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Shareholder Suits and Outside Director Liability: The Case of Korea*

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Abstract

Reforms to Korean corporate and securities law carried out in the wake of the 1997-1998 East Asian financial crisis included a mandate that boards include a minimum number of outside directors and facilitation of shareholder lawsuits against board members for damages. The strategy of imposing liability risk on directors (both inside and outside) appeared to follow U.S. practice. In the U.S., outside directors of public companies are often sued but rarely face personal, or "out-of-pocket," liability unless they engage in self-dealing. Instead, damages and legal fees are paid by the company, directors' and officers' (D&O) insurance, or both. Outside directors of public companies in Australia, Canada, Britain, France, Germany, and Japan similarly rarely face out-of-pocket liability due to shareholder lawsuits. Moreover, when events have occurred in these countries that increase the risk of out-of-pocket liability, there is a strong tendency for political or market forces to reestablish a non-zero but minimal level of risk for actions that do not involve self-dealing. Korea's experience seems to be similar. We argue that Korea could go somewhat further to encourage litigation against outside directors of public companies, but should not open the way for "out of pocket" liability to become commonplace.

I. Introduction

Korea engaged in extensive corporate governance reform after the 1997-1998 East Asian financial crisis. The reforms included a mandate that outside directors constitute a significant fraction of public company boards, new fiduciary duty rules, the creation of a procedure for securities class actions, a sharp reduction in the ownership threshold for shareholders to

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bring a derivative suit, and changes in attorney fee rules.[1)]

Key expectations underlying these legislative actions were that outside directors can play an important role in monitoring and constraining potentially wayward or corrupt managers and controlling shareholders, and that the threat of liability will enhance the incentives of outside directors to be vigilant.[2)] One by-product of reform was that the previously moribund derivative action procedure became viable. While there were no derivative suits filed before 1997, at least 20 had been filed by early 2003, and 55 by the end of 2010, with some of the suits brought against directors of leading *chaebol*, including Samsung, LG, and Hyundai Motors.[3)] Commentators, echoing fears voiced in other countries, worried that legal risk would cause candidates not to serve, and "that Korean companies will be deprived of honest and competent directors precisely at a time when they are most needed."[4)]

In this article, we seek to put into context the Korean corporate governance reforms that require a minimum number of outside directors and impose liability on those directors. Based on experience elsewhere, we predicted in 2004, when this article was initially prepared for a conference at Korea Development Institute,[5)] that even if the new rules prompted a

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1) This article was prepared for a conference held in 2004, and has been only lightly updated for publication. The published version will also be available on SSRN, at http://ssrn.com/abstract=628223. We do not read Korean and cite only English language sources, but were advised by experts in Korean law that our description of Korean law, while lacking nuance, is a fair summary. The non-Korea-specific analysis in this paper is adapted from Black, Cheffins and Klausner (2006a), Black, Cheffins and Klausner (2006b), and Cheffins and Black (2006). Earlier versions of this paper were presented at a conference on Corporate Governance and the Capital Market in Korea and at Stanford Law School. We thank KDI School of Public Policy and Management for financial support, and Joongi Kim, Kon Sik Kim, Hwa Jin Kim, Woo-Chan Kim, Young Sam Kim and Jung Soo Lee for answering our questions about Korean law and practice, anonymous referees for feedback, and Young-Jae Lim for organizing the conference for which this paper was prepared.

2) For evidence that investors share at least the first expectation, and value Korean firms with at least 50% outside directors more highly than other firms, see Black, Jang and Kim (2006); Black and Kim (2011); see also Choi, Park and Yoo (2007).

3) The 2003 figure is from Park and Lee (2003); data through 2010 is from Rho and Kim (2011), appendix 1.

4) Park and Lee (2003), at 17.

5) KDI originally planned to publish conference proceedings, but in the end did not do so. We are grateful to the *Journal of Korean Law* for the opportunity to publish this article here,

surge in lawsuits against outside directors (a question on which we, as outsiders, were ill-equipped to speculate), there would be few cases in which outside directors paid damages or legal expenses out of their own pockets, unless they engaged in self-dealing, which itself is rare for outside directors. We know of no country in the world where outside directors face a large risk of "out-of-pocket liability" — a personal payment by the director, not reimbursed by the company or by D&O insurance — due to shareholder lawsuits. In the United States, for example, outside directors are frequently sued but rarely pay damages or legal expenses personally as a result of these suits. Instead, if a suit survives the defendants' efforts to have it dismissed at an early stage, it will almost always be settled prior to trial with any damages and legal fees paid entirely by the company, by directors and officers' (D&O) insurance, or both.

As we explain by describing arrangements in three other common law countries (Australia, Canada, Britain) and three civil law countries (France, Germany, and Japan), the bottom line is the same in other jurisdictions. The potential for out-of-pocket liability exists, but actual payouts are uncommon. Moreover, from a historical perspective, when events occur that threaten to make out-of-pocket liability a reality for outside directors, political or market forces typically emerge to reduce outside directors' risk of making an out-of-pocket payment to a very low level.

When we prepared the initial draft of this paper for a 2004 conference, the experience in other countries suggested to us that the outcome might well be same in Korea. We predicted that there might be occasional instances where outside directors of Korean public companies paid damages or legal expenses personally, in the absence of self-dealing, but these cases would likely be uncommon. We also predicted that if out-of-pocket payments occurred with any frequency, this would be likely to provoke a political and market response to ensure that out-of-pocket liability remained rare.

In 2011, with the benefit of seven years of hindsight, our predictions seem largely correct, so far. Securities class actions, the most important source of out-of-pocket liability in the U.S., have thus far been rare in Korea.

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updated through 2011.

In the derivative suits that have been brought, settlements with directors have been rare.[6] We know of only two cases in which outside directors of Korean public companies have been found liable and in one, the outside directors did not pay personally. In the other, the source of payment is not known.

Moreover, the Korean Commercial Code has just been amended to permit companies to amend their articles of incorporation to limit director liability to six times annual compensation for inside directors and three times annual compensation for outside directors, absent self-dealing.[7] We expect, based on experience with similar provisions in the U.S., that many public companies will adopt these limits. This is precisely the kind of political reaction one finds in other countries when concerns about liability risk of outside directors arise. If most companies in fact do adopt a liability cap, this risk will be nearly negated. For outside directors, a liability cap of three times annual compensation is so low that it would make no sense to bring a suit motivated by financial recovery. Suits might be brought, perhaps by shareholder activists, to make an example of particular directors, so as to deter others. But the risk of giving back one's compensation hardly poses a serious financial risk to outside directors.

Is Korea's current resting place, including these limits on liability, a good policy outcome? Our assessment is that very low but non-zero risk for outside directors is a reasonable outcome. A substantially higher degree of risk is not readily achievable, and if achieved, might cause more harm than good by deterring good director candidates from serving and inducing risk aversion among those willing to serve.

At the same time, we believe that *some* exposure to liability is likely to be salutary. We worry that the new limits on monetary liability in suits under corporate law, coupled with the rarity of class action suits under securities law, and the likelihood that outside directors will not be named in these suits, might leave outside directors underexposed to the risk of liability. "Related-party transactions" — transactions between companies under common control, or between companies and their controlling shareholders — remain a problem for at least some Korean companies and *chaebol*

6) Rho and Kim (2011).

7) Korean Commercial Code § 400 (effective 2012).

groups. We would want outside directors to have good reason to police the fairness of those transactions, and believe a very low but non-zero risk of out-of-pocket liability helps to achieve this outcome.[8)]

The layout of the paper is as follows. Part 2 discusses outside director liability risk in the United States. Part 3 does the same for Australia, Canada, Britain, France, Germany, and Japan. Part 4 discusses the Korean situation in light of the experiences of these other countries. Part 5 discusses the policy implications of our analysis.

Our analysis focuses on outside directors of public companies. We do not consider unlisted companies. We also do not address inside director liability except to illustrate points we make concerning outside directors. We also exclude cases, which we expect to be rare, where outside directors of public companies put money in their own pockets or otherwise act with a conflict of interest. Thus, we focus on outside directors' duties to be vigilant, and not their separate duty to place the shareholders' interests before their own.

II. Outside Director Liability in the United States

Directors of U.S. public companies face an array of legal obligations. Under federal securities law, they are liable for a company's failure to comply with public disclosure rules if they fail to exercise "due diligence" in verifying the information that their company provides to investors in connection with a public offering of securities.[9)] They are also liable under the securities laws for errors in corporate disclosures unrelated to the issuance of securities if they had knowledge of, or were severely reckless in failing to prevent, a materially false misstatement or omission.[10)] Under corporate law, directors can be liable for breach of the fiduciary duties of

8) For empirical evidence on related-party transactions within Korean *chaebol*, see, e.g., Almeida, Park, Subramanyam, and Wolfenzon (2010); Bae, Kang, and Kim (2002). For evidence on the role of outside directors in monitoring related party transactions, see Black, Kim, Jang, and Park (2011).

9) Securities Act of 1933, § 11.

10) Securities Exchange Act of 1934, § 10(b), and related Securities and Exchange Commission Rule 10b-5.

care and loyalty that they owe to the company.

Class action procedural rules and rules governing derivative suits make it reasonably easy to bring suits against companies and their directors under securities and corporate law. Lawyers typically initiate a suit and, as a practical matter, make decisions concerning how the suit proceeds, including whether to settle with the defendants and if so under what terms. If a class action suit is successful or is settled out of court, the judge will generally award legal fees out of the proceeds to the lawyer.[11] In a derivative suit, the corporation can pay the legal fees of the plaintiffs' lawyers as long as the suit has conferred a "substantial benefit" on the corporation. Such a conclusion is typically part of a settlement between directors and the plaintiff shareholders. While judges must approve settlements, and sometimes limit legal fees, they rarely object to *some* fee award.[12]

In contrast with the practice in Korea and most other countries, defendants pay their own legal expenses in the U.S. even if they win the suit. This means a plaintiffs' lawyer bringing a weak case does not have to worry about paying the defendant's expenses if the claim is dismissed. Although the Private Securities Litigation Reform Act of 1995 provides an exception to this rule by giving judges discretion to order plaintiffs to pay defendants' legal fees, that provision has yet to be invoked.

The substantive and procedural rules governing shareholder suits in the U.S. yield numerous lawsuits every year in which outside directors of public companies are named as defendants. No good count is available, but the annual total is surely dozens, and could be as many as 100-200. The outside directors are sometimes sued along with executive directors and, in securities suits, the company itself. (There are also many suits that are only against executive directors.) A significant fraction of the suits involving outside directors are successful in the sense that plaintiffs receive payments in settlement of their claims. Those payments, however, almost never come from the pockets of the outside directors themselves. We researched outcomes in lawsuits against outside directors under U.S. law from 1980-2005. Self-dealing, itself uncommon, aside, we found only 11 instances of

11) Coffee (1986), at 678-79.

12) Armour, Black, and Cheffins (2011).

personal payments, principally under securities law. All but one involved settlements prior to trial.[13] Since 2005, we are aware of several additional cases in which outside directors made out-of-pocket payments.[14] The overall pattern of occasional but rare out-of-pocket payments continues to prevail.

The apparent anomaly of frequent shareholder suits and virtually nonexistent outside director liability is the product, in part, of legal rules that screen out suits failing to meet a threshold degree of gravity at an early stage. For derivative suits, charter provisions that eliminate the liability of outside directors for monetary damages for breach of the duty of care are an important barrier to personal liability. These provisions can be adopted by corporations under the corporate laws of Delaware and most other states, and almost all public companies have in fact taken advantage of this option. These charter provisions serve as a basis for a case to be dismissed at the outset unless the plaintiffs successfully allege facts indicating that the directors' actions go beyond a breach of the duty of care.[15]

Even if a corporation lacks a charter provision limiting the liability of outside directors, courts in the U.S. review board actions pursuant to the "business judgment rule," under which a judge will refrain from questioning directors' actions so long as they acted without a conflict of interest and the board followed a reasonable process in making a decision.

For securities litigation, a different filter exists. Here, a case will be dismissed unless the plaintiffs support their claim by alleging specific facts regarding the defendant's actions that would support liability. These allegations must be made before plaintiffs may use the discovery process to obtain company documents and to depose or interview key corporate personnel. Many suits in which outside directors are named as defendants are dismissed on this basis.

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13) Black, Cheffins, and Klausner (2006a).

14) The cases we know of with confirmed personal payments are Just For Feet, Maxim, and Mercury Interactive. Details on these cases are available from the authors on request.

15) The directors must act in good faith in order to benefit from this shield against monetary damages, but the Delaware courts (most U.S. public companies are incorporated in Delaware) have interpreted this to require "conscious disregard" of duty — a very high standard that is rarely met. *In re* The Walt Disney Company Derivative Litigation, 906 A.2d. 27, 62-67 (Del. 2006).

Derivative and securities suits do go forward despite these screens, but additional rules come into play to protect outside directors in those cases. Most importantly, in a securities suit, whenever the outside directors are liable, the company will be liable as well, and will almost surely be named as a co-defendant. So long as the company is solvent, it is a more attractive target than the directors for several reasons. First, it is likely to be a richer source of recovery for plaintiffs. Second, the law gives outside directors certain legal defenses that it does not give the company itself. For example, in cases involving disclosure violations in a securities offering, outside directors will not be liable if they exercised a reasonable degree of diligence with respect to the underlying disclosure. The company itself, however, is liable nonetheless. Third, if outside directors are held liable, they are responsible for damages only in proportion to their culpability relative to other defendants. Since outside directors normally play a reactive, monitoring role, their relative culpability will typically be low.

Another important layer of legal protection for outside directors facing a suit is indemnification by the company, which is permissible under state corporate law so long as a director has acted in "good faith." Under the good faith limitation, indemnification is impermissible if a director has engaged in self-dealing or has been consciously inattentive to the extreme. In a derivative suit, the law allows a company to pay only a director's litigation costs. In securities litigation and direct suits by shareholders under corporate law, indemnification can include damages payments as well.

U.S. corporate law further allows companies to purchase directors' and officers' (D&O) liability insurance, which covers the legal expenses and damage payments that directors and senior officials incur, and which is broader in its coverage than indemnification. Virtually all U.S. public companies purchase D&O insurance. D&O insurance coverage is broader than indemnification partly because it also covers derivative suits, and partly because it is not limited by the "good faith" requirement for indemnification.[16] Moreover, whereas indemnification will be unavailable

16) Insurance policies do typically deny coverage in cases where a director engages in "deliberate fraud" or obtains an "illegal profit."

if a company is in insolvent, D&O insurance will remain in effect.[17]

These multiple sources of protection for outside directors combine to provide a setting in which the vast majority of cases settle before trial on terms that leave the outside directors' assets intact. Consider a class action under federal securities law, the type of litigation most likely to pose risks for outside directors of public companies. Outside directors, fearing that a trial could result in out-of-pocket liability, will welcome a settlement that is funded entirely by the company or the D&O insurer.[18] Shareholders' lawyers will be similarly inclined since going to trial is always risky and time-consuming, particularly in light of the inevitable appeal if outside directors face out-of-pocket exposure. Moreover, if a case goes to trial, facts may come to light suggesting that management knowingly participated in the wrongdoing, which could give the insurer grounds for denying coverage for the company and the managers based on the standard insurance exclusions for deliberate fraud or illegal profit (outside directors who did not know of the fraud or personally profit will still be covered, under a commonly used "severability" clause). Finally, if the company is insolvent, the incentive to settle, for plaintiffs and their lawyers, may be even stronger. Since the same D&O policy pays for the defendants' litigation expenses and for damages, if the case goes to trial, the defendants will spend lavishly on their defense and as a result deplete the funds available to the plaintiffs and their lawyers.

The insurers will likely accede to a settlement agreed upon by the shareholders' lawyers and the defendants. For a variety of reasons, including a "duty to settle" rule that makes it difficult for them to oppose a settlement within policy limits that the policyholder favors, insurers often lack leverage to block a settlement and to force a trial. The premiums that

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17) Trustees of insolvent companies have in the past sometimes sought to claim that a company's D&O policy's coverage is an asset of the company, and should be applied, in full or in part, to the company's liability, leaving reduced coverage for directors. Policies being written today, however, treat directors' coverage as taking precedence over the company's coverage, thus ensuring that the full policy limits are available to the directors if the company becomes insolvent.

18) In addition to covering the liability of officers and directors, D&O insurance commonly covers the company's payments directly to plaintiffs as well as payments to indemnify directors and officers.

D&O insurers charge are based on an expectation that they will not strongly contest settlements, so shareholders ultimately bear the cost of this arrangement. Even shareholder activists who have lobbied for corporate governance reform and for tougher financial sanctions for misbehaving corporate executives have rarely objected to settlements that leave outside directors' assets untouched.

Ultimately, based on experience to date, outside directors of U.S. public companies face a real risk of out-of-pocket liability under federal securities laws only if there is a "perfect storm": the company is insolvent, there is significant evidence of outside director culpability, D&O insurance is inadequate (potential damages dramatically exceed available D&O coverage, the insurer has reasonable grounds for denying coverage, or perhaps both), and one or preferably several outside directors have serious personal wealth.[19] These perfect storms are rare.

Derivative suits under corporate law pose even less risk to outside directors' personal assets than securities law suits. Again, almost all U.S. public companies have charter provisions that bar suits for monetary damages against directors based on a breach of the duty of care. A derivative suit thus needs to claim that the directors engaged in self-dealing or otherwise failed to act in "good faith." The ultimate prize sought by plaintiffs in suits against directors, however, typically will be D&O insurance proceeds, and policies typically exclude coverage for fraud and illegal profits. The result is a legal obstacle course: plaintiffs' counsel must typically allege that self-dealing occurred, so as to get around the charter provision, but then seek to settle in a way that keeps the D&O policy available. Going to trial and losing is obviously not a desirable outcome. Neither, however, is going to trial and proving too strong a case! The settlement dynamics therefore resemble those with securities litigation: no party wants a trial, and a settlement funded by the insurer (in turn financed by premiums reflecting this risk) is the path of least resistance.

So, if U.S. outside directors of public companies rarely pay out of their own pocket, why are they often named as defendants in lawsuits? Outside directors might well feel nervous about the possibility of a trial, so naming

19) The presence of just one rich outside director may not change the plaintiffs' calculus due to the securities law rule that caps liability based on proportionate fault.

them increases the pressure on management to settle. The efficacy of this strategy is reinforced by the perceptions of outside directors. There is reason to believe that they are more concerned about ending up out-of-pocket than is merited by the facts.[20] This misapprehension reinforces the momentum in favor of settlement.

The equilibrium consisting of frequent suits against outside directors and protections designed to preclude out-of-pocket liability has been stable over time. As new concerns about actual liability have emerged, markets and lawmakers have responded each time to shield outside directors. Up to the 1960s, a public company would simply foot the bill if a director had to pay legal expenses or damages. After a 1939 ruling by a New York court cast doubt on the authority of companies to indemnify directors a market developed for D&O insurance, which had previously been rare.[21] Since that time, gaps in D&O insurance coverage have occasionally opened up, but the response has been for insurers and companies to negotiate policy language that closes the gaps, usually before many outside directors have fallen through and had to make personal payments.

On the lawmaking front, when case law created doubts about the permissibility of indemnification, Delaware and many other states amended their corporation statutes to provide explicit legal authorization.[22] Further amendments to corporate law occurred in the late 1960s to override restrictive judicial interpretations of existing indemnification laws and to authorize specifically the purchase of D&O insurance by companies.[23] In the mid-1980s *Smith v. Van Gorkom*, a famous Delaware case that resulted in actual liability for outside directors, prompted the enactment of legislation in Delaware and other states that permits companies to adopt corporate charter provisions eliminating director liability for breaches of the duty of care. A decade later, a surge in securities litigation prompted legislative

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20) For the past eight years, one of us (Klausner) has surveyed hundreds of outside directors at various executive education programs on their views regarding liability risk. On average, respondents indicated that they believe outside directors have suffered out-of-pocket losses in about 5% of shareholder suits. This greatly exceeds the actual risk, which to date has been a small fraction of 1%.

21) Bishop (1966), at 96-103.

22) Ibid., at 96-98.

23) Bishop (1968), at 1081-86.

amendments at the federal level (the Private Securities Litigation Reform Act of 1995) that reduced directors' exposure along several dimensions.

These political responses are not accidental. Corporate managers are a powerful lobbying force with a strong interest in protecting both themselves (as officers and inside directors) and outside directors from out-of-pocket risk. Moreover, there is no strong countervailing pressure to put outside directors at significant risk of out-of-pocket liability. Although institutional investors support corporate governance reform generally, they have not sought to expand outside director liability. Indeed, since they advocate that companies rely heavily on outside directors and want public companies to be able to hire good candidates, it would be contradictory for them to support outcomes likely to cause people to shun such posts. Similar reasons could explain why institutional investors routinely approve charter provisions that shield directors from liability for breach of the duty of care. Shareholders' attorneys oppose efforts to reduce the legal responsibilities directors face, but are content for companies to make liberal use of indemnification and D&O insurance. Assuming reasonable policy limits for D&O insurance, shareholders' attorneys rarely find it worthwhile to seek personal payments and thus are unlikely to lobby strongly with regard to reforms that would increase — or limit — outside directors' exposure to personal liability, as opposed to "nominal liability" where another source provides the actual payment. Thus, in the United States there is a rough political equilibrium supporting reasonably robust nominal liability, yet limited out-of-pocket liability risk.

III. Outside Director Liability Outside the United States

To assess whether the U.S. situation of low actual out-of-pocket risk was similar in other countries, we investigated the situation in Australia, Great Britain and Canada (all common law countries) and France, Germany, and Japan (all civil law countries). We found that in all of these countries, outside directors face only a remote risk of out-of-pocket liability. The legal rules differ substantially across borders, but the bottom line is the same: unless blatant self-dealing is involved, out-of-pocket liability is rare. In this section we summarize how the legal systems of these six countries produce this result.

In each country, outside directors play an important role in corporate governance. In Australia, Britain and Canada, companies have a unitary board structure and most public companies have a number of outside directors. In France, public companies are organized as SAs (Sociétés Anonymes) and an SA's board cannot have more than one-third executive directors. In Germany, public companies operate as AGs (Aktiengesellschaften). The AG board structure is divided into a management board (Vorstand) and a supervisory board (Aufsichtsrat), with executives precluded from serving on the supervisory board. Finally, in Japan, while the boards of large companies traditionally were comprised entirely of executives, outside directors are becoming more common. This trend was facilitated by a 2002 amendment to Japanese company law that explicitly authorized companies to create board committees, including committees staffed by outside directors.[24)]

In all six countries, the theoretical potential for out-of-pocket liability exists. In each, directors owe duties to their companies to act with care and skill and to act in their companies' best interests. Also, in each country, investors formally have a cause of action against directors of a public company that has distributed false or misleading documentation in support of a public offering of shares. In Australia, Britain, France, and Germany, severe financial distress creates additional legal responsibilities for directors who fail to take appropriate steps to preserve assets for creditors. In addition to civil liability, outside directors in each of the six countries can face administrative penalties or fines for infractions that they commit personally or that their company commits.

Finally, in circumstances where a government regulator has the power to seek damages to compensate shareholders or creditors, or a similar civil penalty, outside directors face the danger exists that the regulator will want to "send a message" to market participants. A regulator doing so may seek to recover damages from a director's personal assets even when, from a private litigant's perspective, the potential recovery would not justify the delay and legal expense involved in chasing the director. The Australian

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24) Nakahigashi (2003), at 12-13.

corporate and securities regulator has, for instance, sought personal payments from outside directors in a number of cases.[25)]

In all six of the countries we considered outside directors face some risk of personal liability. However, in all, the risk of an out-of-pocket payment is small, especially if one focuses on shareholder suits and puts aside regulatory enforcement, which is not currently a concern in Korea. One important reason is that in each of the six countries, suits against directors are much less common than they are in the United States. A combination of procedural hurdles and practical considerations discourage litigation. Consider derivative suits. Again, in the U.S. relevant procedural rules and the system of attorney fee awards respond to the collective action problem that shareholders would otherwise experience in bringing these suits and provide a potential platform for suits against outside directors, corporate executives and others. In contrast, derivative litigation is unknown in France and Germany.[26)] Obtaining standing to sue is more straightforward in Australia, Britain and Canada, where corporate law specifically authorizes courts to allow shareholders to pursue derivative suits if prescribed criteria are met, but courts do not award attorneys' fees to shareholders' lawyers. Consequently, no one has a meaningful financial incentive to step forward to bring a derivative suit against a public company's directors.

In Japan, 1993 amendments to the Japanese Commercial Code lowered filing fees and allowed successful derivative suit plaintiffs to recover damages for time and money expended in bringing a suit. Consequently, dozens of derivative suits are now brought each year. Nonetheless, unless the misconduct involved is criminal in nature, derivative suits in Japan rarely yield settlements or outright victories for the plaintiffs.[27)]

Procedural rules in the six countries create similar impediments to securities law suits against outside directors. A U.S.-style securities class

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25) For specific examples, see *Australian Securities and Investments Commission v. Rich* [2004] NSWSC 836; *Australian Securities and Investments Commission v. John Barrie Loiterton* [2004] NSWSC 897.

26) In France and Germany a shareholder or group of shareholders owning a prescribed percentage of a company's shares can launch proceedings in the firm's name but litigation of this sort has been virtually unknown in public companies.

27) West (2002), at 361-63.

action is not feasible in France, Germany or Japan since, as in most civil law countries, multi-party litigation is largely unknown.[28] Australia, Britain and certain provinces in Canada have each introduced reforms over the past two decades to facilitate suits with numerous plaintiffs. The management of multi-party suits in these countries, however, remains in flux, and so it is too early to know whether there will be a congenial setting in these three countries for U.S.-style securities class actions.[29]

Even if multi-plaintiff suits do become more common, however, there would likely be few suits against outside directors, and even fewer leading to personal payments by outside directors. In Australia, Britain and Canada, as in the U.S., the company itself can be sued for violations of the securities laws. As long as the company is solvent, plaintiffs should be able to recover fully from the company. A "loser pays" litigation rule creates an additional reason for shareholders and their lawyers not to name outside directors as defendants in the first place. Under this rule, if a suit brought against outside directors is unsuccessful, the plaintiffs could be required to pay the directors' legal expenses, even if the suit were to succeed against the company. Moreover, by suing the directors as well as the company, the plaintiffs' risk having to satisfy a substantially larger costs award without doing much to increase the potential recovery. With the stakes for suing outside directors unbalanced in this way, leaving outside directors out of the picture will often be sensible. Even if a company is insolvent, focusing on more culpable defendants (e.g. the inside directors) and deeper-pocketed defendants (e.g. auditors and other professional advisers) will often be the preferred strategy.

A further factor discourages suits against outside directors, at least for now. In the United States, the prize sought by plaintiffs in suits against directors often is the D&O insurance proceeds. D&O insurance coverage, however, is neither as prevalent nor as lucrative in these other countries. Thus, even apart from the other deterrents, only extremely wealthy outside directors would be logical targets for civil suits. As we discuss shortly, the D&O market in some of these countries is changing in a way that could foster lawsuits while ensuring that out-of-pocket liability will remain rare.

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28) Hodges (2001), at 4.

29) Ibid., at 4-7, 223-24, 235, 269-70, 288.

As discussed above, when events have occurred in the United States that increased the risk of out-of-pocket liability for outside directors, political and economic forces responded to maintain the status quo ante of very low risk. The same pattern can be found in other countries. For instance, in Canada, amid general concerns about "liability chill" in the boardroom, the federal corporate statute was amended in 2001 to expand indemnification and insurance protection for directors and to strengthen directors' due diligence defenses.[30] Similarly in Britain, a highly publicized case in which the new board of insurer Equitable Life launched a suit against former board members, including outside directors, seeking massive damages, prompted lobbying that resulted in 2004 statutory changes expanding the scope of indemnification for legal expenses.[31]

Finally, in Japan, a 2000 court ruling holding eleven executive directors of Daiwa Bank liable for failure to exercise due care, and a 2001 settlement under which Sumitomo Corp. executive directors paid the corporation over half of their total retirement benefits ($3.58 million) produced intense lobbying to protect directors from out-of-pocket liability.[32] In 2002, the legislature responded by amending the Japanese Commercial Code to permit a company to amend its charter to limit lawsuit damages to amounts ranging from two years' annual salary for an outside director to six years' salary for inside directors.[33] We are not aware of recent data on how many Japanese companies have adopted these caps.[34] But if U.S. experience is any guide, we expect that many companies have done so, especially if their boards perceive a significant risk of liability. For

30) Toronto Stock Exchange Committee on Corporate Governance in Canada (1994), at 33-37; Gray (2003), at 11-12.

31) Sherwood, Bob, 'Top Law Firm Urges Limit on Liabilities', *Financial Times*, February 14/15, 2004, at 2; Companies (Audit, Investigations and Community Enterprise) Act 2004, §§ 19-20.

32) In the *Daiwa* case, the eleven directors were initially ordered to pay the bank $775 million in damages. In a subsequent court-ordered settlement, damages were cut to $2.1 million and were deemed to be payable by a larger number of defendants. Aronson (2003), at 26, 42-43.

33) Companies which limit liability must, however, reveal the total compensation paid to their board members, which otherwise is not required.

34) As of 2004, fairly soon after the amendments, 15% of listed companies had amended their certificate to reduce management liability. Fujita (2008), at 25 & n.44.

companies that adopt these limits, outside directors will be unattractive targets for a lawsuit, and in the unlikely event that they are sued will not have to pay substantial damages.

The response to the threat of out-of-pocket liability has not been solely political. Instead, the D&O insurance market has adapted as well. In Germany and Japan, D&O policies were largely unknown prior to the 1990s, but demand has grown steadily since then. The market has also been changing recently in Australia and Britain, with most publicly traded companies now having these policies and many arranging for higher coverage limits. Likewise, in Canada few companies now lack D&O cover.[35)]

The expansion in D&O coverage could encourage litigation against directors. As more companies take out D&O policies, and as coverage limits rise, it becomes increasingly likely that insurance cover will constitute a potential deep pocket in a suit. This would be especially relevant for derivative suits filed against directors under corporate law, because, unlike suits under securities law, the company itself is not a potential defendant.[36)] When D&O insurance is in place with policy limits high enough to be financially attractive to plaintiffs, the risk-reward ratio associated with suing outside directors becomes more favorable. Still, the directors' risk of out-of-pocket liability should not change very much since the same settlement incentives that provide *de facto* protection for American outside directors presumably should apply outside the U.S. as well. Assuming this is right, a country might move from an equilibrium in which suits against outside directors are rare, so that companies and directors don't feel a strong need to buy D&O insurance, to one where D&O insurance is the norm, suits under corporate law are more common, but out-of-pocket liability in these suits remains highly exceptional.

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35) Towers Perrin (2004), at 21.

36) This implicitly assumes that, as in the U.S., companies do not need to disclose whether they have purchased D&O insurance, or what the limits are. If they must disclose this information, plaintiffs' lawyers would know which firms to target for suits against directors under corporate law.

IV. The Korean Situation

1. Legal Reform and Director Liability

Prior to the East Asian financial crisis of 1997-1998, many Korean firms had no outside directors. Moreover, until 1997, there were, to our knowledge, no lawsuits filed even against inside directors for failure to perform their duties, under either company law, or securities law. Thus, directors' liability risk was effectively zero.

In response to the East Asian financial crisis, Korea introduced various reforms that both give outside directors a greater governance role and create greater risks that both inside and outside directors will face a lawsuit challenging their conduct. We summarize here the more important reforms. Korea also required all listed firms to have at least 25% outside directors. Banks and companies (companies with assets greater than 2 trillion won, around $2 billion) must have a majority of outside directors and an audit committee with at least 2/3 outside directors, one of whom must act as chair. New fiduciary rules for company directors were introduced.[37] Korea also reduced the shareholding requirements for bringing a derivative suit from 5% to 1%, and to 0.01% for public companies. Shareholding requirements for access to company records were lowered, from 5% to 3%, 0.1% for public companies, and 0.05% for public companies with over 100 million won ($100 million) in capital.[38] Finally, in 2004, Korea adopted a new class action procedure specifically for securities suits.[39] Previously,

37) See Korean Commercial Code art. 382-3. For an overview of directors' duties under the Korean Commercial Code, see Hwa-Jin Kim (2006). For general background on Korea's legal reforms, see Black, Metzger, O'Brien and Shin (2001); Joongi Kim (2000); Hwa-Jin Kim (2002); Park and Lee (2003). For a view that these reforms are insufficient to raise Korean corporate governance to world standards, see Choi and Kim (2002).

38) See Korean Commercial Code. arts. 542-6(6) (derivative suits against public companies), 542-6(4) (access to public company records), 542-8 (outside directors), 542-11 (audit committees); Banking Act arts 22, 23-2 (outside director and audit committee rules for banks); Korean Commercial Code arts. 403 (derivative suits generally), 466 (access to company records generally).

39) Securities Class Action Act (2004). The class action procedure has been available for larger companies beginning in 2005 and for all public companies beginning in 2007.

class actions of any sort did not exist.

Korean company law is unusual in making directors directly liable to third parties if they "have neglected to perform their duties willfully or by gross negligence" (Korean Commercial Code art. 401).[40] Thus, in effect, the fiduciary duties of Korean directors extend to creditors and other third parties. In our comparison countries, in contrast, the fiduciary duties of directors generally run only to the company, and are enforceable only by the company and its shareholders. Creditors can bring a claim for breach of fiduciary duty only in limited circumstances.

To be sure, Korean insolvency law has no analog to Australia or Britain's "wrongful trading" or "insolvent trading" rules that create insolvency-specific liability rules. But insolvency increases the risk that directors will be sued for breach of their duties under this corporate law provision, by creditors or an insolvency custodian, in circumstances where two normal protections against out-of-pocket liability — the company paying damages or indemnifying the directors — are not available. The Korean Insolvency Law facilitates these suits by providing an expedited procedure for creditors or the bankruptcy custodian to obtain court authorization to bring such a suit.[41]

In sum, both inside and outside directors of Korean public companies face a significant risk of lawsuits and thus are potentially exposed to out-of-pocket liability. However, in Korea, as in a number of other countries, the emergence of a real risk of liability has been followed by a political counter-reaction. In Korea, this has taken the form of allowing corporations to include liability caps in their charters — six times annual compensation for executive directors, and three times annual compensation for outside directors. The liability caps do not apply to self-dealing, but self-dealing by outside directors is likely to be rare. Self-dealing aside, the caps substantially reduce the risk that shareholders will sue outside. As is the case in Japan, which has similar limits on director liability, it will not make financial sense to sue Korean outside directors under the duty of care, at any company which adopts these liability caps.

The liability caps apply only to suits brought under corporate law.

40) Korean Commercial Code art. 401.

41) Korean Insolvency Law arts. 115 and 352.

Securities class actions may still pose a potential personal liability risk for outside directors. There has, however, been only one judicially sanctioned securities class action brought by shareholders under the Securities Class Action Act of 2004.[42] This case was settled soon after it was approved by the court, with damages paid entirely by the company.[43] The rarity of securities litigation is due partly to lawmakers including various provisions in the Securities Class Action Act designed to deter frivolous litigation, including the need for judicial approval before the suit can proceed and a ban on a particular shareholder or lawyer being involved in more than three other suits over the previous three years.[44] The ban on lawyers being frequent players ensures that lawyers lack the incentive to develop the specialized knowledge that is needed to bring these suits effectively or efficiently. Moreover, the dynamics discussed above for other countries with a loser-pays rule for attorney fees, which ensure that outside directors are rarely named in securities suits, are in place in Korea as well.

2. Suits Against Inside Directors

A number of suits that led to out-of-pocket liability for inside directors illustrate that these directors do face potential personal liability risk as a result of a derivative suit. We are aware of four by shareholder suits which led to a finding of liability. Two resulted in out-of-pocket payments; one did not. In a fourth case, the court found liability, but the case is not yet finally resolved. The first case with out-of-pocket payments by inside directors arose from a 1997 derivative suit (apparently Korea's first derivative suit) brought by the People's Solidarity for a Participatory Democracy (*PSPD*), a Korean non-governmental organization with a strong shareholder rights orientation.[45] The suit was brought against four former inside directors of Korea First Bank for failure to oversee Korea First's

42) Rho and Kim (2011); Rahn Kim, *First Class-Action Suit in Offing*, Korea Times, June 25, 2009. This suit, against manufacturer Jinsung T.E.C., is pending as of June 2011. The Seoul Invest investment firm, which holds about 2.5% of Jinsung, is the representative plaintiff.

43) The settlement is reported by Rho and Kim (2011).

44) Ibid.

45) On *PSPD*'s corporate governance efforts and influence, see Kim and Kim (2001); Milhaupt (2004).

lending practices (the company had no outside directors). The trial court awarded damages of 40 billion won ($40 million). On appeal, after Korea First Bank failed and the plaintiff shareholders were wiped out, Korea First Bank (now controlled by the government) took over the litigation and struck a compromise under which the defendant directors agreed to pay 1 billion won ($1 million). Assuming this amount was split equally by the four directors, it is a serious amount, but likely not a bankrupting one. The settlement amount could well reflect the amount that the defendants could reasonably afford to pay.

A 1998 derivative lawsuit, brought by PSPD against nine inside directors of Samsung Electronics (the company again had no outside directors) for approving a bailout of a related company, led to the defendant directors personally paying 12 billion won ($12 million) in damages.[46] A third case, involving LG Petrochemical, is discussed in more detail in the next sub-section. It led to a finding of liability for both inside and outside directors but no out-of-pocket payments by the directors. The fourth is a 2011 case involving Hyundai Motor where the controlling shareholder, who was also a director, was ordered to pay 83 billion won ($83 million) and another inside director was held liable for 8 billion won ($8 million).[47] The company's outside directors were not sued. The decision has been appealed, and it is too early to know whether any directors will make personal payments.

We are also aware of seven cases over the last decade in which inside directors of public companies which became insolvent were found liable, either to creditors or to the company. In a case concerning Daewoo Corp, and Daewoo Heavy Industry, two directors were found liable to creditors after engaging in accounting fraud, a third was found liable for failing to

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46) Samsung's chairman and one director paid an additional 7.5 billion won to compensate Samsung for bribes that they had caused Samsung to pay to government officials. For more details on the Korea First and Samsung cases, see Kim and Kim (2001); Hwa-Jin Kim Yi (2006). The court decisions are Suwon District Court, Decision on 2001.12.27 (awarding 90 billion won in damages), 1998-gahap-22553; Seoul High Court, Decision on 2003.11.20, 2002-na-6595 (reducing award to 12 billion won); Supreme Court, Decision on 2005.10.28, 2003-da-69638 (affirming appellate decision).

47) Seoul Central District Court, Decision on 2011.2.25, 2008-Gahap-47881.

monitor and deter this wrongdoing.[48] A second case, concerning Kohap, also involved liability to creditors for accounting fraud.[49] The others involved liability to the company. The companies involved were Dongbang Peregrine, Cheong-gu Construction, Korea Life Insurance, and Dongah Construction.[50] A final case, concerning Daehan Investment Banking Corp., involved liability to the company for reckless lending, which breached the directors' duty of care.[51] This case suggests that, as in some other countries, including the U.S. and Canada, bank directors may face heightened risks.

Details on any amounts actually paid by inside directors in these seven cases are not available. In some cases, the directors may have been protected by D&O insurance. Nevertheless, these insolvency cases confirm that shareholder and creditor suits against inside directors under corporate law are viable in Korea. They also confirm that in Korea, as in our comparison countries, there is heightened risk for directors after insolvency. For example, insolvency is a key element in the "perfect storm" that is usually needed for outside directors to make personal payments in the United States. Whether the statutory reforms that authorize companies to cap liability of executives at six times' annual compensation will discourage future suits against directors of companies that become insolvent remains to be seen.

3. Suits Against Outside Directors[52]

In Korea, PSPD and other shareholder rights activists have initiated many of the high-profile suits against managers under corporate law. Thus

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48) Supreme Court, Decision on 2008.09.11, 2007-da-31518.

49) Supreme Court, Decision on 2008.02.14, 2006-da-82601.

50) Supreme Court, Decision on 2004.12.10, 2002-da-60467, 60474 (Dongbang Peregrine); Supreme Court, Decision on 2007.09.20, 2007-da-25865 (Cheong-gu Construction); Supreme Court, Decision on 2007.09.21, 2005-da-34797 (Korea Life Insurance); Supreme Court, Decisions on 2007. 10. 11, 2007-da-34746 and on 2007.12.13, 2007-da-60080 (Dongah Construction).

51) Supreme Court, Decision on 2007.07.26, 2006-da-33609.

52) The discussion in this section relies on the discussion of Korea, prepared by Hwa-Jin Kim, in Black, Cheffins, Gelter, Kim, Nolan, Siems and Linia Prava (2007, 2008). Professor Kim confirmed to us that he knows of no additional cases in which outside directors were found liable.

far, to our knowledge, these activists have not included outside directors as defendants in their lawsuits. We are aware, however, of two cases in which outside directors of Korean public companies were held liable after trial, in both cases together with inside directors. In one, the outside director did not pay damages; in the other, who paid the damages is not known.

The first case involved grave misconduct by an insider of Daesun Brewery, which the sole outside director, a university professor, took no action to prevent. The Busan District Court in 2004 awarded damages of 140 billion won ($140 million). The company later became a hostile takeover target, and the bidder, Muhak, sued its directors, including the outside director.[53] No information on who paid the damages is available.[54]

The second case was brought against eight former directors of LG Chemical (currently, LG Corporation). Two outside directors (one was the former President of Seoul National University) participated in the board's decision to approve the sale of LG Petrochemical shares to the company's controlling shareholders and executive directors for a below-market price. In 2006, the Seoul Central District Court found the directors liable and awarded damages of 40 billion won ($40 million) to the company.[55] However, the plaintiff claimed larger damages against the inside directors than against the outside directors, and the court decision limited the liability of the outside directors to 4 billion won ($4 million), 10% of the total damages. The court's decision, which departed from the usual rule of joint and several liability and lacked a direct basis in the Korean Commercial Code, suggests reluctance to impose a large financial penalty on the outside directors. In the end, the controlling shareholders who benefited from the sale paid all damages, so neither the outside nor the inside directors paid anything.

Given these cases, outside directors in Korea clearly face some legal risks. But outside directors also enjoy a set of protections that collectively make out-of-pocket liability a remote possibility, in our judgment, absent

53) Busan Ilbo, May 12, 2004, at 014; court decision on 2004.04.14, 2002-gahap-16791, 2003-gahap-1066.

54) An appeal by the defendants to Busan High Court was withdrawn after the parties settled.

55) Case No. 2003-gahap-1176.

self-dealing. We have already discussed four important protections: the limits on damages in corporate lawsuits; the loser-pays rules for legal expenses, which applies in securities suits; rules discouraging frivolous securities class actions; and the growing practice of obtaining D&O insurance. We discuss below additional aspects of the overall risk faced by Korean outside directors.

4. Sources of Director Liability

To understand the extent to which legal reforms in Korea have increased the likelihood of lawsuits being brought against outside directors, and the directors' exposure to out-of-pocket liability, it is helpful to analyze separately derivative suits under corporate law and securities class actions.

Derivative suits. The filing of 55 derivative actions between 1997 and 2010 indicates that such litigation is feasible in Korea. Of these, just over half involved public companies.[56] Derivative litigation creates, at least theoretically, liability risk for outside directors. Shareholding requirements for derivative suits are now low enough so that derivative suits are feasible, if a major institutional investor, or a shareholder group such as PSPD, is willing to bring them. Moreover, plaintiffs in derivative suits are exempt from Korea's usual loser-pays attorney fee rules unless the judge finds that the case was brought in bad faith. Also, for successful plaintiffs in derivative suits, the Commercial Code authorizes the plaintiff to obtain reasonable litigation costs, paid by the company.[57]

The Commercial Code does not directly specify a standard of liability for breach of the duty of care. It states, in article 382-3, that "Directors shall perform their duties faithfully for the good of the company in accordance with the relevant acts, subordinate statutes and the articles of incorporation."[58] Article 399 then provides that directors who participate in

56) Rho and Kim (2011).

57) Korean Commercial Code art. 405.

58) Korean Commercial Code art. 382-3. The title of this Article is "Directors' Duty of Loyalty." Some Korean commentators in Korea regard the title as misleading, and suggest that this provision creates both a duty of loyalty and a duty of care. Others view the duty of care as deriving from Korean Civil Code art. 681. There seems agreement that such a duty exists. The decided cases tend not to clearly distinguish between the duty of care and the duty

a board decision are jointly and severally liable to the company if they "acted in violation of any Acts and subordinate statutes or of the articles of incorporation or have neglected to perform their duties."[59] One might read these two provisions together as implying a simple negligence standard, especially if one compares article 399 on liability *to the company* to article 401 (quoted above), which contains an explicit gross negligence standard for liability *to third parties*. Nonetheless, some Korean courts, when interpreting this provision, have been receptive to a business-judgment-rule defense in cases that do not involve self-dealing.[60] Much as in the United States, there is much to be said for such a defense. This defense, if generally adopted, would provide an important additional layer of protection for outside directors for cases in which the plaintiffs claim that the directors merely made bad decisions.

Moreover, even before the recent reforms allowing companies to limit directors' liability, Korean courts were apparently developing their own theory to limit the amounts for which directors are liable. They have been willing to exercise discretion to reduce substantially the amount of liability based on mitigating factors such as the director's prior contribution to the firm's success. The courts have justified this discretion on the basis of a general good faith principle in the Civil Code.[61]

Securities law. Korean securities law creates potential liability for outside directors. The new securities class action law may make these lawsuits feasible, in a way that they have previously not been. Unlike derivative suits, the representative plaintiffs do not have to own a minimum percentage of the company's shares to bring a securities class action, though they do have to own shares.[62] At the same time, because class actions are new to Korea, it may take some time for courts to develop procedures to handle them. As noted above, there has been only one securities class action by shareholders filed to date.

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of loyalty, and have not resolved this dispute among scholars.

59) Korean Commercial Code art. 399.

60) Hwa-Jin Kim (2006).

61) Rho and Kim (2011), citing the *LG Petrochemical* case, Seoul Southern District Court 2003-gahap-1176 (Aug. 17, 2006); the *Dongbang Peregrine* case, Supreme Court 2002-na-60467, 60474 (Dec. 10, 2004); and Seoul Central District Court 2008-gahap-47867 (Feb. 8, 2010).

62) Securities Class Action Act arts.11, 12(1)-1.

One reason securities litigation has been less common is that Korean securities law liability has been, until recently, narrower than U.S. liability. Korean directors are liable for faulty disclosure in a public offering, under standards similar to those in the United States. However, for secondary trading, until 2009, there was no direct analogue to Rule 10b-5 in the U.S.[63)] Also, one interpretation of the class action law is that the judge must be persuaded of the merits of the case before it can proceed past a preliminary stage. If so, this ought to give outside directors an opportunity to seek early dismissal from the suit, if they are named to begin with.[64)]

A further factor discouraging suits is uncertainty under Korean law as to the compensation available to plaintiffs' counsel in a successful suit. The Securities Class Action Law provides for attorney fees to be paid out of the recovery to the plaintiff class.[65)] However, in the analogous case of fees for derivative suits, some fee awards have been quite low, both in dollar terms and as a percentage of the recovery.

The fact that a company itself will be liable for securities violations directors might commit, and has fewer defenses (in particular, no due diligence defense) is likely to deter both suits against directors and efforts to collect against directors, even if they are sued and lose. As long as plaintiffs have the company available as a "deep pocket" that will pay any settlement or judgment, they have less reason to sue the outside directors. Moreover, even if plaintiffs sue both the company and the directors and win damage awards against both, they have no reason to seek to collect from the directors, rather than directly from the company.

Korea's loser-pays rule for attorney fees may also come into play here. When plaintiffs know they have to reimburse the defendants if they lose in

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63) Financial Investment Services and Capital Markets Act § 178 (adopted 2010) creates liability for "unfair trading", similar to U.S. Securities Exchange Act § 10(b) and Rule 10b-5, For securities offerings, directors are liable for misstatements by the company in the offering materials, but have a due diligence defense.

64) For a class action lawsuit to proceed, the judge must find that it is "an efficient instrument which is appropriate for the realization of rights of the class and the protection of their interests." Securities Class Action Act art. 12(1)(3). One can read this as requiring only that procedural prerequisites, such as the predominance of common issues, are met. But one can also read it more broadly as permitting the judge to reject a class action, either altogether or against certain defendants, if he decides that the merits are weak.

65) Securities Class Action Law art. 44.

court, they will tend to focus on the most culpable defendants, who are unlikely to include outside directors. On the other hand, Korean attorney fee awards are based on a formula that significantly understates actual fees, which should mute the deterrent effect of having to pay the legal fees of a director who is not found liable.

5. Indemnification

Beyond the procedural and substantive rules and plaintiff incentives that bear on how often outside directors will be sued, or if sued, seriously pursued, for payment of damages, directors have two potential shields against the risk that nominal liability will turn into out-of-pocket liability. These are indemnification by the company and D&O insurance. We discuss indemnification here and D&O insurance below.

Korea's Commercial Code is silent on the power of companies to indemnify directors against damages in non-derivative cases, and case law has not yet addressed this issue. We asked for the opinions of several Korean scholars on the extent to which indemnification is likely to be permitted. There was agreement that indemnification will not be available for damages in a derivative lawsuit, and likely not for legal expenses in a derivative case where a director is found liable for damages. There was also agreement that indemnification for expenses should be available if the director is successful in defending against a suit.

There was disagreement as to the availability of indemnification, whether for legal expenses or damages, in a securities case in which the director or the company pays damages. Our guess, though, is that indemnification will be permitted as to both legal expenses and damages, especially if securities lawsuits take off. Korea's civil code is German-derived, so the German precedent, in which a silent civil code is understood to permit indemnification, may be persuasive. Japanese scholars have advised us informally that a similar pro-indemnification outcome is considered likely there.[66]

More importantly, we predict that, as in other countries, so long as the

66) See Black and Cheffins (2004); Baums (1996).

company is directly liable, indemnification will rarely be an issue in practice. The company will hire and pay joint counsel, so directors' legal expenses will not be a concern. The company will also pay any damages. In the United States, for example, companies pay damages and directors don't, despite a long-standing, never tested Securities and Exchange Commission policy position against indemnification of directors for damages in securities cases. The absence of a test case, despite thousands of lawsuits since securities litigation began in the early 1960s is more telling than any theoretical analysis of what a court might do, if a test case were to arise.[67)]

6. D&O Insurance

D&O insurance provides directors with a second layer of protection against the risk that exposure to lawsuits will translate into significant exposure to out-of-pocket liability risk. D&O insurance protects directors in several ways. First, it covers the risk of directors having to pay damages in a derivative suit, for which indemnification is not available. Second, for securities and other third-party claims, it protects against the risk that Korean courts will find that indemnification is impermissible. Third, for claims that are potentially indemnifiable, D&O insurance addresses the risk that the company will be insolvent. Fourth, D&O insurance ensures advancement and ultimate payment of legal expenses. Finally, if D&O insurance with reasonable limits is available to pay damages, powerful settlement incentives are likely to induce the vast majority of cases to settle within D&O policy limits, thus leaving outside directors' personal assets protected.

The Korean market for D&O insurance is quite new. As noted above, the first known shareholder lawsuits were brought by *PSPD* in 1997 against Korea First Bank and in 1998 against Samsung Electronics.[68)] Not coincidentally, the Korean D&O insurance market took off at the same time. The table below collects the information available to us on the number of D&O policies issued to Korean companies.

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67) We discuss this SEC position in Black, Cheffins, and Klausner (2004).

68) See Kim (2006).

Table 1. D&O Insurance in Korea
The information in this table is taken from several sources, indicated by letter in the table, with citations in the accompanying footnote. The drop in number of companies covered from 1999 to 2000 likely reflects different data sources rather than an actual decline.

Year	Total No. of Policies
1996[a]	1
1997[a]	5
1998[a]	105
1999[a]	320
2000[b]	101
2001[b]	264
2002[b]	386
2003[b]	372
2004 (est.)[c]	500

Sources: a = Financial Supervisory Service (2000) (in Korean, summarized in Kim and Kim (2003). The one policy reported by this source for 1996 could be an error, since the reported premium was only 2 million won (around $2,000), which is implausibly low. b = Korea Insurance Development Institute (2004) (in Korean, selected information provided to us by Joongi Kim). c= Information provided to us in October 2004 by Young-Sam Kim of Marsh and McLennan.

As Table 1 indicates, as of the mid-2000s approximately 500 Korean companies had D&O insurance. We anticipate the number has grown substantially since. Moreover, while we know few details about the nature of D&O coverage that Korean companies currently purchase, we suspect that the market either has — or readily can, if the demand exists — developed policies offering thorough protection for outside directors, similar to that available in the U.S. One of us (Black) was an outside director of a public, U.S.-listed Korean company, and had first-hand experience with attempting to obtain the highly protective coverage that is the norm in the United States. The company had coverage, but with huge loopholes (for example, advancement of legal expenses was left to the insurer's discretion).[69] The effort to obtain better coverage was protracted,

69) A predecessor company first obtained coverage in 1999.

but the company ultimately obtained coverage that was acceptable in amount and was based on a good American policy. The policy was written in English, which reduced the chance that loopholes could be introduced in translation.[70)]

This experience suggests to us that if an increase in lawsuit risk drives companies to seek strong coverage, insurers will adapt and provide this coverage, if only by copying practice elsewhere. The likelihood that the legislature would react by limiting the scope of permissible insurance seems small. We would expect instead, given other countries' experience, that political pressure will be mostly the other way, toward limiting the scope of directors' liability, expanding the scope of permissible insurance, and clarifying the availability of indemnification. With insurance available, the settlement incentives we discuss above for the United States would likely emerge in Korea as well.

V. Implications

Out-of-pocket liability for outside directors is rare in the U.S. and, government action aside, in the six additional countries we have analyzed. We predicted when we initially wrote this article in 2004 that even though Korea's efforts to facilitate shareholder suits had generated concern about excessive director liability, the end result would likely be that out-of-pocket liability would remain rare in Korea as well, self-dealing aside. Thus far, matters have worked out consistent with our prediction. Securities class actions remain uncommon. Derivative litigation has occurred, but only in moderate numbers, and outside directors have not been the primary targets of derivative suits.

We believe that with outside directors, Korea likely has had the balance at least roughly correct over the period from the East Asian Crisis to today.

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70) By using English, Korean insurers should be able to rely on U.S. resolution of interpretive issues. One can thus see Korea as benefiting from a network externality -- it can piggyback on U.S. development of D&O policies and interpretation of disputed clauses. If a coverage dispute arises and must be resolved in a Korean court, translation back into Korean could produce unexpected results. Still, the policy can call for disputes to be arbitrated and the parties can choose an arbitrator who can read the policy in English.

It likely was sensible for Korea to facilitate lawsuits against directors of public companies because such litigation was virtually unknown. Indeed, Korea could go somewhat further in this direction. We worry, too, that the new adopted limits on monetary liability of outside directors will lead, in practice, to their facing almost no risk of being sued. The challenge with caps on the amount of liability, to which there is no easy solution, is ensuring that plaintiffs, and their lawyers, retain financial incentives to bring suits in the first place.

At the same time, we believe that it would be counterproductive for Korea to expose outside directors to a significant risk of out-of-pocket liability. We begin with the potentially positive effects of a moderate amount of shareholder litigation leading to *nominal liability* (where damages and legal expenses are paid by the company or D&O insurance), but not out-of-pocket liability. In such a world, the threat of a lawsuit should prompt directors to be more careful even if personal liability is highly unlikely.[71] Directors may be concerned about loss of reputation if they, or their company, are sued and lose or settle, even if the directors do not pay anything. The threat of lawsuits can also reinforce directors' professional norms, and provide a basis for outside directors to say no to a questionable transaction that management proposes. Moreover, a lawsuit is not fun. The time and aggravation entailed in being sued may be a significant deterrent without more.[72]

On the other hand, significant *out-of-pocket* liability risk could be counterproductive. Outside directors might then become overly averse to the company taking business risks. A high degree of care can be desirable when policing conflict-of-interest transactions involving management or a controlling shareholder, but not when overseeing business decisions generally. Absent the unusual circumstance in which an outside director owns a large block of stock, the director's upside from accepting a business gamble is limited, especially compared to the downside of possibly

71) We develop reasons why a moderate level of litigation, and corresponding *nominal liability* (without out-of-pocket liability) could promote vigilance in Black, Cheffins, and Klausner (2004).

72) Our survey of directors' views about liability risk (see *supra* note 18) confirms that outside directors are concerned about the potential reputational impact of these lawsuits and about the time and aggravation they entail.

devastating liability if something goes wrong. This asymmetry of risk and reward provides a strong reason to limit outside directors' exposure to out-of-pocket liability when no conflict of interest is involved.

Fear of out-of-pocket liability risk could also result in a counterproductive effort by directors to establish and follow procedures and create a paper record for everything they do. Up to some unquantifiable point, the threat of a lawsuit can help to induce a well structured deliberative process and careful deliberation. Beyond that point, however, fear of liability could be counterproductive, with boardroom meetings becoming bureaucratic affairs.

An additional consequence of imposing out-of-pocket liability risk on outside directors is that people will be less willing to serve in these positions, especially if they are wealthy and therefore attractive targets for a lawsuit. This could have an adverse impact on corporate governance. In many cases, the ideal outside director is someone who has succeeded in business and as a result has considerable wealth. To the extent these people were to decide not to serve, board oversight could suffer. Korean outside directors are already drawn heavily, perhaps overly so, from academics and former government officials, rather than experienced businessmen. Wealthy businessmen's fear of liability could deter businessmen from serving where there service would be valuable.

Finally, if there were significant out-of-pocket risk and individuals agreed to serve as outside directors despite that risk, they would presumably demand higher director fees that compensate for that risk. If, however, director fees become a substantial portion of a director's overall income, a valuable measure of independence could be lost. It is important for a director to be willing to walk away from a directorship, or at least to be able to credibly threaten to do so, if management is heading in a direction the he or she believes is ill-advised. As the cost of walking away rises, the likelihood of it happening declines. The risk that high director compensation could undermine independence may be a special concern in Korea, due to Korea's reliance on academics and former government officials as major sources of outside directors. These persons are often not wealthy, so director compensation may well form a substantial part of their income. Fear of losing this income could chill their willingness to speak up in board meetings or to resign if need be.

In assessing the extent to which outside director conduct would be improved by exposing them to the "soft" stick of nominal liability, the "hard" stick of out-of-pocket liability, or both, one must also consider motivating factors other than the fear of liability. One factor is the director's economic interest in the firm. An outside director of a company that performs poorly in the marketplace will be harmed to the extent he holds company shares or options. This economic interest may provide an important motive for many outside directors to work hard. Korean companies can improve these incentives by taking a step taken by many American firms — paying directors partly or mostly with stock and stock options, rather than in cash, and expecting directors to hold their shares until after they leave the board.

More generally, outside directors have a reputational interest in doing a good job. If a scandal occurs on their watch, then quite apart from any litigation risk, their credibility may suffer, with damaging consequences for their future business prospects, their sense of personal pride, and what their friends and colleagues think of them. Korea has a vigorous press that is quick to report on business scandals. Such an active press can reinforce directors' concern for reputation.[73)] Fear of an adverse outcome should motivate outside directors to be attentive and vigilant. To be sure, it is hard for outsiders to assess the extent to which reputational sanctions will provide incentives for good governance. Still, our sense is that Korean directors are at least as attentive to reputation as their American and British counterparts.

As outsiders, we are reticent to offer firm conclusions about Korea's post-crisis reforms and how they will affect outside directors. Still, our hope is that Korea will end up with at least a moderate level of both derivative litigation under company law and securities class actions. If so, then directors, including outside directors, should face a corresponding risk of nominal liability, which should promote greater director vigilance, even if out-of-pocket liability remains low — as we believe it should.

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73) On the role of the business press in addressing corporate misbehavior, see Dyck, Volchkova, and Zingales (2008).

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