Outside Director Liability: A Policy Analysis

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Abstract

Outside directors of public companies play a central role in overseeing management. Nonetheless, they have rarely incurred personal, out-of-pocket liability for failing to carry out their assigned tasks, either in the litigation-prone United States or other countries. Historically, as threats to this near-zero personal liability regime have appeared, market and political forces have responded to restore the *status quo*. We suggest here reasons to believe that this arrangement is justifiable from a policy perspective, at least in countries where reputation and other extra-legal mechanisms provide reasonable incentives for outside directors to be vigilant.

Keywords: outside directors, liability, corporate governance

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1 *Introduction*

For larger public companies around the world, it is the norm for the board of directors to include "outside" directors who are not involved in the day-to-day running of the company but are generally expected to take a central role in overseeing company managers.[1] Outside directors are obliged to comply with various legal duties, the details of which vary across countries. The available evidence suggests, however, that outside directors of public companies are almost never subject to personal liability, whether in the relatively litigious United States or in other countries. Moreover, this near-zero personal liability risk has been a historically persistent feature of the corporate governance landscape, with political and market responses combining to restore the *status quo* whenever outside directors have faced growing legal threats. In this article, we describe how the interaction of legal rules, procedural constraints and market forces yield this near-zero liability result and assess whether the outcome is defensible from a policy perspective.

How is it that the risk of out-of-pocket liability is so small? Even when outside directors have breached legal standards, such as a "duty of care" owed under company law, procedural barriers to bringing suits and a variety of liability "shields" protect them from personal, out-of-pocket liability in the vast majority of cases. The shields include indemnification by the company, reimbursement under directors' and officers' liability ("D&O") insurance policies and incentives the relevant parties have to settle suits without personal payments by outside directors.

Our evaluation of potential policy justifications for outside directors' protection from liability focuses on oversight failures as opposed to self-dealing. Outside directors, as part-timers, rarely have sufficient influence over a company's affairs to engage in self-serving transactions. When they do act dishonestly, few would argue that they should avoid liability. Liability for oversight failures raises more complex issues, with some arguing that if the prospect of liability is highly remote, outside directors could too readily slack off and fail to monitor management in a meaningful way.

The argument in favor of increasing the liability risk of outside directors is plausible in isolation, but the potential benefits of a change must be balanced against the likely costs. These include potentially discouraging good candidates from serving, causing counterproductive risk-avoidance among those who do serve, and inducing directors to focus unduly on taking procedural precautions designed to protect against liability. Especially if reputation and other extra-legal mechanisms are present in a country to a sufficient extent to motivate most outside directors to perform well, the costs of increased liability risk could well outweigh the benefits. Consequently, from a policy perspective, near-zero personal liability risk for outside directors may well be a sensible policy.

[1] In a public company with a controlling shareholder, outside directors can also plausibly play a productive corporate governance role by acting as a check on the blockholder.

2 Sources of Outside Director Liability

We have examined the liability of outside directors in several countries: the United States (BLACK, CHEFFINS, AND KLAUSNER [2006a]); Australia, Canada, France, Germany,[2] Japan and the United Kingdom (BLACK AND CHEFFINS [2006]); and Korea (BLACK, CHEFFINS, AND KLAUSNER [2006b]).[3] In each country, outside directors owe their companies duties of care and skill. Shareholders and creditors may bring suits under securities law directly against directors for misleading disclosure. In the event of bankruptcy, the administrator of bankruptcy proceedings (typically a liquidator) can enforce claims that a company has against its directors. In Australia, Britain, France, and Germany creditors (or a company's bankruptcy administrator) also have causes of action exist against directors who mismanage a company as it approaches bankruptcy.[4]

In all of the countries we have considered government agencies have the authority to bring criminal proceedings seeking to impose fines and similar penalties on directors under various types of legislation, including statutes governing health and safety and the protection of the environment. Moreover, securities regulators in Australia, Britain, Canada, and the United States have authority to launch civil proceedings alleging breaches by directors. Nevertheless, as we describe next, the numerous potential sources of potential liability for outside directors rarely translate into out-of-pocket liability, and outside the United States even the initiation of proceedings is rare.

3 Liability Risk in Countries Other than the United States

Turning first to the countries we have studied other than the United States, procedural deterrents to lawsuits are a central factor that insulates outside directors from personal liability. Consider, for instance, breaches of duties that directors owe to a company. The company itself has the authority to bring a suit against directors who breach this duty, so the board must determine whether to do so. Members of the board, however, will rarely authorize a lawsuit against their colleagues or ex-colleagues. There are legal mechanisms that permit shareholders to bring "derivative" suits on behalf of a company if certain preconditions are met. A shareholder, however, has little incentive to incur the expense of bringing a derivative suit because the company, not the plaintiff shareholder, will be the beneficiary of any judgment obtained. Among the countries we have considered, only Japan provides meaningful incentives to bring derivative suits. It does so by allowing lawyers who launch derivative litigation to recover fees from the company in the event of a successful suit.

Suits for misleading disclosure also face procedural barriers. Due to expense and the dispersion of shareholders, litigation of this sort is difficult to undertake without a mechanism, such as the class action, that responds to the inevitable collective action

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[2] One commentator on this paper (SCHMIES [2006]) addresses an earlier version of our paper that only discussed the situation in the United States. His analysis of the situation in Germany accords fully with our findings.

[3] We provide very few cites on law and practice in this paper. Interested readers should refer to our other work for the relevant details.

[4] In Canada, directors of insolvent companies can face liability for unpaid wages.

problem facing potential plaintiffs. The ability to aggregate shareholder claims ranges from essentially nil in France, Germany, and Japan to uncertain in Australia, Britain, Canada and Korea. Consequently, outside the U.S. securities litigation is a rare occurrence.

In addition, in the countries we have considered "costs follow the event," meaning a judge will generally order the party losing in court to indemnify at least partially the legal expenses of the successful party.[5] A "loser pays" regime of this sort deters any litigation where there is a serious likelihood that a claim will be dismissed and outside directors benefit from this. To the extent that a plaintiff is willing to bring a suit it will want to economize on the number and nature of the defendants that it sues because it will have to pay the legal expenses of the defendants who win. The attractive targets for lawsuits involving alleged violations of corporate and securities law will be the parties who were most directly implicated in the wrongdoing and who have deep pockets. Outside directors are unlikely to qualify on either count, relative to others who may be named as defendants, such as key corporate executives, the company's external auditor and, depending on the nature of the cause of action, the company itself. Plaintiffs, knowing they are likely to face an adverse costs order if a claim against outside directors fails, will therefore tend to avoid bringing the outside directors to trial.

Other procedural factors protect outside directors from suits that could potentially be filed in the event of corporate bankruptcy. Assuming a bankrupt company is being liquidated, the liquidator will generally want to act promptly to draw together the assets and distribute the proceeds so as to accommodate potentially impatient unpaid creditors. Litigation involving the duties and responsibilities of directors of public companies is unlikely to fit the bill. Any such proceedings would probably be time-consuming, meaning that unless the outside directors were both highly culpable and very wealthy, a suit against them would not be worth the wait.

While in the countries we have studied directors can potentially be prosecuted for a wide range of offences under corporate legislation and other statutory regimes, prosecutorial activity against them has been negligible. There are only isolated exceptions. For instance, in Germany, following Vodafone Group PLC's controversial 2000 takeover of Mannesmann, a major German telecom company, members of Mannesmann's supervisory board were tried on charges of breach of trust after authorizing the payment of $60 million in executive bonuses as a reward for a deal well done. The charges were dismissed at trial but in 2005 a federal appeals court ordered a new trial. Nevertheless, as a critic of German company enforcement has observed:

> "We Germans undertake a lot regarding the field of Company Law, but we are seldom successful. Our warnings are usually harmless warnings. Blunt arrows in the hands of incapable warriors. Only in extremely few cases are convictions actually achieved" (EIDAM [1999, p. 64]).

The pattern is much the same elsewhere.

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[5] In Japan, a plaintiff launching a suit has to pay a fixed fee plus a fee based on a percentage of the value of the case and, in the event of defeat in court, must reimburse certain expenses the winning party has incurred, though not legal bills.

While outside directors of non-U.S. public companies are rarely confronted with legal proceedings, their liability risk is not zero. Civil proceedings brought by government regulators constitute the primary source of concern. Among the countries we have studied, we are aware of five instances since 1990 in which outside directors of public companies made out-of-pocket payments either to settle civil suits or pursuant to an order following a trial.[6] In each instance, government officials took the lead role in bringing the case. Four of the five cases arose in Australia. They were brought as part of "Project Icarus," a concerted effort by a newly appointed chairman of the Australian Securities and Investments Commission (ASIC) to take "credible and visible enforcement actions" (HUGHES [2003, p. 21]). The fifth involved proceedings brought by federal agencies in Canada against directors of two banks that failed in the mid-1980s.

The fact that lawsuits launched by public officials constitute the primary source of liability risk for outside directors can be explained largely by the economics of litigation. Private plaintiffs, due to the procedural factors described above, rarely find it worthwhile to sue outside directors. In contrast, government regulators, for policy reasons, are willing in certain instances to bring a case where the costs associated with suing, going to trial and enforcing a judgment exceed, perhaps by a considerable margin, any payments outside directors might make.

4 Liability Risk in the United States

4.1 Lawsuit Volume and Instances of Out-of-Pocket Liability

In the United States, in contrast to elsewhere, procedural rules facilitate litigation by shareholders, including suits against outside directors. The class action suit and the derivative suit are well-established devices for solving the collective action problems that otherwise discourage shareholders from launching proceedings against directors. In addition, the U.S. generally does not have a "loser pays" civil litigation regime, which means plaintiffs contemplating bringing a suit do not need to worry about reimbursing the defendants if the case fails.

Attorneys' fee arrangements for derivative suits and securities class actions also encourage lawsuits. In corporate and securities litigation involving directors, plaintiffs' lawyers are typically paid out of the funds the defendants pay pursuant to a settlement or a judgment after trial. In a derivative suit, there does not even have to be a monetary recovery by the plaintiff for the plaintiff's lawyer to be paid in this way. A common resolution of derivative suits involves an agreement in which the company agrees to reform its corporate governance structure or process, purportedly in order to prevent future fiduciary breaches, and also pays the plaintiff's lawyers' fees. Lawyers respond to these incentives by acting as entrepreneurs, actively seeking out possible legal violations and potential clients and then bringing suits, rather than waiting passively for a prospective litigant to come to them.

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[6] During this period there were also two cases in Germany where supervisory board directors were held liable for damages, but it is not clear from the case reports whether the companies involved were publicly traded.

A result of the rules facilitating derivative and securities suits is that shareholder litigation is a common phenomenon in the U.S. Between 1991 and 2004, 3,239 federal securities class action cases were filed in U.S. federal courts, an average of just over 230 each year. A study of Delaware court filings for 1999–2000 – where most litigation involving fiduciary breaches by public company management takes place – implies that approximately 140 public companies annually face lawsuits alleging breaches of fiduciary duty by their directors (THOMPSON AND THOMAS [2004, pp. 168f.]). There is no data available on how often outside directors are named as defendants in either securities suits (where the company and inside management are commonly named) or in fiduciary duty suits (where inside management and outside directors can both be named). It is reasonable to assume, however, that there are dozens of suits filed against outside directors each year.

While U.S. outside directors are often named as defendants in corporate and securities litigation, are frequently parties to settlements and are occasionally found liable at trial, actual out-of-pocket liability for outside directors is extremely rare. As discussed below, this is due to several layers of protection for outside directors. The result is that the vast majority of cases against outside directors are settled on terms that require them to make no out-of-pocket payments. Instead, any payments, either for damages or legal expenses, are funded by the company, the D&O insurer, or both.

Under either corporate or securities law, only a handful of cases are tried to verdict. We have uncovered only about 20 securities cases tried to judgment since 1980 that involved damages claims against public companies, their officers and directors, or both. Outside directors were defendants in only a fraction of these, and only lost in one case, which did not lead to an out-of-pocket payment. Over the same time period, we have identified only a similar number of corporate law trials based on breach of fiduciary duty claims where outside directors of public companies were defendants. In four of those cases the plaintiffs won judgments against the outside directors, but the outside directors only made out-of-pocket payments once.[7] The only trial that led to out-of-pocket payments was the much-discussed 1985 *Smith v. Van Gorkom* case where a Delaware court ruled that outside directors had failed to use sufficient care in approving a merger and ordered them to pay damages well in excess of the D&O coverage in place.

Many lawsuits that do not go to trial are dismissed, but many are settled as well. For instance, of the 3,239 federal securities class actions filed between 1991 and 2004, 1,754 of these had settled by the end of 2004. When cases settle, it is sometimes impossible to discover from public records the source of payments. To find out how often outside director made out-of-pocket payments in settlements, we combed the relevant secondary literature (*e.g.*, practitioner-oriented journals dealing with director liability and news stories in the legal and business press) and conducted an extensive telephone survey of leading corporate and securities law firms, D&O insurers and D&O brokers.

Our investigation continues but we have yet to uncover a single corporate law settlement where an outside director of a public company made a personal payment. We are aware of four securities law settlements involving out-of-pocket liability,

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[7] For further details on the securities and corporate law cases discussed here, see BLACK, CHEFFINS AND KLAUSNER [2006a].

including two highly publicized 2005 settlements involving WorldCom and Enron.[8] The third was a confidential settlement in a smaller securities suit in which four outside directors of an insolvent company each paid $500,000 and the fourth involved a small company whose directors lacked D&O insurance.[9]

Finally, there is one public enforcement proceeding we are aware of in which an outside director made an out-of-pocket payment. In 2002, the Securities and Exchange Commission and a New York prosecutor, respectively, brought civil and criminal actions against an outside director of Tyco International stemming from a $20 million fee he was paid without board authorization. The outside director pled guilty to the criminal charges and settled the SEC proceedings by returning the fee to Tyco and paying a $2.5 million fine.

In sum, our investigation has turned up a total of only a small handful of instances over the past 25 years where the outside directors of public companies made out-of-pocket payments for damages or legal expenses. Since settlement terms are sometimes confidential and since we did not investigate industry-specific laws that create liability for directors of companies in particular industries (*e.g.*, banking, insurance, and utilities), we may have missed some instances of out-of-pocket liability. What we have found, however, certainly suggests that personal payments by outside directors in the United States are rare.

4.2 Layers of Protection

The small number of instances of out-of-pocket liability for outside directors of U.S. public companies is attributable largely to several layers of protection: safeguards for directors built into the rules setting out the duties of directors, ample scope for indemnification by companies, and a congenial legal environment for D&O insurance. The legal standards governing director liability under corporate law leave outside directors essentially unexposed unless they engage in self-dealing or consciously disregard their obligations. Similarly, with securities law liability for trading losses suffered in secondary markets, directors will generally not be liable unless they have exhibited at least a high degree of recklessness with regard to the truth. In contrast, when companies issue disclosure statements in connection with public offerings of securities, outside directors are subject to a simple negligence standard. Three of the four securities law settlements in which outside directors made out-of-pocket payments for oversight failures arose out of alleged misstatements in offering documents.

Indemnification provides a second layer of protection for outside directors. State corporate legislation allows a company to indemnify directors for damages and legal expenses unless they have engaged in self-dealing or intentionally disregarded their oversight obligations. Companies typically enter into indemnification agreements with directors under which they commit to provide indemnification to the fullest extent

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[8] In WorldCom, the outside directors collectively paid $25 million and in Enron, the outside directors paid $13 million. Enron's outside directors also paid $1.5 million to settle a suit by the Department of Labor for failing to provide proper oversight of employee stock option schemes.

[9] In a couple of additional cases, outside directors paid their own legal expenses, in whole or in part, to defend against securities suits. For further details see BLACK, CHEFFINS AND KLAUSNER [2006a].

permitted by law.[10] Consequently, when outside directors face liability – again most likely in lawsuits arising from misstatements in offering documents – their companies' indemnification obligations will generally offer protection. The primary vulnerability for outside directors is when the company is insolvent and cannot indemnify them.

Finally, there is D&O insurance. State law explicitly authorizes companies to purchase insurance on behalf of their directors, and virtually all U.S. public companies purchase D&O policies. The principal limits on insurance coverage are contained in the policies themselves, which typically exclude deliberate fraud and self-dealing from coverage, and which provide for an upper limit on coverage.

The interaction among liability rules, indemnification, and insurance yield the following three principal areas of out-of-pocket liability exposure for an outside director of a U.S. public company:

Conduct that is not insurable and not indemnifiable: The outside director has engaged in *deliberate fraud* or has otherwise extracted *personal profit* from the corporation, thus disqualifying himself for D&O insurance coverage or indemnification.

Conduct that is insurable but not indemnifiable: The outside director has engaged in a *knowing dereliction* of his oversight obligations, thus disqualifying him from indemnification. He will be exposed to out-of-pocket liability to the extent that the company's insurance coverage falls short of the damages and legal expenses he incurs.

Company is insolvent and insurance is inadequate: The corporation is both insolvent, thus precluding indemnification, and has inadequate insurance coverage. The outside directors' behavior will need to include *conscious disregard* of duties under corporate law, *severe recklessness* in complying with ongoing securities law disclosure obligations, or *negligence* in overseeing disclosures related to public offering. This third category likely poses the greatest risk in practice and within it liability for misdisclosure in a public offering is the single most important source of risk.

The details of the analysis underlying these zones of liability are complex, but there are two key points. First, if a company either has adequate insurance or it is solvent and therefore can provide indemnification, then an outside director will suffer out-of-pocket liability only if he has engaged in self-dealing or knowing misconduct. The second key point is that even if a company is insolvent, as long as it has enough D&O insurance to cover legal bills with some left over for outside directors to pay damages, out-of-pocket liability is unlikely.[11]

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[10] When a lawsuit is brought by a company against its directors, which typically only occurs when a shareholder launches derivative litigation, indemnification can only extend to legal expenses a director incurs.

[11] If there is insufficient insurance to pay even likely legal expenses, then outside directors are in a situation we label "Can't Afford to Win", meaning that they may settle even a weak claim to avoid having to incur the legal bills involved with a trial. At least one of the four instances of out-of-pocket liability we found under U.S. securities law fits this scenario.

4.3 Settlement Incentives

For outside directors of U.S. public companies, settlement dynamics close the window of liability exposure even further. A company's executives have little interest in a trial that disrupts its business, threatens its reputation, and puts at risk both their own personal assets and those of the outside directors. They therefore tend to make attractive settlement offers to plaintiffs, which are funded by the company, the D&O insurer, or both. Outside directors have similar incentives to settle rather than risk trial. D&O insurers agree to these settlements as well. For a variety of reasons, including reputational harm if an insurer forces a case to trial when the defendants want to settle, and legal rules that make it risky for an insurer to do otherwise, insurers typically lack the leverage to force a trial.

For plaintiffs, trials pose two concerns. First, they may lose. Second, if facts come out indicating the defendants' conduct constituted deliberate fraud or self-dealing, the insurer will have grounds to deny coverage and company indemnification will likely be unavailable as well. Plaintiffs will generally prefer to settle prior to trial rather than risk losing access to these "deep pockets." The end result is that settlements routinely occur on terms that have the company and/or the D&O insurer paying all damages.

This settlement dynamic, however, is not inevitable. For securities lawsuits, which our study of outside director liability suggests is the primary source of risk, a plaintiff can, in a scenario we term a "Perfect Storm," credibly threaten to go to trial and collect damages from the outside directors personally that might bankrupt them. In response, the outside directors should be willing to settle for out-of-pocket payments that are less than what they expect to pay if they lost at trial.

For outside directors, in simplified form, the elements of a Perfect Storm are: (i) the company is insolvent and the D&O insurance available to cover the directors is less than the lead plaintiff's estimate of the net present value of going to trial; (ii) the case against the outside directors involves a claim based on disclosures related to a public offering of securities or an unusually strong claim based on disclosures outside the public offering context and; (iii) one or preferably several directors are wealthy enough to allow substantial damages to be recovered. In the absence of a Perfect Storm only a plaintiff who is prepared to reject an otherwise reasonable settlement funded fully by D&O insurance (perhaps to "send a message" to directors of other public companies) will be able to threaten credibly to go to trial and extract assets from the outside directors via that route. As the small number of instances of out-of-pocket liability indicates, both Perfect Storms and plaintiffs willing to make a sacrifice of expected recovery are rare.

5 The Outside Director Liability Equilibrium: Historical Dimensions

A low risk of out-of-pocket liability for outside directors has been the norm not only across borders but also historically. When events have periodically threatened to upset the existing equilibrium, politicians and the market have responded to preserve the *status quo*. Low liability risk for outside directors has thus persisted.

In the U.S., events arising out of the volume of litigation against outside directors have periodically generated fears of out-of-pocket liability. A recurring source of concern has been the appearance of gaps in D&O insurance policy terms that allow insurers to deny coverage. Insurers have generally responded by marketing policies that close the gaps, and U.S. public companies have generally proved to willing to purchase the new products.

On the political front, U.S. lawmakers have responded on various occasions to events that threatened to increase outside director liability risk. Prominent examples include: (i) In 1939, when a court ruling cast doubt on the power of corporations to indemnify directors, state legislatures enacted laws giving corporations that power. (ii) In the 1960s, when court rulings gave shareholders the right to sue directors under the federal securities laws, state legislatures expanded companies' powers to indemnify directors and authorized them to purchase D&O liability insurance. (iii) In 1986, after *Smith v. Van Gorkom*, the Delaware legislature and state legislatures nationwide enacted statutes that permitted companies to amend their charters to protect outside directors from liability for breach of the duty of care except in cases involving a lack of good faith, which encompasses a conscious dereliction of duty. (iv) In 1995, in response to a rise in securities class actions against directors, Congress enacted the Private Securities Litigation Reform Act, which put in place several measures intended to reduce outside directors' exposure. These included replacing joint and several liability for damages with proportionate liability and tightening the rules for successfully pleading securities fraud. (v) In 1998, after lawyers began bringing securities suits in state court to avoid the impact of the 1995 federal legislation, Congress enacted the Securities Litigation Uniform Standards Act, which required that securities class actions be brought in federal court.

The same pattern has recently become evident in other countries. Concerns about director liability risk have been rising lately, but there have been counter-reactions that are keeping this risk low. The market for D&O insurance is not as well developed outside the U.S. as it is within the U.S., largely due to the dearth of lawsuits. Still, it is rapidly becoming the norm for public companies outside the U.S. to purchase D&O coverage. Moreover, companies are negotiating for higher coverage limits. Public companies that cross-list in the U.S. generally purchase coverage similar to that bought by their U.S. counterparts since the liability risks are similar. Also important have been some headline grabbing lawsuits, such as a 2001 case involving Daiwa Bank in Japan in which inside managers were ordered by the trial court to pay $775 million in damages[12] and a $3 billion claim launched in 2002 by U.K. insurer Equitable Life against the company's old board for mismanagement that resulted in the insurer's near failure in the 1990s. The Equitable Life case ultimately settled out-of-court but a number of non-executives had to pay hefty legal bills.

As in the U.S., there have also been legislative responses to recent fears of excessive director liability. Examples include: (i) In 2001, Canada's federal government responded to supposed "liability chill" in the country's boardrooms by amending federal corporate legislation to create a "due diligence" defense for claims based on breaches of duty by directors, to provide for proportionate liability among defendants in lawsuits based on breaches of corporate law and to liberalize rules on D&O insurance. (ii) In Japan, in response to the Daiwa Bank case and other high-profile lawsuits involving allegedly inattentive inside directors, legislation was enacted in 2002 giving companies the option to limit the liability of outside directors

[12] Pending an appeal, a settlement was reached under which the damages payable were reduced to $2 million.

to twice their annual remuneration. (iii) The Equitable Life litigation prompted a 2004 amendment to U.K. companies legislation authorizing companies to indemnify directors for legal expenses as a case proceeds. (iv) The German government has proposed introducing liability caps based on director remuneration levels for securities lawsuits, combined with a relaxation of liability standards.

6 Policy Justifications for Current Arrangements

Does it make policy sense for outside directors of public companies to face a low risk of out-of-pocket liability for oversight failures, even extreme ones? One could argue not. If there is only a remote chance that an inattentive or reckless outside director will end up paying damages personally, the legal system could be nurturing carelessness in the boardroom. Since outside directors are an important check on managerial conduct, various commentators have called for sanctions to be toughened (see, for example, DENT [1981], DICKERSON [2003]). On the other hand, the historical and cross-border persistence of low risk of out-of-pocket liability suggests that the current arrangements are sensible from a policy perspective. We consider here possible justifications for the *status quo*. We conclude that current arrangements are plausibly defensible, and that a large expansion in out-of-pocket liability would be inadvisable.

6.1 Outside Director Incentives

The first point to consider is whether increased liability risk is necessary to give outside directors' sufficient incentives to be more vigilant watchdogs. The answer is perhaps, but not necessarily. This is in part because outside directors already have a variety of incentives to be attentive monitors without a threat of personal liability (SCOTT [1983]).

Share ownership constitutes one factor that can motivate outside directors to perform effectively since an equity stake gives a director a financial incentive to take steps designed to preserve and enhance the value of his investment. Currently, however, few outside directors own a large number of shares in their companies (BHAGAT, CAREY, AND ELSON [1999]). Various commentators have urged public companies to do more to increase the ownership stake outside directors have in the companies they serve (see, for example, ELSON AND THOMPSON [2002]). Reform of this nature might do more to improve the incentives of outside directors than increasing the risk of out-of-pocket liability. This is because share ownership, unlike liability rules, provides outside directors with an upside reward for improvements in corporate performance. In contrast, liability only provides downside risk, and thus tends to make outside directors counter-productively cautious.

Reputation can also motivate outside directors. On the positive side, if outside directors respond deftly to a managerial crisis or otherwise effectively protect shareholder interests, the praise they receive can pay off. FERRIS, JAGANNATHAN, AND PRITCHARD [2003] conducted a study of the influence of firm performance on the number of directorships held and found a positive correlation between good financial results and additional board appointments. Conversely, directors suffer professionally when boards do not perform adequately. According to a study by GILSON [1990], directors of bankrupt firms hold significantly fewer directorships thereafter. KAPLAN AND REISHUS [1990] found that top executives of companies that cut dividends were significantly less likely to secure additional directorships than their counterparts in companies that did not do so. Outside directors who are in office when a company is afflicted by serious mismanagement or fraud seem especially likely to suffer an *ex post* reputational penalty, which should motivate them *ex ante* to take precautions to avoid such an outcome.

"Norms" of proper boardroom conduct can work in tandem with concerns directors have about their reputation to provide incentives to do a good job (EISENBERG [1999, pp. 1265–1271]). Individuals appointed as outside directors are generally successful professionals who are well-respected in the business community. Depending on the norms in a particular country or locality, if a public company does poorly, or, even worse, if a scandal occurs, the social standing of the outside directors will suffer. This reputational bonding mechanism is reinforced by the popular and business press. As long as norms of conduct are well understood and the press is active in reporting on the successes and failures of corporate boards, outside directors will have additional incentives to be vigilant in their oversight activities.

At least in the U.S., where lawsuits are common, the hassle associated with litigation is an additional factor that can motivate outside directors to be attentive. Even if personal liability is an unlikely occurrence, being a defendant in a lawsuit is often a time-consuming process that can lead to unwelcome media coverage. Those acting as outside directors should therefore be eager to avoid being on the wrong side of legal proceedings, which gives them an incentive to steer management clear of legally problematic transactions.

6.2 But Do Extra-Legal Incentives Really Matter?

WAMBACH [2006] in his comment on this article raises the question whether the near absence of out-of-pocket payments by outside directors shows that the existing legal regime fully deters wrongdoing by outside directors. Penalties, as he points out, exist not to be paid but rather to deter misconduct. The absence of out-of-pocket payments may therefore indicate that the current liability regime has achieved optimal deterrence, thus implicitly rendering irrelevant extra-legal incentives outside directors might have.

We believe that a strong case can be made in favor of the low level of personal liability we have found in every country we have studied. But we do not believe either that legal rules are the principal drivers of vigilance or that that these rules are optimal in isolation. Instead, our argument in favor of existing arrangements hinges on extra-legal penalties and reward mechanisms doing much to provide adequate incentives to outside directors to do a good job.

To illustrate the evident non-optimality of the legal rules in the U.S., consider the events that likely need to coincide for outside directors of a public company to face out-of-pocket liability in a securities suit: (i) Their company has made a material misstatement in a disclosure document for a securities offering, thus triggering liability for simple negligence. In contrast, much worse conduct is not actionable in other contexts. (ii) The company's problems must be deep enough to cause insolvency, thus removing the company as a source of indemnification or payment of a judgment. (iii) The company's D&O insurance policy must have a coverage limit that is low relative to investor losses in the public offering. In other words, the directors must have failed to spend enough of the shareholders' money to buy insurance with limits high enough to eliminate their *ex post* risk. (iv) One or preferably several directors must be culpable and wealthy enough to be worth chasing.

There is little reason to believe that this liability regime, viewed in isolation, generates incentives for outside directors to exercise optimal vigilance with disclosures made to the investing public. The same conclusion holds for other sources of legal risk in the U.S. and for the other countries that we have studied, where procedural rules often bar suits to enforce the substantive rules governing outside director conduct. If near-zero liability risk is optimal, it is in substantial part because other sources of incentives already do much to motivate outside directors to do a good job.

6.3 Counterproductive Aspects of Heightened Liability Risk

Greater out-of-pocket liability risk for outside directors could actually be counterproductive for corporate governance. So long as outside directors continue to own few shares in their companies and therefore lack substantial upside benefits from risk-taking, increasing the scope for personal liability will force them to accept a disproportionate downside. The extensive precautions they would adopt in response could well stifle risky business initiatives capable of delivering positive risk-adjusted returns to investors (VEASEY AND DI GUGLIELMO [2005, pp. 1421–1425]).[13] In addition, boards might respond to higher liability risk by adopting excessively bureaucratic procedures to create records justifying the decisions they make. This could delay decisions and encumber board decision-making to such a degree that valuable business opportunities are lost (MANNING [1984]).

6.4 Shrinkage of the Pool of Potential Outside Directors

One often hears the warning that concerns about liability risk reduce the pool of people willing to serve as outside directors (*e.g.*, THE EDITORS [2003] of *The Economist*). If out-of-pocket liability became more common, many directors would still no doubt find the attractions to board membership (*e.g.*, directors' fees, prestige, and networking opportunities) were sufficient to persuade them to retain their posts. At the margin, though, the supply of good outside directors should decline in response to an increase in liability risk. The danger is especially acute for wealthy individuals, who would be attractive targets for plaintiffs. Those who have become rich as a result of having succeeded in business can be ideal outside directors because they have proven business expertise and because their wealth will provide them with the freedom to walk away from a directorship a less wealthy individual might lack. To the extent these people choose not to serve, corporate governance will suffer.

Companies concerned about recruitment of suitable outside directors should be able to correct a decline in supply by increasing directors' fees. WAMBACH [2006]

[13] SCHMIES [2006] argues the stifling of risk-taking is less likely to be of concern when outside directors serve on the supervisory board of a two-tier board since they will not be directly involved with corporate policy-making. Nevertheless, so long as outside directors have a meaningful influence on corporate governance, a bias against risky business ventures can have an adverse impact.

doubts the need to increase compensation, citing CORE's [1997] finding, based on a sample of Canadian companies, that there was no meaningful correlation between directors' cash compensation and a company's level of D&O coverage. This is an unusual comment to receive from an economist, since in a market context it seems reasonable to expect that higher pay would be a necessary correction if companies wanted to recruit able outside directors after the risk of out-of-pocket liability was increased. As for Core's results, our research on Canada finds outside directors in Canadian public companies face only a tiny chance of making personal payments. As a result, it is inappropriate to extrapolate from his findings to predict what fees companies would pay directors if out-of-pocket liability risk were increased significantly.

If companies did raise fees substantially to recruit and retain quality outside directors, the change could impair the quality of corporate governance. A director who is going to be a vigilant and effective monitor of management ideally will be fully independent, which means he needs to be ready to give up his position if his concerns are not heeded. Higher pay, however, could create a substantial group of inframarginal directors who would, by definition, lose rents upon giving up their positions. Such directors may be reluctant to resign when resignation is called for, or to rock the corporate boat at the risk of losing their board positions. This loss of independence, if it were to occur, would compromise their contribution to good corporate governance.

Under the current low-pay/low-risk regime, there no doubt are some inframarginal directors who, for reasons of pay or other benefits, are too attached to their positions to be fully independent. But for many people who serve as directors today – CEOs, other business people and professionals – directors' fees are not a substantial portion of their income or wealth, so current levels of compensation alone are unlikely to create an unproductive attachment to a directorship. On the other hand, if fees were increased enough to compensate even wealthy people for the risk of financial ruin in a lawsuit, some already inframarginal directors would become much more so and others would presumably move into the inframarginal category. The reduced independence likely to result might well have a counterproductive impact on corporate governance.

7 Conclusion

The consistency of near-zero liability risk for outside directors across countries and over many decades suggests that exposing outside directors to greater risk might be bad policy. Our analysis of the relevant policy dynamics strengthens the case in favor of the low-risk *status quo*, especially in countries where extra-legal mechanisms provide outside directors with incentives to be vigilant monitors. Substantially increasing outside directors' personal risk would likely provoke negative consequences.

The extent to which extra-legal incentives exist surely varies by country. For instance, some countries have an active press that will report failures in the boardroom while others do not. Social norms that encourage boardroom vigilance also likely vary across borders. So long as meaningful sources of extra-legal discipline are present in a country, the low risk of out-of-pocket liability for outside directors we currently observe could well be a sensible policy outcome.

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