards outweighed directors' considerable market and legal incentives to avert corporate failures.

Moreover, directors must prove that they acted with reasonable vigilance in all relevant periods in order to earn rewards. But a director who acted opportunistically would encounter two important obstacles to capitalizing on her efforts to induce a triggering event. The first is the hindsight bias of the court, which is likely to be particularly tough in evaluating director conduct in the aftermath of a corporate failure. The second is likely competition from other reward claimants on the board, who could provide the court with detailed information about the behavior of the opportunistic director. Indeed, competition over rewards would be particularly effective in producing information if the reverse negligence regime limited eligibility for rewards to a small number of directors.

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99. Cf. Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997) (exploring plausible mechanisms to address a similar problem on the liability side).

Finally, even if a few directors were to behave opportunistically under a reverse negligence rule, their impact on the incidence of misconduct is unclear. On the one hand, the presence of opportunistic directors would make boards less likely to prevent managers from initiating misconduct; on the other, these directors might also discourage opportunistic managers from initiating misconduct in the first instance. Consider again our self-dealing example. Assume that the transaction was indeed a sham designed to facilitate earnings manipulation, and that savvy but opportunistic directors suspected as much but were nonetheless willing to approve the deal in order to uncover the fraud later on and thereby earn a reward. In this case, managers with fraudulent intentions would have reason to fear that easy board approval was little short of an invitation to an ambush. They would have little to gain—and much to lose—from initiating a deal that the board approved only in the hope that it could subsequently be exposed as a fraud.

B. *Funding*

A reverse negligence regime must fund both its rewards and the costs of administering them. At first glance, the corporation itself would seem to be the most attractive funding source. A director—or a former director—might demand a reward and, if it were not forthcoming, sue the corporation. But even apart from the awkwardness of inviting directors to sue their own companies, direct corporate funding of rewards would create two major problems. First, there is a risk of collusion. Supposedly disinterested directors and managers might fail to contest reward claims in court, especially claims brought by continuing directors who remain on the board. If this practice became entrenched, a reward regime might soon degenerate into its opposite, namely, a kind of payoff for directors who turned a blind eye to signs of misconduct. Second, many corporations might lack the resources to pay rewards, especially since reward payouts would occur only in the aftermath of triggering events that are often associated with financial distress. Relying exclusively on corporate funding, then, might cripple a reward regime in just those circumstances in which its incentives are most needed.

If direct corporate funding is unsuitable, what options remain? Although government funding could eliminate collusion concerns and ensure the availability of rewards even for insolvent companies, it

would understandably provoke objections as a highly visible public subsidy of the costs of corporate governance. A market solution to the funding problem is therefore preferable. One possibility is to encourage companies to purchase "reward insurance" from third parties who would also undertake the tasks of screening and litigating reward claims. These insurers would have no reason to collude with (or retaliate against) petitioning directors, and they would have every incentive to process claims on the merits. Directors would be saved the embarrassment of litigating against their own companies. And finally, turning to solvent insurers would guarantee that meritorious reward claims would always be paid, even if the corporations that gave rise to them subsequently went bankrupt.

C. *Computing Reward Amounts*

Relative to negligence-based liability, a key drawback of reverse negligence is the possible misalignment of incentives that follows from the difficulty of picking optimal levels of rewards. Negligence regimes conventionally set damages equal to the actual harm resulting from misconduct, which is optimal assuming that all concerned have perfect information.[100] An analogous calculation for reverse negligence would set rewards equal to the value of the expected harm that a director *prevented* by meeting her monitoring obligations. We suspect, however, that courts operating with imperfect information can rarely get damages right under an ordinary negligence rule, much less divine the hypothetical savings produced by directors' vigilance under a reverse negligence regime.

Rather than setting payouts on a case-by-case basis, reward regimes presumably would need to adopt a fixed formula. In the case of directors, the award could be a multiple of board fees or a fraction of annual CEO compensation. The payouts need only be large enough to motivate even wealthy directors (after discounting for the likelihood of the occurrence of a triggering event) to monitor diligently and then initiate reward claims. Payouts also ought to be small enough to temper public outrage. Any qualifying figure (say $5 million for an S&P 500 firm) will do as well as any other.

To be sure, the necessity of using a fixed formula would constitute a major drawback of reward regimes in those areas in which liability regimes produce optimal incentives merely by setting damages to

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100. *See* Steven Shavell, *Strict Liability versus Negligence*, 9 J. LEGAL STUD. 1 (1980).

equal social harm. This last description, however, does not seem to apply to outside directors. To begin, the prescription that damages should equal social harm does not necessarily apply in the case of director liability. Many believe that optimal sanctions for directors' negligent oversight are far smaller than the harm associated with corporate failure.[101] Although a full analysis is beyond the scope of this paper, we suspect this intuition to be correct. Apart from the well-known result that negligence-based rules can produce optimal incentives even when sanctions differ from social harm,[102] the reason might be that the cost of optimal monitoring by directors is normally far smaller than the expected harm from an oversight failure. Beyond a certain threshold, therefore, enhancing liability exposure would produce substantial costs, but insignificant deterrence benefits. With respect to securities fraud, moreover, it is unclear whether the existing liability regime's measures of damages—loosely based on investors' out of pocket losses—accurately reflect social harm produced by a misleading disclosure.[103]

The reward payout must also be large enough to induce directors to file claims. Under the reverse negligence rule, inducing directors to file claims has both reputational and cultural dimensions. As a cultural matter, filing a claim is likely to carry a faint odor of mercenary intent during the initial years of the regime. From a reputational perspective, initiating a reward claim risks an affirmative judicial finding that director failed to exercise proper vigilance. To be sure, directors who merely failed to prove that they performed their duties would not fear stigma. But a party defending against a reward claim (whether the company or an insurer) might argue that a director not only failed to carry her burden of proof but was also affirmatively negligent or worse, and a court that made findings to this effect would severely damage the director's reputation. This risk is exacerbated by the open-ended nature of the reverse negligence rule, and the hindsight bias afflicting courts in the aftermath of serious management misconduct. Hence, unless

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101. *See* Black et al., *supra* note 9, at 17–18 (concluding that a near-zero risk of out-of-pocket liability for outside directors may be optimal); Kamar, *supra* note 97, at 896–900 (low and frequent sanctions are optimal in corporate law).

102. Setting sanctions higher than harm will not induce directors to exercise over-caution since exercising the "due" level of care shields directors from liability. *See* Steven Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 251–52 (2004); Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984). When sanctions are lower than harm, a negligence standard would have a stronger incentive effect than strict liability. *See* Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 47–49 (1986).

103. *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639 (1996).

directors were offered the prospect of very large rewards, they would be likely to give up the opportunity of receiving a reward to safeguard their reputations.[104]

D. *Board Divisiveness*

The reverse negligence rule aims at motivating directors to become vigilant gatekeepers of management. One could argue, however, that rewards would interfere with board cohesiveness and the trust between the board and senior management as directors wishing to qualify for rewards would become adversarial and uncooperative.

We would first like to note that any form of external legal intervention—rewards and liability alike—would interfere with board cohesiveness and group dynamics.[105] Indeed, one of the key objections to holding directors liable for oversight failures is that such intervention would adversely affect trust and cooperation within boards.[106] Conversely, those who support measures to enhance directors' liability believe that it is necessary to overcome the reluctance of individual directors to challenge group consensus.[107] We do not take a position in this debate.[108] As we explained earlier, this paper explores the potential benefits of rewards under the assumption that legal intervention is required to motivate vigilance.

The important question for us, therefore, is whether rewards are inherently more likely than liability to disrupt board cohesiveness. Liability arguably creates a common incentive for all directors to

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104. Several measures can overcome this concern. First, leaving courts out of the picture would make it less likely that fact finders would feel compelled to arrive at affirmative findings of directorial failure or publicize such findings. Second, policymakers could reduce uncertainty by specifying in advance what types of director conduct would merit a reward. Third, policymakers could limit eligibility to directors demonstrating exceptional vigilance. Finally, policymakers could devise a procedure under which third parties initiate the examination into directors' conduct. In the next Part, we sketch reward regimes that take advantage of some of these mechanisms.

105. *See generally* Donald Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

106. *See, e.g.*, Stephen M. Bainbridge, *Why a Board: Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 49–50 (2002) (arguing that judicial review might destroy the interpersonal relationships that foster internal board governance).

107. *See, e.g.*, James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435 (2004); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003).

108. *See also* Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, J. FIN. (forthcoming 2006) (developing a model showing that management-friendly boards may be an optimal governance structure under certain circumstances).

take measures that would reduce the risk of being found liable.[109] Rewards, in contrast, might create intra-board rivalry, especially if they are limited to exceptional conduct or a small number of directors. In order to be entitled to a reward, so the argument goes, a director would have to establish that she outperformed her peers. We judge the disruptive effect of rewards to be small, given the careful screening of directors for public companies, the powerful norms governing the behavior of individuals within small groups such as corporate boards, and the large ensemble of market and reputational incentives that act on corporate directors.

E. *Political Skepticism*

We expect political acceptability to be the principal obstacle to reverse negligence. The reverse negligence rule requires extensive legal design. It must be synchronized with the existing regime of director liability under both securities and corporate laws. This, in turn, requires lawmakers to address thorny questions, such as whether a single court should handle both liability and reward disputes, and the proper impact of settlements in shareholder lawsuits on a director's reward eligibility. Lawmakers would have to determine whether reverse negligence will be part of federal securities laws or state corporate law. Resolving these issues would require legislation and thus solid political support.

But the reverse negligence regime would have to overcome three sources of political resistance. First, the business community would likely oppose any reform—whether a rewards or a liability regime—that would empower courts to evaluate director conduct in hindsight. Second, the general public, which might well support a liability regime in a populist mood, would presumably react skeptically to a regime that rewards directors in the aftermath of corporate crises. Finally, the reverse negligence rule runs against deeply entrenched institutional and cultural norms under which courts' role is to impose sanctions rather than distribute rewards. Even judges might resist the notion that directors of failing companies should be rewarded for what might be perceived as merely doing their job (and failing). To be sure, clarifying the aims of this regime—encouraging vigilance to deter management wrongdoing—might persuade the

109. *See* Bainbridge, *supra* note 1, at 126 ("Duty-of-care litigation is typically concerned with collective actions taken by the board of directors as a whole.").

business community, the public, and the judiciary to appreciate the benefits that it offers. But it is difficult to identify a group that would be willing to bear the significant cost of such an educational campaign.

To summarize, as a technical matter, reverse negligence appears to be workable and, on balance, superior to negligence-based liability for directors. It would be no more costly to administer than a negligence regime and far less likely to distort board decisionmaking or recruitment practices. With proper legal design, reverse negligence would not disrupt established bodies of law and practice, such as the business judgment rule, the permissive conventions governing director indemnification and insurance, and the director exculpation provisions common in corporate charters. But the lack of sufficient political support renders this regime presently an unlikely candidate for success. Moreover, relative to the status quo, the principal policy objection to reverse negligence is also the principal policy objection to a negligence regime: the concern that courts won't get it right in evaluating director conduct in hindsight.

VI. Towards Workable Reform

The reverse negligence regime is problematic given political skepticism and prevailing cultural and legal norms. Even so, moreover our analysis thus far has demonstrated the advantages and the potential costs of rewarding directors. Drawing on this analytical framework, this Part offers preliminary sketches of two alternative reward regimes that just might work. Although narrower than reverse negligence, both regimes share its core features: they dispense generous, high-impact rewards for exemplary behavior after a review of director conduct that follows the occurrence of certain "triggering events." While we believe that the regimes we describe are workable, we nonetheless acknowledge that they require further study and discussion. This Part does not purport to offer a complete list of reward regimes. Rather, our goal is to encourage future attempts to devise novel proposals for director reward regimes.

A. *The Resignation Rule*

The reverse negligence rule does not specify what a director must do to earn a reward. As we explained earlier, this indeterminacy might discourage directors from filing reward claims. The first regime that we propose—which we term the "resignation rule"—addresses this shortcoming by

specifying what directors need to do to be eligible for a reward.[110] It also targets an important institutional disincentive to vigorous monitoring: the risk that an active and concerned director might be sidelined on the board and hounded into resigning.

The resignation rule would reward directors who lose their board seats in the line of duty. A director would become eligible for a reward under this rule when she filed a letter with the board: (1) announcing her immediate resignation; (2) detailing her suspicions about an incipient crisis or hidden company misconduct; (3) identifying facts that gave rise to her suspicions; and (4) describing her efforts to prompt action or investigation, which had either failed to move the board's majority or excited management's antagonism. If subsequent events vindicated the withdrawing director's suspicions, she would become eligible to receive a generous fixed reward.[111] To collect, the resigning director would merely submit her application and "exit letter" to the administrating authority, which might be a court (as under the reverse negligence rule) or the board itself (as we discuss in the next Section). If the director's suspicions prove to have been well founded, the company or its insurer would be forced to pay the reward unless it could be shown that the claimant had failed to communicate her suspicions before resigning, or that the board had immediately initiated action that should have made her resignation unnecessary. It may seem paradoxical that only failed gatekeeping efforts would be rewarded under this proposal, but it is not. Directors will presumably monitor more vigorously if they are protected from the financial and reputational costs of retaliation by a recalcitrant management.[112]

A difficult point in the application of the resignation rule, however, concerns the director who does not resign but is forced to depart because the company drops her name from the proxy as a candidate for reelection. A director might be excluded from the proxy for two reasons. On the one hand,

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110. The resignation rule is more akin to a regulatory regime than a liability regime. For a comprehensive review of the relevant considerations for choosing between liability and regulation, see Steven Shavell, *Liability for Harm versus Regulation of Safety*, 13 J. LEGAL STUD. 357 (1984).

111. On the considerations bearing on the magnitude of rewards, see *supra* Part V.C.

112. The SEC requires pubic companies to disclose promptly directors' departure, describe the disagreement triggering the departure, and file as an exhibit any written correspondence. See SEC, Current Report (Form 8-K), at 14–16 (requiring the disclosure of the departure of directors in Item 5.02), *available at* http://www.sec.gov/about/forms/form8-k.pdf. Disclosing the content of the exit letter immediately upon a director's resignation might discourage directors from truthfully listing their concerns and suspicions and would presumably undermine the effectiveness of the resignation rule. Thus, implementing the proposed rule might require the SEC to exempt the letter from the disclosure requirement.

management's allies on the board's nominating committee might be retaliating against an aggressive monitor. On the other hand, a director might be dropped for incompetence or disruptiveness. Ideally, directors who were excluded for the former reason should be eligible for rewards while directors who were excluded for the latter reason should be discouraged from filing an exit letter. However, given the practical difficulty of distinguishing between the two reasons for exclusion, our tentative inclination is to exclude "non-nominations" from the resignation rule, and limit rewards to directors who in fact resign. Doing this ensures that a director pays for the option of seeking a reward with her board seat, which makes the claim that she had fruitlessly sought to perform her monitoring duties more credible.[113]

The resignation rule offers both weaknesses and strengths. Its principal strength is that it clearly marks the path that directors must follow in order to earn rewards. The rule thus reduces uncertainty for directors ex ante and imposes few burdens ex post on reward administrators, who need only examine exit letters in light of subsequent events. Nevertheless, predictability comes at a cost. The resignation rule is unhelpful when, for example, a director discovers misconduct and remains on the board to participate in its rectification. Indeed, this rule might encourage some outside directors to resign prematurely. But the resignation rule is not meant to be a comprehensive device for motivating director oversight. Rather, it is designed to rectify a single failing of the existing market for directors: management's de facto influence over the tenure of directors. Moreover, if its objectives are limited, so are its likely political costs.[114]

B. *A Board-Administered Regime: Rewarding Leadership*

Our second proposal, which we term a "leadership regime," requires very little legal intervention. It would authorize boards themselves to reward directors who exercised extraordinary initiative in times of company crisis. The justification for this would be similar to the rationale for rewarding departing directors under the resignation rule: pursuing difficult issues and persistently asking tough questions in

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113. The resignation requirement mitigates the collective action problem characterizing boards. Without the resignation requirement, directors who happen to leave the board for whatever reasons could deposit confidential letters without taking any further action. Under the proposed rule, only the director who resigns will be entitled to a reward. Directors thus cannot free ride the vigilance efforts of their colleagues without personally incurring the cost of leaving the board.

114. The resignation rule offers an ancillary enforcement benefit: an exit letter puts the board on notice of possible wrongdoing, and thus makes it more likely that directors who do not resign will face personal liability for neglecting their gatekeeping duties, even under the weak, knowledge-based liability regime that prevails today.

the face of management indifference or hostility goes well beyond what most directors expect to do when they join their boards.[115] Directors who make this extra effort and who spark major corporate changes as a result deserve the special recognition of shareholders.

Companies would opt into the leadership regime by means of a charter provision requiring boards to consider whether to reward directors who had exercised exemplary initiative. The board's duty—and authority—to make leadership awards would arise after the occurrence of a triggering event, such as an involuntary departure of the company's CEO,[116] a major financial restatement, or an SEC investigation. The precise set of triggering events would be identified in each company's charter. In the best of worlds, moreover, the law would expressly provide for company charters to authorize leadership awards, much as Delaware law now blesses charter provisions that relieve directors of monetary liability for breach of the duty of care.[117] But the law's imprimatur would not be essential; including this regime in a respected code of best practices might be enough. Even without legislative change, state law presently allows corporations to adopt the charter provisions necessary for establishing the leadership regime.

Because the board would make leadership awards, it would be important to limit the number of eligible directors to one or two per triggering event. The award, after all, is meant to recognize *individual* initiative relative to the behavior of other board members; it is not intended to allow the entire board to give itself a bonus for a job well done, as this would undercut the function of the award as well as its political credibility. The number of recipients per period should be limited explicitly, in the company's charter, and also implicitly, by setting a high threshold for eligibility. In particular, leadership awards should not be granted to directors who were merely non-negligent in supervising management, but only to those who took the initiative and performed a leading role in sparking corporate change.[118]

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115. *See, e.g.*, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 103–04 (1985); Langevoort, *supra* note 105, at 797 ("[T]he work of the board prizes consensus, not conflict.").

116. The company can define in advance the circumstances under which the CEO's resignation would qualify as a forced resignation for our purposes. For example, the company can determine that a resignation in conjunction with events such as a restatement or the opening of an SEC investigation would be considered a forced resignation.

117. DEL. CODE ANN. tit. 8, § 102(b)7 (2001).

118. Such limitations should virtually eliminate any concern that the triggering-event requirement would perversely affect boards. *See supra* Part V.A.

The considerations bearing on magnitude would be similar to those we discussed earlier,[119] with the exception that directors would not be expected to initiate reward claims. Furthermore, if boards rather than courts administered leadership awards, there would be more room to adjust their magnitude to the particular characteristics of a director's actions. Whatever the size of a leadership award, moreover, the corporation itself would presumably have to pay it, since the board could not both select the recipients and expect an insurer to foot the bill. For small firms, this might mean that the board should make provision ex ante to assure the availability of funds for a reward even if the company were to become insolvent.

The real question with respect to the leadership regime is: why should it work at all? Why should the same institution that initially greets the prodding of an activist director with indifference or even hostility later become capable of assessing her eligibility for an award? Or, since we talk of incentives here, why would an activist director who faces initial resistance later expect the board to gratefully recognize her efforts to the tune of a million dollars or more?

The answer has several parts. To begin, boards are better positioned than courts to acquire the information necessary for evaluating director conduct, especially when the inquiry focuses on quite elusive actions, such as sparking a corporate change.[120] If one or two directors mobilize their colleagues by exposing wrongdoing that results in a material change in corporate governance—say, a displacement of the CEO or a restatement of the financials—the importance of the contribution that these directors have made to the firm's governance will be obvious to everyone on the board, including the remaining directors and the new CEO.[121]

The question is whether boards could be relied upon to deny payments to those who do not deserve them (the collusion problem) and to make payments to those who do (the retaliation problem)? One important check on the quality of the board's decisionmaking is the fact that the corporate crises we

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119. *See supra* Part V.D.

120. For a review of recent action by boards to oust CEOs, see Alexei Barrionuevo, *The Rise of the Boards*, N.Y. TIMES, Mar. 15, 2005, at C1 (reporting board action leading to the departure of CEOs at Disney, Hewlett-Packard, Boeing, and other companies).

121. Leaving courts out of the picture also makes this regime far less dependent on political support, which would be difficult to obtain given the considerations we discussed in Part V.E.

suggest as triggering events—major financial restatements or involuntary terminations of CEOs—are typically accompanied by a change in the management team and major turnover on the board. The board after a crisis is unlikely to be the same as the board that presided before it.[122] In addition, companies could adopt mechanisms that would alleviate collusion concerns. For example, a special committee of new or disinterested directors might be charged with making awards. The board could also commit to obtaining shareholder approval of such awards. Finally, press coverage and intra-board rivalries would make it difficult to reward a single continuing director without good reasons to do so.

The need for a fresh start in the wake of a regime change or major financial restatement is also the best guarantee that continuing directors will not retaliate against the activist director who uncovered wrongdoing or pressed for new management. Under the leadership regime, we would not permit lawsuits to compel boards to pay out awards, as this would implicate legislative intervention and judicial participation that are contrary to the self-help character of this regime. Instead we would rely on the reputational value to the company of celebrating its honest and persistent directors, particularly when these directors remain on the board. In addition, if a new management team assumes control of the company in the wake of a crisis, as frequently happens, these managers will have every reason to feel grateful toward the directors who sparked the fall of the old regime.

Like the resignation rule considered in the previous Section, the leadership regime is underinclusive. It is unlikely, for example, to provide incentives for directors to perform routine oversight tasks such as the hard work of the audit committee and particularly of its chair. The leadership regime is also less precise in terms of the conduct it reaches. Directors would have a difficult time predicting ex ante how to qualify for this reward. On the other hand, the fact that a company recognizes the possibility that individual initiative on the board may pay large dividends to the company and its shareholders will have an important incentive effect. The fact that the leadership award is wholly voluntary and requires

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122. *See, e.g.*, Kathleen A. Farrell & David E. Whidbee, *The Consequences of Forced CEO Succession for Outside Directors*, 73 J. BUS**.** 597 (2000) (finding increased likelihood of outside director turnover following forced CEO succession). *But see* Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, J. FIN. ECON. (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687412 (finding no evidence of abnormal turnover of outside directors on the boards of firms facing shareholder lawsuits).

almost no government involvement also increases its political attractiveness. If the costs are low enough, there is every reason to adopt a reward regime even if we believe that its determinations will be noisy and its error rate high.

C. *Extensions*

We have outlined two tentative regimes that may translate the advantageous features of rewards into a workable arrangement. While they differ on many aspects, both regimes seek to encourage outside directors to demonstrate initiative, leadership, and willingness to challenge management when necessary—precisely the type of conduct that equity pay and court-imposed sanctions are inherently incapable of producing. This menu of reward regimes, however, is by no means complete. The benefits of rewards may be achieved by other innovative rules designed to implement the core features that we have identified—substituting rewards for sanctions and relying on ex post evaluation of director conduct.

Our analysis assumed that rewards should be granted to individual directors based upon an assessment of their performance. But rewards could be employed in some group settings as well. Collective rewards may be useful when there is a need to encourage members of a board's committee to act as a group rather than demonstrate individual leadership, or when identifying the contribution of each member is difficult. Consider, for example, a rule that would reward all members of the audit committee for making the company restate its financials**.** This would enhance the incentives of committee members to uncover problems with the company's financial statements without requiring fact-finders to enter the thicket of determining which members of the committee outperformed her peers in investigating red flags in the company's financial disclosure.

Furthermore, institutional investors could become more active in devising innovative reward regimes, encouraging companies to opt into such regimes,[123] and perhaps even administering rewards. Institutional investors make considerable investments in various corporate governance matters—with respect to both specific companies and overall market issues. They are thus positioned to develop a mechanism for rewarding directors who demonstrated exceptional leadership during corporate crises.

123. Institutional investors currently encourage companies to include equity pay in the compensation arrangements of outside directors. Yermack, *supra* note 15 at 2282.

Institutional investors are also positioned to evaluate directors' conduct and offer rewards to directors who demonstrated exceptional vigilance. Such a regime would have several attractive features: it provides a viable source of funding that is less susceptible to collusion; it does not require directors to initiate reward claims; and paying directors by a third party is less likely to raise objections.

VII. Conclusion

The preceding Part addressed a family of reward regimes loosely based on the principle of reverse negligence as a means of motivating corporate directors. As outlined above, regimes of this sort would reward directors for diligent monitoring during certain identifiable periods—generally speaking, periods of harm to the firm or managerial misconduct. At first glance, these regimes might seem to reward directors for bad outcomes. In fact, however, the association of rewards with bad outcomes is merely a matter of administrative economy. The true effect of these regimes is to induce outside directors to monitor most closely during precisely those periods when their vigilance is most needed—that is, when management is misbehaving. The likely result would be the deterrence of some misconduct (as managers desist from misbehaving for fear of being discovered), and the interruption of other wrongdoing midstream (as directors discover ongoing wrongdoing).

To be sure, a negligence-based liability regime could create the same incentives as the reward regimes we describe. But liability would pose obstacles to recruiting top-caliber directors and pressure boards toward risk-averse decisionmaking. Thus, expanding directorial liability would be not only far more costly than offering rewards, but also infeasible on political grounds. Over the years, the law has woven a cocoon of liability insulation around the director's oversight role, and this is unlikely to change any time soon. If legal reform is needed, a reward regime—of the reverse negligence type—may be the only practicable alternative.[124]

124. The other alternative—which lawmakers currently follow—is regulating board functions and structure. *See* Fairfax, *supra* note 53 at 400-05.

This Article focuses on outside directors. But would rewards outperform liability with respect to other kinds of gatekeepers as well?[125] A full answer is beyond the scope of this Article. Nevertheless, we would like to generalize about the qualities that might make a gatekeeper's role suitable for a reward regime by briefly returning to the characteristics that make outside directors attractive candidates for rewards. There are, by our count, at least four of these characteristics.

The first is the "lumpiness" of the directors' services and the magnitude of the harm that they can prevent relative to the size of their own assets. Directors are individuals—not organizations[126]—who sit on a small numbers of boards for long periods of time. Conventional wisdom suggests that most directors are wealthy executives for whom directors'fees are small relative to personal assets, and therefore not strong motivators. But even if directors expect "large" compensation relative to their assets, the possible liability they would face (relative to their assets) under a negligence regime is still larger. As we have argued, this catastrophic liability risk, which cannot be fully insured if it is to provide meaningful monitoring incentives, produces recruitment difficulties and distorted decisionmaking.

Second, as we note above, directors have two functions: they are both managers' monitors and advisers in business decisionmaking. Personal liability, which arguably enhances the director's monitoring performance, simultaneously distorts her performance as an advisor and architect of corporate policy. In theory, paying rewards only in the aftermath of certain harmful events also would distort the director's performance by motivating her to select risky ventures for the company. Rewards, however, are less likely to degrade directorial advice because directors have neither the power—given their limited responsibility for initiating projects—nor the inclination—given the severe market and legal consequences that follow misconduct—to urge overly risky business strategies. Put differently, by virtue of their organizational roles, directors are asymmetrically susceptible to distorted decisionmaking on the side of excess caution rather than risk-taking.

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125. We assume that rewards lose their appeal with respect to primary wrongdoers, at least with respect to intentional misconduct.

126. In some jurisdictions, organizations qualify to serve as directors. The possibility of "entity" directors raises additional gatekeeper alternatives that parallel those we discuss below in the context of accountants.

A third characteristic that makes directors well-suited to a reward regime is the fact that they act collectively in a small group rather than individually. Monitoring by groups is inevitably subject to free riding and other collective action problems. Even if all directors faced equal liability costs for failing to challenge a problematic course of action pressed by the CEO, each director might refrain from making a challenge—assuming a challenge would risk costly retaliation—in the hope that another director would step up to the plate. This problem is exacerbated by the pressure on directors to settle shareholder lawsuits, thereby preventing courts from scrutinizing the performance of individual directors. By contrast, individualized compensation under a reward regime would overcome this collective action problem.

Finally, and perhaps most importantly, the difficulty of describing ex ante precisely what a director must do in fast-moving business circumstances makes directors particularly suitable candidates for a reward regime. Uncertainty as to the precise content of a director's duty under a negligence rule leads to a high risk of error, which in its turn aggravates the secondary liability costs of recruitment and distorted decisionmaking. By contrast, even if it left error rates unchanged, a reward regime would eliminate liability costs associated with recruitment and reduce the costs of distorted decisionmaking. Moreover, because the prospect of rewards will motivate directors to reveal rather than conceal information about their own behavior, a reward regime is likely to lead to more informed evaluations of directorial conduct and, therefore, fewer errors.

The importance of these four elements of the outside director's role in favoring reward-based incentives over liability can be gleaned from the fact that at least one class of participants in corporate governance—auditors—have long been held liable under a negligence regime for monitoring failures. Auditors stand at the opposite end of the spectrum from directors on all four characteristics that recommend a reverse negligence regime. The auditors of public companies are large firms rather than individuals, with deep pockets and diversified professional relations that extend to hundreds or even thousands of clients.[127] Outside auditors are gatekeepers pure and simple. Their sole function is to monitor the firm's financial statements; they are not involved in other aspects of the firm's

127. *But see* Floyd Norris, *Will Big Four Audit Firms Survive in a World of Unlimited Liability?*, N.Y. TIMES, Sept. 10, 2004, at C1 (reporting the industry's concern that auditor liability would cause audit firms to become insolvent).

decisionmaking.[128] In addition, auditors qua organizations are unitary entities; they do not face conventional collective action problems, even though—as the fate of Arthur Andersen in the Enron debacle suggests—accounting firms can face severe agency problems.[129] Finally, auditors pursue a highly elaborate methodology that can be described ex ante and evaluated ex post with far more precision than a director's duty of care. On all dimensions, then, liability under a negligence rule makes far more sense for auditors than for outside directors. Correlatively, a reward regime of the reverse negligence variety appears less appealing for auditors. Without auditor liability, the risk of implicit collusion between auditors in search of rewards and managers intent on misrepresentation seems unacceptably large; with auditor liability, there is no need for a parallel reward regime.

This analysis tells us that auditors—in contrast to outside directors—are poor candidates for a reverse negligence regime. It does not imply, however, that the existing regime provides auditors with adequate incentives.[130] Nor does it answer the larger question of whether the law might improve auditor incentives with a different sort of reward regime. Here the possibility of "reverse strict liability" comes to mind, or, alternatively, of a regime that would allocate rewards on an aggregate basis, according to a normalized measure of financial restatements among all of an auditor's clients. We list these possibilities not because we endorse them, but because they demonstrate that augmenting the traditional liability regimes with a full set of possible legal sanctions, both negative and positive, can provide potentially valuable tools for fixing the incentives of gatekeepers that have not yet been analyzed—or even imagined.

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128. In fact, lawmakers impose various restrictions on auditors' ability to provide their clients with non-audit services. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1533–37 (2005). Section 404(b) of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 789, introduced a requirement that auditors attest to managerial assessments of internal controls and report their conclusions publicly. On the implications of this new internal control audit requirement, see Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability, and Safe Harbors*, 55 HASTINGS L.J. 1449 (2004).

129. *See* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167 (2003).

130. The proper scope of auditor liability is indeed controversial. *See, e.g.*, John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 349–53 (2004) (offering a new regime of auditor liability); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39 (2002) (advocating a regime of financial statement insurance that would replace the existing audit system).

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