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Outside Director Liability Across Countries

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Articles

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Brian R. Cheffins[*] and Bernard S. Black[**]

Settlements reached in 2005 in securities litigation involving Enron and WorldCom highlighted the financial risks faced by outside directors of public companies. We argue elsewhere that Enron and WorldCom, as instances where directors made damages payments out of their own pockets, are and likely will remain exceptional in the United States.[1] *In this paper, we show that the risk of out-of-pocket payment is likewise very low on a cross-border basis, in both common law and civil law countries. The largest source of risk is efforts by government agencies to make an example of particular directors, even when the cost of doing so likely exceeds the financial recovery. We study Britain and Germany in depth and offer summaries of the position in Australia, Canada, France, and Japan. We find that while specific laws quite often differ, there is substantial functional convergence. In each country we analyze, due to a combination of substantive law, procedural rules, and market forces, the out-of-pocket liability risk faced by outside directors of public companies is similar—present but very small. We draw upon our cross-border analysis to assess the legal risks outside directors can expect to face going forward, both in the United States and elsewhere. We also briefly consider whether the current approach reflects sensible public policy.*

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1. Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) [hereinafter *Outside Director Liability*].

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I. Introduction

Around the world, vigilant outside directors are a key component of most prescriptions for good corporate governance. But what makes outside directors work hard and pay attention? One potential source of incentives is legal liability. This possibility is highly topical. "The press went into overdrive"[2] as it covered a trial in which the Delaware Chancery Court held in a 2005 ruling that the directors of Walt Disney Company had not breached their fiduciary duties to the company when hiring and dismissing a senior executive.[3] Similarly, in 2005, when highly publicized out-of-court settlements were announced under which former outside directors of WorldCom and Enron agreed to pay a total of nearly $40 million out of their own pockets to settle class action securities lawsuits, the media heralded these settlements as signaling an era of both greater director risk and increased boardroom vigilance.[4]

Theoretically, legal liability can help to motivate those serving in the boardroom to be attentive since they will fear adverse financial consequences if they fail to perform up to legal standards. In fact, across countries, laws governing outside directors of public companies often lack financial "bite." Outside the United States, most would assume that America is an exception to this pattern. A standard refrain is that directors in the United States operate in a hostile legal climate and that directors of foreign companies whose shares trade on U.S. stock markets face grave liability risks.[5] This received wisdom is erroneous. Outside directors of U.S. public companies indeed face a much higher risk of being sued than their counterparts in other countries. These suits, however, pose little risk of an out-of-pocket payment, particularly if a company buys directors and officers' liability (D&O) insurance sufficient to cover legal expenses and a decent damages payment.

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2. Yvette Kantrow, *Mouse House*, DAILY DEAL, Aug. 15, 2005, *available at* 2005 WLNR 12744112.

3. *In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).

4. *See, e.g.*, Joann S. Lublin, Theo Francis & Jonathan Weil, *Directors are Getting the Jitters*, WALL ST. J., Jan. 13, 2005, B1; Kara Scannell, *AIG Considers Cutting Greenberg Ties—After Enron, WorldCom, Directors Display Higher Level of Concern Over Their Own Legal Liabilities*, WALL ST. J., Mar. 16, 2005, at C1.

In Enron, 10 outside directors agreed to pay a total of $13 million, equal to 10% of their pre-tax proceeds from selling Enron shares while misdisclosure was inflating the company's share price. Ben White, *Directors Run Risk of Paying Penalties Out of Their Pockets*, WASH. POST, Jan. 20, 2005, at E1. In WorldCom, there were two separate deals. Under one, 11 ex-outside directors agreed to pay collectively 20% of their combined net worth, amounting to $20.25 million. *Id.*; Ben White, *WorldCom Ex-Leaders Reach Deal in Lawsuit: Directors Personally Will Pay $20 Million To Shareholder Class*, WASH. POST, Mar. 19, 2005, at E1. Under the second, the former chairman of the board, another outside director, agreed to pay $4.5 million, with D&O insurers contributing another $1 million. *Former WorldCom Chairman to Pay $5.5 Million Settlement*, N.Y. TIMES, Mar. 22, 2005, at C4.

5. Brigid Rentoul, *U.K. plc and the U.S.: Tapping the U.S. Capital Markets*, PRAC. L. COMPANIES, June 1998, at 31, 35.

As we document in a paper analyzing outside director liability in the U.S., the payments in Enron and WorldCom were a major departure from the norm.[6]

But what about elsewhere? What legal risks do outside directors of non-U.S. public companies face? Do they have less to fear than their U.S. counterparts? Or more? This Article addresses these questions and related issues. In so doing, we also offer a unique perspective on outside director liability in the U.S. by using non-U.S. experience to identify circumstances under which American directors might in the future face a significant risk of making personal payments.

Our cross-border study covers six countries. We examine outside director liability in the United Kingdom (U.K.) in depth;[7] Britain is perhaps the only country where the role of outside directors has been debated with the level of intensity present in the United States. We also carefully study Germany to explore how director liability differs in a civil law country and to assess the impact of formalizing the role of outside directors through a two-tier board structure. In addition, we offer summaries of two additional common law jurisdictions (Australia and Canada) and two additional civil law jurisdictions (France and Japan).

In each of these six countries, and in Korea (another country we have studied in separate work[8]), outside directors are subject to various legal rules that, in the event of breach, can give rise to a claim for damages or other financial sanctions. Although the substantive sources of liability vary substantially across countries, in practice the legal obligations outside directors face rarely lead to personal payments. Instead, a combination of factors narrow greatly the risk that outside directors will have to pay damages, fines, or legal expenses personally, with procedural considerations often being pivotal (e.g. "loser pays" rules requiring those who lose in court to pay a proportion of the winning party's legal expenses).

Nevertheless, the risk of a personal payment is not zero. The risk is greatest when a government agency brings a civil lawsuit seeking to "send a message" to future directors rather than to maximize—with due regard to litigation costs and the time value of money—the financial recovery in the instant case. This strategy resonates with the WorldCom and Enron settlements. In both, a "public" lead plaintiff—the New York State Common Retirement Fund and the University of California, respectively—sought to

6. *Outside Director Liability*, *supra* note 1.

7. Technically, the United Kingdom of Great Britain and Northern Ireland is divided into three legal systems: England and Wales, Scotland, and Northern Ireland. These distinctions, however, may be safely glossed over for present purposes. Consistent with the British practice, we use the terms Britain and the United Kingdom interchangeably.

8. Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Shareholder Suits and Outside Director Liability: The Case of Korea*, *in* CORPORATE GOVERNANCE AND THE CAPITAL MARKET IN KOREA (Young-Jae Lim ed., forthcoming 2006), *available at* http://ssrn.com/abstract=628223 [hereinafter *Shareholder Suits in Korea*].

extract out-of-pocket payments from outside directors to "send a message" to other boards about appropriate standards of director conduct.

The risks posed by "public-minded" civil litigation naturally leads one to wonder whether criminal enforcement by public officials might put outside directors of public companies at risk. Each of the six countries we study has numerous statutory provisions under which directors can be prosecuted. We find, however, that there is only a tiny risk of criminal prosecution for outside directors.

In the process of establishing that "functional convergence" on low (but non-zero) risk is the order of the day for outside directors' personal liability, we draw attention to various market and political forces that contribute to this convergence.[9] We also consider the policy implications of the current arrangements. Have the countries we consider arrived independently at an outcome that gives outside directors too little incentive to carry out their corporate governance functions? We (tentatively) argue no. Instead, we suggest that the existing pattern of liability risk could reflect sensible public policy. Reputational concerns can motivate outside directors to be vigilant even when they have little fear of ending up out of pocket in a lawsuit. Moreover, substantial liability risk could have negative corporate governance consequences. Capable people, fearing financial ruin, might decline directorships; boards could spend too much time on the wrong things; and boardroom decision-making could become counterproductively cautious. Thus, while director liability can have beneficial incentive effects, its scope should be carefully circumscribed. The countries we study may well have gotten the level of risk about right.

The analysis we offer in this Article is innovative in several ways. First, most studies of directors' duties are limited to a single country.[10] In contrast, our approach is explicitly comparative. Second, the available cross-border studies of directors' legal responsibilities generally focus on corporate law.[11] In contrast, we assess directors' legal exposure under a range of laws that give rise to potentially significant liability risk. Third, while existing comparative work on director liability tends to focus on substantive law "on

9. For discussions on the notion of "functional convergence," see REINIER R. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 4 (2004); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

10. Klaus J. Hopt, *Directors' Duties to Shareholders, Employees, and Other Creditors: A View from the Continent*, *in* COMMERCIAL ASPECTS OF TRUSTS AND FIDUCIARY OBLIGATIONS 115, 115 (Ewan McKendrick ed., 1992).

11. Comparative studies of directors' duties under corporate law include: Bruce E. Aronson, *Learning from Comparative Law in Teaching U.S. Corporate Law: Director's Liability in Japan and the U.S.*, 22 PENN ST. INT'L L. REV. 213 (2003); Luca Enriques, *The Law on Corporate Directors' Self-Dealing: A Comparative Analysis*, 2 INT'L & COMP. CORP. L.J. 297 (2000), *available at* http://ssrn.com/abstract=135674; Hendrik F. Jordaan, *A Comparative Analysis of Corporate Fiduciary Law: Why Delaware Should Look Beyond the United States in Formulating a Standard of Care*, 31 INT'L LAW. 133 (1997).

the books," we take into account procedural considerations and market forces, and, in so doing, reveal the often large gap between the letter of the law and practical outcomes.

The broad scope of our study complicates our analysis and does much to explain this Article's length, but it is essential to our effort to assess outside directors' overall liability risk. Academics who study directors' legal obligations usually focus on a single area of law. Most directors, however, likely do not respond to their legal milieu in this way. Instead, they operate with a general sense of how likely they are to be held liable for *something* under *some law*. For example, when outside directors of insurance giant American International Group Inc. gathered in 2005 to decide whether to dismiss long-time chairman Maurice Greenberg—a decision governed purely by corporate law—the WorldCom and Enron securities settlements were a central reason why the directors wanted their personal lawyers to attend the meeting.[12]

This paper proceeds as follows. Part II discusses the Article's scope. Part III draws upon our research on the U.S. to summarize the American position. Part IV discusses Britain. Part V considers Germany. Part VI assesses the situation in Australia and Canada, and Part VII does likewise for France and Japan. Part VIII draws matters together, summarizing the principal risks of out-of-pocket liability for outside directors in civil lawsuits and offering a brief overview of potential liability under criminal law. Part IX concludes.

II. Scope of the Inquiry

An article as broad as ours—covering the key sources of law relevant to director liability, examining six countries, and attending to both law on the books and practical outcomes—must be circumscribed in some ways to remain of manageable length. First, we focus here on outside directors, not "inside" directors (directors who are also executives).[13] Second, we address only publicly traded companies since debates over the contribution outside directors can make to better corporate governance usually involve only these firms. A fair amount of what we say should, however, be relevant to the liability of directors of private companies.

Third, we do not address directors' liability for self-dealing or other forms of dishonest conduct. This omission is appropriate when studying

12. Scannell (2005), *supra* note 4, at C1. The outside directors ended up with joint counsel, separate from company counsel, but not with individual counsel. *Id*.

13. Much of what we say is relevant to the liability of all directors since most of the substantive rules, procedural factors, and market practices we consider also affect inside directors. On the other hand, the growing role of outside directors is prompting development of some distinctive legal standards for outside directors. *See, e.g.*, *infra* note 51 (citing U.K. cases); *infra* section VII(B)(2) (discussing Japanese corporate law provisions that authorize companies to cap director liability and set the caps at a lower level for outside directors than for executives).

outside directors because they rarely have sufficient influence over a company to engage in self-serving transactions. Insider trading is an exception, since, in practical terms, outside directors can readily trade shares while in possession of confidential, price-sensitive information obtained as a director. There can be serious legal risks for outside directors who engage in insider trading. In a number of instances, outside directors of U.S. public companies have paid civil penalties to resolve insider trading cases brought by the Securities and Exchange Commission (SEC).[14] Among the countries studied here, we are aware of one Australian case, described briefly in Part VI.A.3, where an outside director of a public company paid a civil penalty as a result of insider trading. Nevertheless, excluding self-dealing from our enquiry is appropriate because outside directors are unlikely to worry much about risks they can eliminate readily by refraining from engaging in suspect actions. Their fears will instead be about liability arising from misguided decisions made in good faith or problems they failed to see. Similarly, concerns about whether outside directors are performing well usually presume honesty and relate to their diligence and competence.

Fourth, we focus on civil rather than criminal liability. We do discuss how directors can be punished through fines and analogous financial penalties. Nevertheless, since there is only a remote chance that an outside director of a public company will be prosecuted and convicted, we address criminal liability in a summary way, in Part VIII.C, rather than in our country-by-country analysis.

Fifth, we do not take into account legislation that authorizes the disqualification of individuals from serving as directors. The disqualification sanction is available under bankruptcy law in the United Kingdom and France, under corporate law in Australia, and under securities legislation in the United States and Canada.[15] Orders banning individuals from serving as

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14. *See, Outside Director Liability*, *supra* note 1, at 1132 n. 259 (identifying a number of U.S. examples).

15. For the U.K., see Company Directors Disqualification Act, 1986, c. 46, §§ 6–9 (mandating the disqualification of any individual who has served as a director for an insolvent company if a court determines that the individual's conduct makes that individual "unfit to be concerned in the management of a company"). On France, see C. COM. [Commercial Code], art. 653-8 (Law 2005-845 of July 26, 2005 Journal Officiel de la Republique Francaise [J.O.] [Official Gazette of France], (July 27, 2005); Paul J. Omar, *French Insolvency Law and the 2005 Reforms*, 16 INT'L COMPANY & COM. L. REV. 490, 499 (2005). For Australia, *see* R.P. AUSTIN ET AL., COMPANY DIRECTORS: PRINCIPLES OF LAW AND CORPORATE GOVERNANCE 87-99 (2005) (discussing disqualification of directors under Corporations Act, 2001, No. 50, §§ 206B-206F). For Canada, *see* for example, Securities Act, R.S.O., ch. S-5, § 127(1) (1990) (authorizing the Ontario Securities Commission to issue orders requiring a director to resign and orders prohibiting individuals from "becoming or acting" as directors). For the U.S., the statutory standard for an order barring an individual from serving as a director is that "the person's conduct demonstrates unfitness to serve as an officer or director of [a public company]." Until 2002, a court order was required for such an order to be imposed. *See* Securities Act of 1933 § 20(e), 15 U.S.C. § 77t(e) (2006); Securities Exchange Act of 1934 § 21(d)(2), 15 U.S.C. § 78u(d)(2) (2006). The Sarbanes-Oxley Act of 2002 authorized the SEC to impose this sanction in an administrative cease and desist proceeding, subject to appeal to a court. *See* Securities Act of 1933 § 8A(f), 15 U.S.C. § 77h-1(f) (2006); Securities Exchange Act of

directors can have an adverse financial impact on the affected individuals since they may well lose remuneration from future board service. Nevertheless, we treat disqualification as beyond the paper's scope because a financial penalty is not an intrinsic aspect of the sanction.

Finally, some remarks need to be made concerning terminology. We refer to all circumstances where directors pay damages, financial penalties or legal expenses for which they are not indemnified by their company or by D&O insurance as "out-of-pocket" or "personal" liability. The terms "company law" and "corporate law" are used interchangeably to refer to the statutory regimes under which companies are created. Similarly, "bankruptcy law" and "insolvency law" are both used to describe statutory schemes governing companies in severe financial distress. Legislation that regulates disclosure by public companies and governs related investor protection issues is referred to as "securities law" in preference to the European term of "capital markets law." We sometimes follow the British practice of labeling outside directors as "non-executive directors" or "non-executives."[16] Directors who simultaneously serve in an executive capacity are referred to as "inside" directors, "executive" directors, or simply "executives." We use the term "public company" in its American sense to mean a company with shares listed for trading on a stock market. Our study does not cover unquoted companies organized as a "public limited company" (plc) in the U.K., or its analogues in other countries.[17]

III. The United States

In this Part, we summarize the risk of out-of-pocket liability for outside directors of U.S. public companies. Most people outside of the United States would expect that, in America's litigious environment, directors face considerable liability risks. For "insiders" who act in a self-serving or dishonest fashion, there is anecdotal evidence to support the received wisdom, such as the 2005 agreement by Bernard J. Ebbers, the founder and former chief executive of World Com convicted of fraud, to surrender nearly all of his personal fortune—about $40 million—to investors who lost billions when the company went bankrupt.[18] For outside directors of public

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1934 § 21C(f), 15 U.S.C. § 78u-3(f) (2006) (added by Sarbanes-Oxley Act § 1105). The judicial review provisions are in Securities Act of 1933 § 9(a), 15 U.S.C. § 77i(a) (2006), and Securities Exchange Act of 1934 § 25(a), 15 U.S.C. § 78y(a) (2006).

16. On the fact that this is the British practice, see JONATHAN P. CHARKHAM, KEEPING BETTER COMPANY: CORPORATE GOVERNANCE TEN YEARS ON 310 (2005).

17. As of 2002 in the U.K., there were 12,400 plcs on the register of companies but only 1,600 companies listed on the London Stock Exchange. BRENDA HANNIGAN, COMPANY LAW 22 (2003). We provide similar statistics for Germany and France *infra* notes 198 and 404, respectively.

18. Gretchen Morgenson, *Ebbers Set to Shed His Assets*, N.Y. TIMES, July 1, 2005, at C1. For additional examples of "insiders" in U.S. public companies who have made out-of-pocket payments, see John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation* 21–22 (Columbia Law Sch. Center for Law & Econ., Working Paper No. 293, 2006), at http://ssrn.com/abstract=893833 (arguing, however, that insiders do not make personal

companies, there is a real risk of being a defendant in a case resulting in a cash settlement or a verdict in favor of the plaintiff. However, when it comes to an outside director actually making an out-of-pocket payment in a settlement or following a trial, non-U.S. views will likely be out-of-step with U.S. reality.

To put matters into context, the legal environment in the United States is uniquely hospitable to litigation against directors. Multiple features of the American legal system contribute to this unique environment. First, litigants in the U.S. pay their own legal expenses, regardless of whether they win or lose in court.[19] Other countries generally require the losing side to pay at least some of the successful party's legal costs, which deters some claims.[20]

Second, in the U.S., the class action suit and the "derivative" suit (litigation brought by shareholders on a company's behalf) are well-established devices for solving collective action problems that otherwise discourage shareholders owning a small percentage of shares from launching proceedings against directors. Class action certification is routinely available for a securities lawsuit brought by investors against directors, and most securities suits are framed as class actions.[21] Similarly, procedural rules governing derivative litigation allow any shareholder to bring proceedings on behalf of the corporation against a director for violating duties formally owed to "the corporation."[22] These suits face procedural hurdles, but derivative-suit litigants surmount them reasonably often.

Third, to a unique extent, the U.S. legal system treats plaintiffs' attorneys as entrepreneurs who seek out legal violations and suitable clients rather than waiting passively for litigants to come to them. If a class action securities suit is successful at trial or (much more likely) settled out of court, the judge will generally award legal fees out of the proceeds, usually as a percentage of the class recovery.[23] When a derivative suit is settled, the

payments often enough or large enough for civil liability to constitute a meaningful deterrent to misconduct).

19. NEIL ANDREWS, ENGLISH CIVIL PROCEDURE: FUNDAMENTALS OF THE NEW CIVIL JUSTICE SYSTEM 1001 (2003); John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 670 n.2 (1986). In the U.S., the federal Private Securities Litigation Reform Act of 1995 (Pub. L. No. 104-67, 109 Stat. 737) authorized judges to order plaintiffs' attorneys to pay the cost of defending a securities suit if the plaintiff has not complied with specified federal civil procedure rules. *See* Securities Exchange Act of 1934 § 21D(c), 15 U.S.C. § 78u-4(c) (2006). To our knowledge, judges have yet to invoke this provision.

20. Jonathan D. Glater, *For European Companies, A Season of Big, Big Losses: 2002 Data May Reflect 'Big Bath' Accounting*, INT'L HERALD TRIB., Mar. 15, 2003, Finance, at 11 (observing that the "loser pays" rule in Europe significantly discourages shareholder suits); Dave Lenckus, *New D&O Woes Seen for Foreign Firms: Corporations Coping with Shareholder Activism, New Standards*, BUS. INS., Nov. 28, 2005, at 4.

21. For a summary of class certification under the Federal Rules of Civil Procedure, see CHRISTOPHER HODGES, MULTI-PARTY ACTIONS 206–07 (2001).

22. FED. R. CIV. P. 23.1.

23. *Outside Director Liability*, *supra* note 1, at 1103.

settlement agreement will typically recite that the suit has conferred a "substantial benefit" on the corporation, and the corporation will pay the plaintiffs' attorneys' fees. Judges must approve settlements, but they rarely object to the parties' agreement on fees.[24]

With the congenial setting for lawsuits, shareholder litigation is common in the U.S. Between 1991 and 2004, 3,263 federal securities class action cases were filed in U.S. federal courts, an average of just over 230 each year.[25] A study of court filings for 1999–2000 implies that that 140 public companies incorporated in Delaware face lawsuits annually alleging breaches of fiduciary duty by their directors (Delaware is where most litigation involving alleged fiduciary breaches by public company management takes place).[26]

There is little data currently available on how often outside directors are named as defendants in either securities suits or in fiduciary duty suits. It is reasonable to assume, however, that there are dozens of suits filed against outside directors each year.[27] Despite the volume of litigation, there is only a small chance outside directors of U.S. public companies will pay out of their own pockets. An exhaustive study carried out by the authors with professor Michael Klausner covering 1980 to 2005 bears this out.[28]

Our study of outside director liability in the U.S. uncovered eight instances in which outside directors made personal payments in securities law civil suits, three of which involved only expenditures on legal fees. There were four instances in which outside directors paid damages in cases arising under corporate law and one case involving the Employee Retirement Income Security Act of 1974 (ERISA) where the outside directors did likewise. Finally, there was one instance in which an outside director who had engaged in self dealing disgorged the illicit profits secured and paid fines to conclude a civil action by the SEC and a criminal action by a New York prosecutor.[29]

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24. ROBERT W. HAMILTON, THE LAW OF CORPORATIONS 540–41 (5th ed. 2000).

25. ELAINE BUCKBERG, TODD FOSTER, RONALD MILLER & STEPHANIE PLANCICH, NERA ECON. CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEAR MARKET CASES BRING BIG SETTLEMENTS 2 (2005). NERA reports that 1,897 of these cases had been settled as of year-end 2004. *Id.* at 6.

26. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 168–69 (2004).

27. Preliminary data collected by one of the authors (Black) for another project indicates that, from 2000 to 2003, outside directors were named as defendants in 19% of securities class actions. This preliminary research also finds that the number of fiduciary duty cases that name outside directors as defendants and involve claims for damages is substantially smaller than the 140 cases per year reported in Thompson & Thomas (2004), *supra* note 26, but could be on the order of 20 cases per year.

28. *Outside Director Liability*, *supra* note 1.

29. These fourteen instances of out-of-pocket liability involved 13 companies. The Enron directors paid to settle both a securities case and an ERISA case.

The fact an outside director of a public company faces only a remote chance of breaching duties owed to the company under corporate law is one reason why out-of-pocket liability is rare in the U.S.[30] For instance, as long as a director acts without a conflict of interest, a judge will review board actions pursuant to the "business judgment rule" and, if the board was tolerably well-informed, will dismiss a suit for breach of the duty of care without inquiring into the merits of the decision. The outcome in *Disney* illustrates this point: the judge rejected the claim against the Disney directors despite his observation that "there are many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance."[31] Also, most public companies take advantage of provisions in state corporate law allowing them to eliminate director liability for breaches of the duty of care.[32]

Under federal securities law, a judge will dismiss a suit based on allegations of misdisclosure unless the plaintiffs can plead facts indicating liability with sufficient particularity. Many claims brought against outside directors are set aside on this basis. For lawsuits that survive this preliminary hurdle, most settle. If the company is solvent, the outside directors will pay nothing since the company will either pay damages directly or indemnify them for any liability incurred pursuant to provisions in state corporate legislation that authorize the indemnification of directors who have acted in good faith and in the best interests of the company.[33]

Once a public company becomes insolvent, its outside directors face greater risk. Self-dealing aside, all of the U.S. instances of outside director personal liability we found occurred at insolvent firms. One problematic scenario arises when outside directors either have no insurance or the insurance they have is inadequate to cover their litigation expenses through trial. Under these circumstances, the directors will likely incur out-of-pocket expenses by going to trial, regardless of the merits of the case. Consequently, even directors convinced they have done nothing wrong "may

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30. For authority supporting the propositions advanced in the rest of this Part, see *Outside Director Liability*, *supra* note 1.

31. *In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113, at *1 (Del. Ch. Aug. 9, 2005). The plaintiffs appealed to the Delaware Supreme Court; the outcome was pending as this article went to press.

32. *See id.* at *168 ("The vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by § 102(b)(7) [of Delaware's corporate legislation]."). On the relevant legislative provisions, see the supporting commentary for MODEL BUS. CORP. ACT ANN. § 2.02 (2002), the Model Business Corporation Act (MBCA) provision authorizing corporations to limit or eliminate the personal liability of a director. Twenty-eight states have enacted provisions based on Delaware's § 102(b)(7), which creates a "good faith" exception that has been treated by the courts as amounting to a conscious disregard of duty. Fourteen states have adopted the MBCA provision and five states have enacted provisions that do not closely resemble those in the Delaware statute or the Model Act.

33. *See* WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 22-12 (6th ed. 1998) ("Contracts, bylaws or charter provisions frequently provide for indemnification 'to the fullest extent permitted by law.'").

conclude that they will do better by settling for an out-of-pocket payment than by trying the case and winning, let alone taking the risk of losing."[34]

Four of the eight 1980–2005 securities lawsuits in which outside directors made out-of-pocket payments fit this low-or-no-insurance "Can't Afford to Win" pattern; a fifth might do so.[35] However, this scenario should not be a substantial concern for outside directors today, assuming a public company has a well-counseled board. Virtually all U.S. public companies now carry D&O insurance,[36] and the vast majority have insurance at levels that should cover litigation expenses with enough left over to fund a decent settlement. Furthermore, companies can now purchase insurance designed to preserve outside directors' coverage irrespective of misconduct that will permit insurers to deny coverage to the inside directors.

With an insolvent company that has D&O coverage sufficient to cover legal expenses and fund a decent settlement, settlements are likely to occur within the D&O policy limits and leave directors' personal assets intact. Plaintiffs will accept such terms to avoid the risk and expense of going to trial and to ensure that the proceeds of the D&O policy—often the sole remaining "deep pocket"—are not depleted by directors' legal expenses. This settlement dynamic, however, is not inevitable. For securities lawsuits, which are the primary source of risk for outside directors of U.S. public companies, a plaintiff can, in a "Perfect Storm" scenario, 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 by making out-of-pocket payments that are less than their expected loss if they were to go to trial.[37]

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 all 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 either a claim for prospectus misdisclosure under § 11 of Securities Act of 1934, for which the operative standard is negligence,[38] or an unusually strong claim based on disclosures outside the public offering context, which involve a higher "scienter" standard of culpability; and (iii) there must be defendants with sufficient wealth, aligned with culpability, so that the plaintiffs can expect to recover more by going to trial than by settling within D&O policy

34. *Outside Director Liability*, *supra* note 1 at 1109.

35. On the actual cases and for a broader examination of the "Can't Afford to Win" scenario, see *id.* at 1109–10.

36. TILLINGHAST TOWERS PERRIN, UNDERSTANDING THE UNEXPECTED: 2004 DIRECTORS AND OFFICERS SURVEY REPORT 25 (2004) (reporting that 100% of publicly held U.S. firms responding to the survey had D&O insurance).

37. On the "Perfect Storm" scenario, see *Outside Director Liability*, *supra* note 1, at 1113–18.

38. 15 U.S.C. § 77(k) (2006).

limits.[39] Four (possibly five) of the securities lawsuits where outside directors made personal payments between 1980 and 2005 were Perfect Storms or came close to being so, including Enron and WorldCom.

With Enron and WorldCom, an additional element of the settlements captured attention. In both instances, a public-minded plaintiff made it a priority to collect directly from the outside directors so as to send a message to future boards. In the WorldCom settlement, the New York State Common Retirement Fund, as lead plaintiff, insisted that the outside directors pay some damages out of their own pocket in order to send "a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent."[40] The Enron settlement likely reflected a similar motive on the part of the lead plaintiff, The Regents of the University of California, although plaintiffs' counsel was more vocal than the lead plaintiff in so stating the objectives.[41]

The Enron and WorldCom securities fraud settlements were quickly heralded as "legendary."[42] John Coffee, a Columbia law professor, said the "explicit agenda of requiring a personal contribution ha(d) traumatized outside directors."[43] It is doubtful, however, whether future lead plaintiffs will be able to adopt successfully the negotiating stance of the Enron and WorldCom lead plaintiffs unless conditions approaching a Perfect Storm are present. To illustrate, a "send a message" strategy is only likely to be feasible if the company is insolvent. In a securities case, the company is primarily liable for all damages, and the case is easier to prove against the company than against outside directors.[44] Moreover, a company is usually bound to indemnify the outside directors for any damages they might be liable to pay. Assuming a company offers to pay damages in full in a settlement or after a trial, a lead plaintiff will be hard pressed to justify prolonging the case by demanding that outside directors be held partly accountable, particularly since lead plaintiffs owe duties to act in the interests of the class.

Even if public pension funds or other institutional investors were to seek out-of-pocket payments from outside directors with some frequency, a market or political counter-reaction could restore the status quo. When

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39. It is not necessary that the outside directors themselves be wealthy. Plaintiffs may choose to keep them in a case, perhaps at relatively little extra cost, where the primary recovery would come from other defendants.

40. Press Release, Office of the New York State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Dirs. to Pay from Own Pockets (Jan. 7, 2005), http://www.osc.state.ny.us/press/releases/jan05/010705.htm.

41. *See* Ben White, *Former Directors Agree to Settle Class Actions; Enron, WorldCom Officials to Pay Out of Pocket*, WASH. POST, Jan. 8, 2005, at E1 (quoting plaintiffs' counsel, William Lerach, saying the settlement will "send a message").

42. Roger Eabee, *Director Shortage? No Way*, FIN. EXECUTIVE, May 2005, at 38.

43. John C. Coffee, Jr., *Hidden Issues in 'WorldCom,'* NAT'L L.J., Mar. 21, 2005, at 13.

44. *See Outside Director Liability*, *supra* note 1, at 1080–81.

concerns about directors' legal risks have emerged in the past in the U.S., legal and market responses have brought the risk down again. The rise of securities fraud lawsuits in the 1960s fostered the liberalization of indemnification rules under corporate law and the widespread purchasing of D&O insurance.[45] Also noteworthy was the legislative response to the famous *Smith v. Van Gorkom* case, in which the Delaware Supreme Court ruled that outside directors had failed to use sufficient care in approving a merger and awarded damages in excess of the D&O insurance coverage.[46] Delaware 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.[47] The efforts to reduce director exposure in the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 offer further examples of a legislative reaction to fears of director liability.[48] Should outside directors begin to face serious liability risks in the wake of the WorldCom and Enron settlements, a similar legislative correction might well occur.

One way to place recent U.S. developments into perspective is by examining how matters work elsewhere. We will do this now. From an American perspective, this exercise will show that the United States is exceptional in its level of litigation. Lawsuits involving directors are less common in other countries because losing litigants are often required to pay at least part of the successful party's legal expenses, lawyers cannot claim attorneys' fees in derivative litigation, US-style contingency fees are not permitted, and class actions are difficult to launch. There are, however, various key common themes across borders:

(i) Outside directors of public companies face only a remote chance of paying out of their own pocket for oversight failures;

(ii) Risk exists primarily when the company has suffered an acute financial crisis, often leading to bankruptcy;

(iii) Lack of protection by D&O insurance (including low policy limits and policy exclusions) increases the likelihood of an out-of-pocket payment;

(iv) The "send a message" scenario does pose dangers for outside directors, but often it is regulators rather than private litigants who are seeking to make a point; and,

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45. Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Liability Risk for Outside Directors: A Cross-Border Analysis*, 11 EUR. FIN. MGMT. 153, 161 (2005).

46. 488 A.2d 858, 864 (Del. 1985). The acquirer paid the judgment in excess of available D&O coverage on behalf of the outside directors but required each director to donate 10% of this amount to charity. *See Roundtable Discussion: Corporate Governance*, 77 CHI.-KENT L. REV. 235, 238 (2001) (quoting Robert Pritzker, a controlling shareholder of the acquiring company).

47. On the amendments made to corporate law, see *supra* note 32 (discussing adoption of § 102(b)(7) of Delaware's corporate legislation and the corresponding provision in the MBCA).

48. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995); Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227; *see* HAMILTON (2000), *supra* note 24, at 562–74 (summarizing the key aspects of the two Acts).

(v) Political and market reactions often emerge to reduce the risk of out-of-pocket payments, when it arises.

IV. United Kingdom

A. *Outside Directors in the U.K.*

In a typical British public company, non-executive directors make up about half of the board, compared to the two-thirds ratio (or more) that is common today in the U.S.[49] U.K company law, like U.S. law, does not make a formal legal distinction between the duties of executive and non-executive directors. Instead, all directors generally bear equal legal responsibility for company actions.[50] Recent case law suggests, though, that the English judiciary has recognized the part-time role that non-executives play in a public company and is prepared to adjust their duties accordingly.[51]

Despite judicial recognition of the distinctive role non-executive directors play, concerns about liability risk have been growing recently in Britain.[52] A catalyst for this concern was a lawsuit brought by Equitable Life, a major British insurer that nearly went bankrupt in the late 1990s. The old board was replaced after the debacle, and the new board sued the auditor and fifteen former directors, including nine non-executives, for damages exceeding £3 billion.[53] The non-executive directors sought to have the claim

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49. DEPARTMENT OF TRADE AND INDUSTRY, THE CURRENT POPULATION OF NON-EXECUTIVE DIRECTORS 4–17 (2003) (Eng.), *available at* http://www.dti.gov.uk/cld/non_exec_review/pdfs/finalcensus.pdf (discussing U.K. board composition); DELOITTE & TOUCHE, BOARD STRUCTURE, DISCLOSURE AND NON-EXECUTIVE DIRECTORS' FEES 15–17 (2003) (same); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 238 (2002) (discussing U.S. board composition); Ira M. Millstein & Paul. W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1285–88 (1998) (same).

50. Dorchester Fin. Co. Ltd. v. Stebbing, [1989] B.C.L.C. 498 (Ch.); COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK ¶ 3.137 (2000), *available at* http://www.dti.gov.uk/cld/claw_2_3.pdf; PALMER'S COMPANY LAW ¶ 8.050 (Geoffrey Morse et al. eds., 25th ed. 1992).

51. *See* Equitable Life Assurance Soc'y v. Bowley, [2003] EWHC (Comm) 2263, [35]-[41], (2004) 1 B.C.L.C. 180, 188–89 ("There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so."); Re Cont'l Assurance Co. of London Plc, [2001] B.P.I.R. 733, 850 (Ch.) ("I accept that the managing director of a company. . .has a general responsibility to oversee the activities of the company, which presumably includes its accounting operations. But I do not think that those responsibilities go as far as to require the non-executive directors to overrule the specialist directors, like the finance director, in their specialist fields.").

52. CHARKHAM (2005), *supra* note 16, at 356; Maija Pesola, *Raw Deal for IT Non-Executives*, FIN. TIMES, July 4, 2005, at 20; Bob Sherwood, *Non-Executives Worry Over Legal Liabilities*, FIN. TIMES, June 30, 2003, at 4.

53. Tessa Thorniley & Philip Aldrick, *Equitable Life Sues Directors for £3bn*, TELEGRAPH, Oct. 18, 2003, at 1 (identifying the nine non-executive directors and the six executive directors who were named as defendants).

against them dismissed, but this application failed.[54] Equitable had D&O coverage of £5 million, which was insufficient to cover the directors' legal expenses, let alone potential damages.[55] The trial began in 2005 but after the case went badly for Equitable it agreed to drop its claim and pay the legal expenses of the non-executive directors.[56] Despite this outcome, and despite the fact that Equitable Life was a mutual society owned by its policyholders rather than a publicly quoted company owned by its shareholders, the litigation was often cited as the sort of nightmare that would make the boardrooms of public companies tougher to fill.[57] We discuss the case in more detail below.

In the remainder of this Part, we discuss duties owed by U.K. directors to their companies (III.B), enforcement of directors' duties by the company (III.C), direct suits by shareholders (III.D), shields against out-of-pocket liability (III.E), and the impact of insolvency on director liability (III.F).

B. Duties Owed by Directors to the Company

Under venerable case law authorities, U.K. directors owe several "core" duties to their companies. One is an obligation to act in the best interests of the company.[58] The typical scenario in which this duty is breached involves self-dealing, a form of misconduct in which outside directors of public companies are unlikely to engage. Directors acting with pure motives can, however, breach a related obligation not to use their powers for an "improper collateral purpose."[59] In theory, directors can be liable to their company for any loss the company suffers as a result of such a misuse of power. The

54. Equitable Life Assurance Soc'y v. Bowley, [2003] EWHC (Comm) 2263, [2004] 1 B.C.L.C. 180.

55. Antonia Senior, *Equitable Case Fuels Directors' Insurance*, TIMES (London), Sept. 29, 2003, at 23; Nikki Tait & Andrea Felsted, *Bad Policies: Counting the Costs of the Equitable Case in Life Savings and Reputations*, FIN. TIMES, Dec. 5, 2005, at 21 ("It was not until early 2003, following an arbitration, that (the ex-directors) finally secured a £5 million pool – although it was completely inadequate.")

56. On the settlement terms provided to eight of the nine non-executives, see Christine Seib, *Equitable Drops the Last of its £3.75bn Legal Claim*, TIMES (London), Dec. 3, 2005, at 60; Tait & Felsted (2005), *supra* note 55. Equitable Life had settled earlier with the ninth non-executive director on the basis that each side would bear their own costs, but he had defended himself in court and available D&O insurance should have been sufficient to cover his minimal out-of-pocket costs. Christine Seib, *Deals Likely as Equitable Drops Claim*, TIMES (London), Oct. 4, 2005, at 44.

57. Sandra Speares, *Does Non-Executive Mean Uninsurable?*, LLOYD'S LIST, Oct. 26, 2005, at 6; Tait & Felsted (2005), *supra* note 55. On Equitable Life's status as a mutual society and the distinction between mutuals and public companies, see Christopher Brown-Humes, *Survival Depends on Differentiation*, FIN. TIMES, Mar. 10, 1998, at 1.

58. In Re Smith & Fawcett, Ltd., [1942] Ch. 304.

59. Regentcrest Plc v. Cohen, [2001] 2 B.C.L.C. 80, 105; *see* Richard C. Nolan, *The Proper Purpose Doctrine and Company Directors*, *in* THE REALM OF COMPANY LAW 1, 7–10 (Barry A.K. Rider ed., 1998) (explaining that directors, independent from their subjective honesty or integrity, must exercise their powers only for permissible purposes). On the sort of cases involved, see HANNIGAN (2003), *supra* note 17, at 233.

remedy typically sought, however, is an order unwinding the challenged transaction, not damages.[60]

U.K. directors also owe to their companies duties of care, skill, and diligence. This duty is similar in spirit to the U.S. duty of care, but the culpability standard is roughly one of negligence rather than gross negligence as applied in the U.S.[61] There is also no formal doctrine of judicial abdication in applying the duty, akin to the U.S. business judgment rule.[62] On the other hand, English judges have been reluctant to second guess corporate decision-making and have refrained from holding directors liable for mere errors of judgment.[63]

Over the past couple of decades, English judges have drawn upon a provision governing claims against directors of insolvent companies for "wrongful trading" (continuing to operate a company once insolvency is inevitable) to toughen common law standards.[64] For instance, while older decisions merely required directors to exhibit the skill reasonably expected of persons of equivalent knowledge and experience, more recent cases require them to act in a manner reasonably expected of persons performing the duties in fact undertaken.[65] Similarly, while a director traditionally was not obliged to give continuous attention to the company, a director is now obliged to remain informed about a company's affairs.[66]

Also noteworthy is that while older cases indicated that directors, in the absence of grounds for suspicion, were entitled to rely on fellow directors and on officers of the company, newer decisions emphasize that delegation to others does not absolve a director from the duty to supervise the delegated

60. HANNIGAN (2003), *supra* note 17, at 242; Nolan (1998), *supra* note 59, at 27–29.

61. In the U.K., see In Re City Equitable Fire Ins. Co., [1925] Ch. 407, 427–28; PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.409. In the U.S., see Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

62. PAUL DAVIES, INTRODUCTION TO COMPANY LAW 156–57 (2002).

63. *See* PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.409 (citing Lagunas Nitrate Co. v. Lagunas Syndicate, (1899) 2 Ch. 392).

64. The relevant provision, Insolvency Act, 1986, c. 45, § 214(4), reads:

> [T]he facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—
>
> (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
>
> (b) the general knowledge, skill and experience that that director has.

65. *Compare* In Re City Equitable Fire Ins. Co., [1925] Ch. 407, 428, *with* Norman v. Theodore Goddard, [1991] B.C.L.C. 1028, 1030–31.

66. On the old law, see Re City Equitable Fire Ins. Co., [1925] Ch. 407, 429. On the new standards, see Re Barings Plc (No. 5), (2000) 1 B.C.L.C. 523, 535–36; Re Westmid Packing Services (No.2), (1998) 2 All E.R. 124, 130; Equitable Life Assurance Soc'y v. Bowley, [2003] EWHC (Comm) 2263, [39]-[41], (2004) 1 B.C.L.C. 180, 189.

function.[67] Hence, even when a director has no reason to suspect that reliance on fellow board members or corporate officers is misplaced, a director might still be in breach of duty if he fails to monitor and control what is going on.[68] On the other hand, the judiciary has recognized that the competence of a director should be assessed by reference to the role assigned to him. As a result, the duties and responsibilities of an outside director of a U.K. public company will be judged by what could be reasonably expected of an individual serving in that capacity rather than the more exacting standards likely to apply to an executive director.[69]

In addition to duties owed to their companies under the common law, U.K. directors must comply with numerous obligations imposed by the Companies Act 1985, the U.K. analogue to U.S. state corporate statutes. In general, infringements of the Companies Act 1985 do not provide a foundation for civil suits.[70] Still, the Act does provide for redress against directors in some circumstances. For instance, if a company makes an improper dividend payment to shareholders, directors who knew or had reasonable grounds for believing it was improper are liable to the company for the improper payment.[71] Due to the "reasonable grounds" foundation for liability, a careless non-executive could became liable without knowing the dividend was improper. This may be a tougher standard than under U.S. corporate law, where outside directors are liable for improper dividends but state legislation typically offers protection if they believed in good faith that the company had sufficient assets to justify the dividend.[72]

Another distinction between U.K. and U.S. corporate law deserves emphasis. In the U.S., companies can, and typically do, adopt charter provisions that eliminate directors' liability for breach of fiduciary duty for all but intentional or self-serving conduct.[73] In Britain, shareholders can excuse a breach that does not involve misappropriation of corporate assets or

67. Re Barings Plc (No. 5), (1999) 1 B.C.L.C. 433, 489; PALMER'S COMPANY LAW, *supra* note 50, ¶¶ 8.411.1–8.411.2.

68. Re Landhurst Leasing Plc (1999) 1 B.C.L.C. 286, 346; Richard C. Nolan, *The Legal Control of Directors' Conflicts of Interest in the United Kingdom: Non-Executive Directors Following the Higgs Report*, 6 THEORETICAL INQ. L. 413, 452 (2005).

69. Re Barings Plc. (No. 5), (2000) 1 B.C.L.C. 523, 535; Re Equitable Life Assurance Soc'y v. Bowley, [2003] EWHC (Comm) 2263, [35], (2004) 1 B.C.L.C. 180, 188; Re Barings Plc. (No. 5), (1999) 1 B.C.L.C. 433, 483–84.

70. On judicial reluctance to imply civil remedies for the breach of statutory duties, see Lonrho Ltd. v. Shell Petroleum Co. Ltd., [1982] A.C. 173 (H.L.).

71. Companies Act, 1985, c. 6, § 277. *See, e.g.*, Bairstow v. Queens Moat Houses Plc., [2001] EWCA (Civ) 712, [29]-[36] (inside directors of a public quoted company were held liable for £26.7 million after seemingly proper dividend payments turned out to be illegal because of accounting irregularities).

72. On director liability for improper dividends in the U.S., see R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 5.32 (2d ed. 2005); JAMES D. COX, THOMAS LEE HAZEN & F. HODGE O'NEAL, CORPORATIONS § 20.23 (1997).

73. *See supra* note 32 and accompanying text.

other conduct amounting to "fraud" on a case-by-case basis.[74] The Companies Act 1985 renders void, however, a provision in the corporate constitution that exempts directors from liability for breach of duty.[75]

At the time of this writing, a massive 885-clause Company Law Reform Bill was before Parliament that would substantially amend current companies legislation.[76] A key innovation in the Bill is a statutory statement of directors' main duties.[77] According to the Government, the general intention is to clarify rather than change the law.[78] There has been much speculation that a clause that obliges directors to consider the interests of employees and the impact of the company's operations on the community and the environment could lead to more lawsuits against directors.[79] Such fears are likely misconceived. The relevant obligations would not be directly owed to stakeholder groups. Instead, their interests would merely be part of a broader duty that directors owe to the company, and stakeholder groups would have no right to sue in the company's name for an asserted breach.[80] The proposed amendments should therefore not increase significantly the risks faced by non-executive directors.

C. Enforcement of Breaches of Duty by the Company (including Derivative Litigation)

Formal liability is one thing; enforcement is another. Launching a suit under U.S. corporate law alleging directors have breached duties owed to the

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74. Regal (Hastings) Ltd. v. Gulliver, (1942) 1 All E.R. 378, 389 (H.L.). Though it is well accepted that shareholders have the power to waive directors' liability for breach of duty, it is questionable whether there is an English case directly on point. R.J.C. Partridge, *Ratification and the Release of Directors from Personal Liability*, 46 CAMBRIDGE L.J. 122, 123–25 (1987). On which breaches of duty can be ratified by shareholders under U.K. company law, see Burland v. Earle, [1902] A.C. 83, 93; Atwool v. Merryweather, [1867] L.R. Eq. 464; Brenda Hannigan, *Limitations on a Shareholder's Right to Vote—Effective Ratification Revisited*, 2000 J. BUS. L. 493.

75. Companies Act, 1985, c. 6, § 309A(2).

76. Company Law Reform Bill, 2005, H.L. Bill [34], *available at* http://www.publications.parliament.uk/pa/ld200506/ldbills/034/2006034.pdf [hereinafter H.L. Bill [34]].

77. *Id.* at §§ 154–61.

78. Company Law Reform Bill Explanatory Notes, 2005, H.L. Bill [34–EN], ¶ 301, *available at* http://www.publications.parliament.uk/pa/ld200506/ldbills/034/2006034.pdf [hereinafter H.L. Bill [34–EN]]; *see also* H.L. Bill [34], § 154(3) (saying that the codified duties are based on, and have effect in place of, certain common law and equitable rules). The Government has acknowledged its intention to change the law in certain respects with conflicts of interest. H.L. Bill [34 E-N], ¶ 302. Since this article focuses on directors who have acted in good faith, these changes to the law will not be analyzed here.

79. H.L. Bill [34], § 156(1), (3); Jean Eaglesham & Christopher Adams, *Fears Weight of Law Will Fall on Directors*, FIN. TIMES, Feb. 3, 2006, at 3; Robert Watts, *'This Bill Will Discourage People from Becoming a Director,'* TELEGRAPH, Jan. 29, 2006, at 6.

80. H.L. Bill [34], § 154(1); *see* PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 377–79 (7th ed. 2003) (describing a similarly structured draft clause in DEPARTMENT OF TRADE AND INDUSTRY, MODERNISING COMPANY LAW, 2002, Cm. 5553-II, at 112–13, *available at* http://www.dti.gov.uk/companiesbill/volume2.pdf).

corporation is straightforward, but charter amendments eliminating directors' liability help to ensure outside directors' personal assets are rarely at risk. U.K. directors lack similar liability exemptions, but procedural factors ensure that public companies rarely sue their directors.[81]

In most instances, directors of U.K. companies owe their duties to the company and the company alone; the company will be the "proper plaintiff" in a potential suit.[82] While derivative suits in the U.S. often provide a viable platform for such litigation, the picture is quite different in Britain.[83] Under U.K. company law, the board normally decides when a company will sue.[84] So long as non-executive directors remain in office and relations in the boardroom are cordial, a suit against them is highly unlikely.[85] The situation can change when things have taken a bad turn at a company and the former directors have departed, since the new directors will be less constrained by a sense of collegiality and might launch proceedings. The Equitable Life litigation illustrates this point: the post-crisis board decided to take tough action against those allegedly responsible for the insurer's plight, including both executive and non-executive directors.[86] Nevertheless, this type of case will be the exception rather than the rule.

The English judiciary has recognized that leaving the decision to sue purely in the hands of the board may lead to serious wrongdoing going unaddressed and has crafted limited exceptions where shareholders can sue for a breach of duty by directors through derivative litigation. However, these exceptions—for "fraud on the minority," *ultra vires* conduct, and acts requiring a vote by a special majority of shareholders[87]—will rarely apply in cases involving outside directors of public companies. Consider fraud on the

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81. On the rarity of such litigation, see SIMON DEAKIN & ALAN HUGHES, DIRECTORS' DUTIES: EMPIRICAL FINDINGS 15–16 (1999).

82. On whom directors owe duties to, see Peskin v. Anderson, (2000) 2 B.C.L.C. 1, 14–15 (Ch.); and Percival v. Wright, (1902) 2 Ch. 421, 423–25. On the "proper plaintiff" principle, see Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), (1982) 1 All E.R. 354, 357. Due to 1999 civil procedure reforms, in English civil trials the "plaintiff" is now referred to as a "claimant." ANDREWS, *supra* note 19, at 26. We will, for consistency, use the term "plaintiff" throughout this article.

83. Anthony J. Boyle, *The Private Law Enforcement of Directors' Duties*, *in* CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES: LEGAL, ECONOMIC AND SOCIOLOGICAL ANALYSES ON CORPORATE SOCIAL RESPONSIBILITY 261, 276–78 (Klaus J. Hopt & Gunter Teubner eds., 1985).

84. Mitchell & Hobbs (UK) Ltd v. Mill, (1996) 2 B.C.L.C. 102 (Q.B.); Breckland Group Holdings Ltd. v. London & Suffolk Props. Ltd., [1989] B.C.L.C. 100 (Ch.); HANS C. HIRT, THE ENFORCEMENT OF DIRECTORS' DUTIES IN BRITAIN AND GERMANY: A COMPARATIVE STUDY WITH PARTICULAR REFERENCE TO LARGE COMPANIES 79–80 (2004).

85. Colin Baxter, *Demystifying D&O Insurance*, 15 OXFORD J. LEGAL STUD. 537, 538–39 (1995); Hans-Christoph Hirt, *The Review of the Role and Effectiveness of Non-Executive Directors: A Critical Assessment with Particular Reference to the German Two-Tier Board System: Part 2*, 14 INT'L COMPANY & COM. L. REV. 261, 266 (2003).

86. *See supra* note 53 and accompanying text.

87. HIRT (2004), *supra* note 84, at 143–54.

minority, the most important exception.[88] Misconduct by outside directors will probably involve failures to exercise care and skill rather than dishonesty or self-dealing and thus will not constitute "fraud."[89] Moreover, a derivative suit can only proceed if there is "wrongdoer control," which requires that the defendants own enough shares and exercise sufficient influence to dictate voting outcomes.[90] Non-executive directors of U.K. public companies rarely own a substantial percentage of the outstanding shares, so a shareholder generally cannot meet this standard.[91]

Even if the "fraud on the minority" exception is available, the time, hassle, and expense involved will discourage the launching of a suit. One hurdle is that a shareholder seeking to litigate on behalf of a company must establish at a preliminary hearing that the company is likely to be entitled to the relief claimed and that the action involves an exception to the usual ban on derivative suits.[92] Only if leave is granted can a trial on the merits follow.

A shareholder can incur large legal bills applying for leave to sue and potentially further expense if the matter goes to trial. Offloading the risk on to lawyers is theoretically possible since plaintiffs in the U.K. can enter into conditional fee agreements under which a lawyer can agree to a "no win, no fee" arrangement.[93] For lawyers, however, the maximum "upside" under such an agreement is 100% of hourly fees.[94] This compares poorly with the

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88. On the significance of the "fraud on the minority" exception, see PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.813. Because of statutory reforms altering the effect of transactions falling outside a company's powers, the *ultra vires* exception has been rendered essentially irrelevant in practice. *Id.* at ¶ 8.812. With respect to the "special majority" exception, U.K. companies' legislation only requires a supermajority vote in a narrow range of circumstances, such as the amendment of the corporate constitution, the alteration of a company's core financial structure, or the ratification of transactions beyond a company's powers. *Id.* at ¶ 8.812.1; HANNIGAN (2003), *supra* note 17, at 461.

89. An exception is where a negligent exercise of managerial power by directors causes the directors to benefit at the expense of the company. Daniels v. Daniels, [1978] Ch. 406. While the concept of fraud is not well-specified, it is widely acknowledged that it encompasses the misappropriation of money, property, or advantages which belong to the company. PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.814.

90. Birch v. Sullivan, (1957) 1 W.L.R. 1247 (Ch.). Control does not require ownership of a strict majority of shares. Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), (1982) 1 All E.R. 354, 364.

91. BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 465 (1997); *see also* Hans C. Hirt, *The Company's Decision to Litigate Against Its Directors: Legal Strategies to Deal with the Board of Directors' Conflict of Interest*, 2005 J. BUS. L. 159, 171 ("*[De] jure* control of large companies is generally uncommon in England. However, directors of such companies may have *de facto* control, for example, as a result of poor attendance at shareholders' meetings in conjunction with the proxy voting system.").

92. Civil Procedure Rules, 1998, S.I. 1998/3132, art. 19.9, ¶¶ 1–3; HIRT (2004), *supra* note 84, at 125–27.

93. A. J. BOYLE, MINORITY SHAREHOLDERS' REMEDIES 37, 59 (2002); HIRT (2004), *supra* note 84, at 132–34.

94. U.S.-style contingency fees, where a lawyer receives a percentage of any judgment or settlement, remain unlawful in the U.K. Neil Andrews, Note, *Common Law Invalidity of*

contingency fees that American lawyers receive in the event of a successful outcome, and the development of a U.S.-style shareholder plaintiffs' bar in Britain has suffered accordingly.[95]

Even with a "no win, no fee" arrangement in place, an unsuccessful plaintiff shareholder will likely have to pay a substantial proportion of the defendants' legal fees due to "loser pays" rules. Rulings on costs are within the court's discretion but in most civil cases fees are assessed against the loser.[96] Typically, this award will be on a "standard basis" and will cover litigation expenses "proportionately and reasonably incurred" and "proportionate and reasonable in amount."[97] "Standard basis" costs orders traditionally yielded approximately two-thirds of actual legal bills, but the fraction has been approaching four-fifths in recent years.[98] With this potential downside, even if a lawyer will work on a "no win, no fee" basis, only a wealthy individual or an institutional investor is likely to risk applying for leave to bring derivative litigation.[99]

Assume now that leave to sue is granted. The judge authorizing the suit to go ahead has discretion to order the company to indemnify the shareholder for legal fees incurred as a result of the proceedings to date, for the trial to come, or for both.[100] Such an order is unlikely, however, if the shareholder applicant has the financial wherewithal to pay counsel.[101] Since only institutional investors or wealthy individuals are likely to apply for leave in the first place, company payment of legal expenses will be the exception rather than the rule.

Assume, finally, that a trial goes ahead. If the derivative claim fails, the plaintiff shareholder will have to pay the defendants' costs unless, at the leave hearing, the shareholder applied successfully for a protective-costs order requiring the company to reimburse the directors.[102] The Equitable Life litigation illustrates the financial hit a shareholder could endure. Even though Equitable Life dropped the case in mid-trial, the estimated legal

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Conditional Fee Agreements for Litigation: "UTurn" in the Court of Appeal, 59 CAMBRIDGE L.J. 265, 266 (2000).

95. Richard Matthews, *Why America Is in a Class of Its Own*, TIMES (London), Jan. 25, 2005, at 10.

96. ANDREWS (2003), *supra* note 19, at 824–25.

97. Civil Procedure Rules, 1998, S.I. 1998/3132. art. 44.5, ¶ 1; Lownds v. The Home Office, [2002] EWCA (Civ) 365, [6], (2002) 1 W.L.R. 2450, 2453.

98. ANDREWS (2003), *supra* note 19, at 830–31.

99. One other possibility would be for a plaintiff to seek government-funded legal aid, but the scope for doing so was substantially curtailed when conditional fee agreements were introduced. BOYLE (2002), *supra* note 93, at 37.

100. Civil Procedure Rules, 1998, S.I. 1998/3132, art. 19.9, ¶ 7; Wallersteiner v. Moir (No. 2), [1975] Q.B. 373.

101. Smith v. Croft, (1986) 1 W.L.R. 580, 597 (Ch.).

102. ANDREWS (2003), *supra* note 19, at 986.

expenses for all parties were £75 million ($135 million), including £35 million for Equitable Life and over £10 million for the defendant directors.[103]

There is one final deterrent to derivative litigation in the U.K., namely that if a derivative suit is successful, the company will be the winning party. One implication of this is that, unless the court orders otherwise, any costs award made against the defendants will be granted in favor of the company rather than the shareholder who launched the proceedings.[104] More importantly, since the claim is derivative, the recovery will be paid to the company.[105] Thus, a shareholder must bear the downside risk from losing to pursue an action that will benefit all shareholders pro rata.[106]

Given the legal expenses involved, the "loser pays" rule, the restriction to "fraud" claims, the need to apply for leave to sue, and the collective action problem created because the recovery is paid to the company, derivative litigation involving outside directors of U.K. public companies has been almost nonexistent. The last reported decision involving a derivative suit for damages against directors of a public company was in 1981.[107] In that case, Prudential Assurance, a major U.K. institutional investor, pursued derivative litigation on behalf of a public company against two inside directors who allegedly had engaged in self-serving transactions at the company's expense. The company ultimately opted to sue the directors itself, rendering the derivative litigation moot.[108] The English Court of Appeal nevertheless took the opportunity to criticize Prudential's self-proclaimed "public spirit" and created the foundations of the current leave procedure so as to keep derivative litigation in proper check.[109]

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103. Nikki Tait, *Costs Pose an Obstacle in Settling Equitable Case*, FIN. TIMES, Sept. 26, 2005, at 6; Nikki Tait, *Equitable Risks Bill of £75m for Legal Costs*, FIN. TIMES, Feb. 4, 2005, at 3.

104. ELIZABETH J. BOROS, MINORITY SHAREHOLDERS' REMEDIES 191 (1995). In Marx v. Estates & Gen. Invs. Ltd., (1976) 1 W.L.R. 380, the shareholder plaintiffs were awarded costs from the defendant on the basis that the plaintiffs had done a great service for the company.

105. Spokes v. The Grosvenor & W. End Ry. Terminus Hotel Co. Ltd., (1897) 2 Q.B. 124, 128.

106. Quigxiu Bu, *The Indemnity Order in a Derivative Action*, 27 COMPANY LAW. 2, 3 (2006); Nolan (2005), *supra* note 68, at 429.

107. Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), (1982) 1 All E.R. 354 (Ch.). In Qayoumi v. Oakhouse Prop. Holdings Plc, [2002] EWHC (Ch) 2547, (2003) 1 B.C.L.C. 352, a damages claim was brought against an insider by way of a derivative action but the company, while a plc, was apparently not publicly quoted. Two searches were conducted to verify the point made here. One was a search of the Westlaw's English case law database using the terms "derivative suit" and "plc." The other was a check of the annual indexes of Butterworths Company Law Cases, a law report series published since 1983 devoted solely to company law cases. Butterworths Company Law Cases is edited by Dan Prentice, a law professor at Oxford, and Mary Stokes, a barrister, each of whom has excellent connections among the company law bar in London.

108. Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), (1982) 1 All E.R. 354, 364–65 (Ch.). The company's stance changed because the non-executive directors "switched sides" before the matter came before the Court of Appeal. *See* BOYLE (2002), *supra* note 93, at 29.

109. The Court of Appeal wrote: "[W]e were invited to give judicial approval to the public spirit of the plaintiffs who, it was said, are pioneering a method of controlling companies in the public interest . . . . In our view voluntary regulation of companies is a matter for the City [London's financial district]. The compulsory regulation of companies is a matter for Parliament."

The Company Law Reform Bill currently before Parliament would give judges more flexible criteria to apply in determining whether to grant leave so a shareholder can pursue a derivative suit.[110] Fears have been expressed that reform will open the door to litigation against directors, including non-executives.[111] Such concerns seem overblown. Under the Bill, a judge is obliged to deny leave where the applicant is not seeking to promote the success of the company or where the breach has been ratified by the shareholders. A judge also can, in his discretion, rely on additional prescribed grounds to dismiss an application (e.g. lack of good faith on the part of the applicant).[112] Furthermore, legislative reform will not alter other deterrents to derivative litigation, such as the "loser pays" rule, the potential reluctance of courts to order the company to reimburse a shareholder's legal expenses, and the company's right of recovery in a successful lawsuit.[113] It therefore seems unlikely that statutory reform will increase markedly the frequency of derivative suits.[114]

D. Direct Shareholder Suits

When a shareholder in a U.K. company has had his personal rights infringed, the twists and turns of the derivative suit procedure do not come into play because the shareholder sues in his own name to enforce his own rights.[115] Section 459 of the Companies Act 1985 permits shareholders who

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Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), (1982) 1 All E.R. 354, 367–68 (Ch.). On the Court of Appeal's judgment and the leave procedure, see PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.804.1.

110. H.L. Bill [34], § 239(3); H.L. Bill [34–EN], ¶ 482. On the courts' increased discretion under the proposed reforms, see DAVIES (2003), *supra* note 80, at 464–65 (discussing a proposal for reforming derivative litigation made by the Law Commission of England and Wales that was the foundation for the Company Law Reform Bill provisions).

111. Andrew Hill, *Reform the Reform Bill*, FIN. TIMES, Feb. 11, 2006, at 14; Nikki Tait & Bob Sherwood, *Directors on Guard Against Legal Action*, FIN. TIMES, Nov. 2, 2005, at 3; Watts (2006), *supra* note 79, at 6.

112. H.L. Bill [34], § 242(2).

113. Brian R. Cheffins, *Reforming the Derivative Action: The Canadian Experience and British Prospects*, 1 COMPANY FIN. & INSOLV. L. REV. 227, 259–60 (1997) (discussing proposals for reform of derivative litigation set out in LAW COMMISSION OF ENGLAND AND WALES, SHAREHOLDER REMEDIES: A CONSULTATION PAPER (1996)).

114. *See* James Rice, *Company Law Reform Raises UK Corporate Governance Questions*, INT'L FIN. L. REV., Dec. 2005, at 7 (quoting a lawyer at Clifford Chance, a London law firm, who said of the proposed rules "[t]hey don't give institutional investors any more tricks for rattling directors' cages").

115. PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.809. Theoretically, there is also scope under tort law for a direct suit against outside directors, but the likelihood is too small to merit discussion in the main text. Under English law, directors generally do not owe duties directly to creditors, employees, or customers but can be held liable for procuring the commission of a corporate tort, for torts they commit personally in the course of office for which the company is vicariously liable, and for assuming personal responsibility for a negligent misstatement by the company. Neil Campbell & John Armour, *Demystifying the Civil Liability of Corporate Agents*, 62 CAMBRIDGE L.J. 290 (2003). Outside directors are unlikely to be sufficiently involved in running a public company's business for any of these scenarios to be relevant.

have been "unfairly prejudiced" by the conduct of a company's affairs to apply for relief.[116] Proceedings brought under § 459, sometimes referred to as "[t]he most valuable shareholder remedy,"[117] are similar to a suit for oppression under U.S. law. Still, whereas U.S. courts do not entertain applications for relief based on oppressive conduct by a shareholder in a public company, English courts sometimes will.[118] Moreover, a breach of duty by a company's directors may be deemed unfair prejudice under § 459.[119] Thus, in theory, proceedings under this provision could put the assets of outside directors at risk. In practice, however, there is little to fear.

Most cases brought under § 459 of the Companies Act 1985 involve the improper diversion of assets or similar self-serving conduct.[120] Outside directors of public companies are unlikely to engage in such misbehavior. Serious mismanagement can also amount to unfair prejudice but again this should not pose a serious problem for non-executives.[121] A court is unlikely to make such a finding unless those in charge of a company have, for ulterior motives, continued to rely on demonstrably incompetent directors.[122] Matters are unlikely to degenerate to this level in a U.K. public company.

Practical considerations further ensure that non-executives have little to fear from § 459. The customary remedy after a successful petition is a buy-out at fair value.[123] In a public company, only rarely will a judicially-ordered buy-out be more attractive than simply selling one's shares on the stock market.[124] This does much to explain why almost all petitions brought under § 459 involve private companies.[125]

A shareholder in a public company might contemplate seeking a buy out under § 459 if the share price was depressed due to alleged managerial misconduct or adverse market conditions.[126] Nevertheless, launching a petition is unlikely to be a worthwhile gamble. Petitioners often have to fend off motions to have their petition struck out on the basis that it does not

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116. Companies Act, 1985, c. 6, § 459.

117. HANNIGAN (2003), *supra* note 17, at 411.

118. On public companies and the U.S. oppression remedy, see COX, HAZEN, & O'NEAL (1997), *supra* note 72, § 14.12. On § 459 petitions being theoretically viable in U.K. public companies, see BOYLE (2002), *supra* note 93, at 101–02; HANNIGAN (2003), *supra* note 17, at 425–26.

119. BOYLE (2002), *supra* note 93, at 100.

120. PALMER'S COMPANY LAW, *supra* note 50, ¶ 8.904.

121. Re Elgindata Ltd., [1991] B.C.L.C. 959, 993–94 (Ch.).

122. Re Macro Ipswich Ltd., (1994) 2 B.C.L.C. 354, 406 (Ch.); JOHN LOWRY & ALAN DIGNAM, COMPANY LAW 237–38 (3d ed. 2005).

123. See BOYLE (2002), *supra* note 93, at 108; LAW COMMISSION OF ENGLAND AND WALES, *supra* note 113, at 96.

124. BOYLE (2002), *supra* note 93, at 102; Arad Reisberg, *Shareholders' Remedies: In Search of Consistency of Principle in English Law*, 16 EUR. BUS. L. REV. 1065, 1081 (2005).

125. *See* LAW COMMISSION OF ENGLAND AND WALES, *supra* note 113, at 236 (reporting that in 1994–95, of the 156 petitions brought under § 459, 150 involved private companies. The Law Commission does not say whether any of the 6 "plcs" were publicly traded).

126. *Id.* at 96 n.27.

disclose a reasonable cause of action (analogous to a U.S. motion to dismiss).[127] If a case proceeds toward trial, a petitioner's legal fees can mount quickly since the open-ended "unfair prejudice" standard creates scope for lengthy, fact-intensive trials.[128] In addition, while petitioners in private companies can rely on breaches of informal undertakings and agreements to support a claim for unfair prejudice, shareholders in public companies cannot.[129] Due to all of the foregoing factors, § 459 is of little practical relevance for public companies.[130] Indeed, there does not appear to be a reported case involving a public company where a petition has been successful.[131]

Aside from factors that deter § 459 petitions against public companies, non-executive directors are further protected in two ways. First, as with any cause of action, the loser-pays rule will instill caution in shareholders as to whom they name as defendants. If a suit is brought against non-executive directors and is dismissed against them they will be able to seek reimbursement for their legal expenses from the petitioner even if the suit succeeds against other defendants. With the stakes raised in this way, a plaintiff may well focus on the insiders—who are usually more culpable—and leave the outside directors out of the picture.

Second, even if non-executives are named as respondents in § 459 petition and the suit succeeds, it is unlikely they will be held liable personally. A court dealing with a s. 459 petition is specifically authorized to "make such order as it thinks fit" when unfair prejudice has been established so in theory a judge could make a damages award against a director.[132] Petitioners, however, only rarely seek damages as a form of relief.[133] Again, the most common remedy in § 459 proceedings is a buyback of shares, which would not put the directors' assets directly at risk.

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127. Civil Procedure Rules, 1998, S.I. 1998/3132, art. 3.4, ¶ 2(a); LAW COMMISSION OF ENGLAND AND WALES, *supra* note 113, at 112. In theory, a petitioner under § 459 could apply for summary judgment on the basis that "the defendant has no real prospect of succeeding the claim or issue." Civil Procedure Rules, 1998, S.I. 1998/3132, art. 24.2; ANDREWS (2003), *supra* note 19, at 508–09. Such a claim is unlikely to succeed because the open-ended "unfair prejudice" standard under § 459 ensures most respondents will be able to proffer a credible defense.

128. DAVIES (2002), *supra* note 62, at 240.

129. PALMER'S COMPANY LAW, *supra* note 50, ¶¶ 8.906–8.906.4.

130. Nolan (2005), *supra* note 68, at 434.

131. This was verified by searching the indexes of unfair prejudice cases in Butterworths Company Law Cases and a search of Westlaw's English case law database using the search terms "plc" and "unfair prejudice". In one case, Rock Nominees Ltd. v. RCO (Holdings) Plc, [2003] EWHC (Ch) 936, (2003) 2 B.C.L.C. 493, directors of a public company acquired by takeover were found to have breached fiduciary duties owed to the company. The petitioner, a minority shareholder, was unable to establish, however, that it had suffered any loss by virtue of the misconduct.

132. Companies Act, 1985, c. 6, § 461(1).

133. *See* LAW COMMISSION OF ENGLAND AND WALES, *supra* note 112, at 236 (reporting that of s. 459 petitions brought in 1994-95, compensatory damages were only sought as a form of relief in 7% of the cases).

In addition to § 459 of the Companies Act 1985, shareholders in a public company can potentially sue in their own name under U.K. securities law to recover losses caused by false or misleading corporate disclosures. As with § 459, however, ultimately the risks posed to non-executive directors of U.K. public companies are negligible. One reason is that U.K. law lacks an analogue to S.E.C. Rule 10b-5, the far-reaching provision which provides a private right of action under U.S. securities law for material misstatements that affect secondary trading of securities. Negligent misstatements in the annual accounts and other documents disseminated by directors of a U.K. public company can in theory form the basis for a suit by investors, but such a suit can only succeed in the rare event that the information was provided to guide a specific purchase or sale of shares.[134]

Directors of U.K. public companies can become liable to shareholders for "listing particulars" (documents circulated in support of a public offering) that fail to include required material or that contain false or misleading disclosures. Section 90 of the Financial Services and Markets Act 2000 authorizes a claim for compensation against persons responsible for preparing listing particulars. Supporting regulations provide that directors fall within the definition of responsible persons and do so without distinguishing between executive and non-executive directors.[135] A claim under section 90 is analogous to a U.S. claim under § 11 of Securities Act of 1933 for prospectus misdisclosure.[136] Lawsuits of this sort are, however, virtually unknown in Britain. Indeed, there is no reported case in which a claim has been brought under § 90 of the Financial Services and Markets Act 2000 or that provision's predecessor in the Financial Services Act 1986.[137]

Difficulties associated with organizing multiparty litigation do much to explain the absence of shareholder lawsuits based on misleading disclosure. Traditionally, the closest English equivalent to the U.S. class action has been the "representative action," but doubts exist whether this mechanism can be used to claim damages, at least without a two-stage procedure under which represented parties have to prove their loss individually in separate

134. *See* GORE-BROWNE ON COMPANIES ¶ 43.27 (Alistair Alcock ed., 50th ed. 2004).

135. On the fact that directors are deemed to be persons responsible for listing particulars, see Financial Services and Markets Act, 2000, c. 8, § 79(3) (which leaves the issue to be determined by regulation); Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations, 2001, S.I. 2001/2956, art. 6, ¶ (1)(b) (which names directors as a "person responsible").

An investor can also sue at common law for compensation on the basis of a misleading prospectus. *See* Possfund Custodian Tr. Ltd. v. Diamond, (1996) 2 All E.R. 774 (Ch.). We focus on statutory liability since it is more extensive in a variety of respects. *See* ENCYCLOPEDIA OF FINANCIAL SERVICES LAW ¶ 2A-190 (Eva Z. Lomnicka & John L. Powell eds., 1987–2001).

136. 15 U.S.C. § 77k (2000).

137. Financial Services Act, 1986, c. 60, § 150. This was verified by a search of the index of statutory provisions cited in all volumes of Butterworths Company Law Cases and a search of Westlaw's English case law database using the search terms "section 90" with "Financial Services and Markets Act" and "section 150" with "Financial Services Act."

proceedings.[138] Reforms carried out in 2000 sought to facilitate multiparty litigation by letting those launching proceedings bring a case under the control of a single court at a very early stage under a "group litigation order."[139] These reforms led to speculation that a wave of securities fraud litigation would follow.[140] This, however, has not yet occurred.[141]

While group litigation orders can make multi-party litigation feasible, funding constraints have thus far deterred securities lawsuits in the U.K.[142] A core difficulty is that no one party will want to pay for a lawsuit benefiting a large class of plaintiffs. No-win, no-fee agreements have been identified as a potential corrective,[143] but, as mentioned such arrangements are not particularly attractive for lawyers.[144] Also, the "loser pays" rule discourages the use of group litigation orders since litigants know that if a group claim is lost each will likely be ordered to pay a proportion of any costs awarded in favor of the defendants.[145] With such obstacles in place, it is unsurprising the group litigation order has not acted as a catalyst for securities fraud class actions in the U.K.

If securities class actions alleging misleading listing particulars do become common, non-executive directors may still be infrequently named as defendants. In such litigation, the company should be a sufficiently deep pocket for the plaintiffs to aim at and will be an easier target since it will not

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138. NEIL ANDREWS, PRINCIPLES OF CIVIL PROCEDURE 135–43 (1994) (discussing the two leading cases: Markt & Co. Ltd. v. Knight S.S. Co. Ltd., (1910) 2 K.B. 1021 and Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 1), [1981] Ch. 229).

139. ANDREWS (2003), *supra* note 19, at 977–83 (discussing Civil Procedure Rules, 1998, S.I. 1998/3132, art. 19.11).

140. *See, e.g.*, Kate Burgess & Jean Eaglesham, *Litigious Rush May be Equal to Courting Worse Disaster*, FIN. TIMES, May 4, 2002, at 2; Florian Gimbel, *U.K. Gets Ready to Adopt a U.S. Class Act*, FIN. TIMES, Nov. 25, 2002, at 3.

141. On the difficulties afflicting the group litigation procedure, see Andrew Bolger, *Counting the Cost of Full Cover*, FIN. TIMES, July 7, 2003, at 4; Paul Ferrow, A *Class Act?*, SUNDAY TELEGRAPH, May 12, 2002, at 6; *How a Law Firm Makes a Claim to be the Investors Champion*, FIN. ADVISER, Aug. 7, 2002, *available at* 2002 WLNR 4104324.

142. Heather Smith, *Critical Mass,* AM. LAW.: FOCUS EUR., Jan. 1, 2006, *available at* http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1139479511687 (quoting a litigation partner in a London firm as saying "it is not easy to bring these sort of cases because of the funding of the cases").

143. *See*, *e.g.*, Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L L. 477, 501 (2004).

144. *Supra* notes 93–95 and accompanying text. *See also* Nikki Tait, *Class Actions Cross the Atlantic*, FIN. TIMES, June 16, 2005, at 14 (quoting a senior partner at one of the UK's top litigation firms: "Where is the incentive for class actions? Unless you give lawyers the real incentives to bring these class actions, they won't happen.").

145. ANDREWS (2003), *supra* note 19, at 983. A class action by private shareholders of Railtrack, a bankrupt privatized rail operating company, illustrates. The shareholders alleged the U.K. government had, with malice, cut off funding for Railtrack in order to bankrupt and renationalize it. Before the 2005 trial could go ahead, the plaintiffs had to put up £2.03 million of their own money so that there would be sufficient funds to pay an adverse costs order. Of the original 55,000 class members, 6,000 dropped out rather than pay to keep the case going. The action failed, so those who paid up lost their contribution. Smith (2006), *supra* note 142.

be able to rely on what amounts to a "due diligence" defense available to directors.[146] Even if the company is insolvent, investors may still leave the directors out of the picture. The U.K.'s loser pays rules provide one incentive for plaintiffs to forgo bringing directors to court, this being to avoid the risk of paying the directors' legal costs if the action fails.[147]

Non-executive directors will also be low in the pecking order because they are unlikely to be a deep pocket worth pursuing vigorously. They will often have enjoyed successful business careers. Still, the damages claimed in a lawsuit where a sizeable public company has suffered a significant financial reversal will most often dwarf the directors' personal wealth, especially if the directors have been paying their own counsel.[148] Once again, Equitable Life illustrates. As the case was proceeding, a number of the ex-directors said that if they became liable to pay damages under a settlement or as a result of a trial, there would be nothing for the company to collect from them because their financial assets would have been swallowed up by legal expenses.[149]

A final point. A significant number of British public companies cross list on an American stock exchange and thus face exposure to U.S. securities class actions.[150] Our search for personal payments by directors of U.S. public companies uncovered one instance where outside directors of a cross-listed U.K. public company—Independent Energy Holdings plc—paid out of their own pocket.[151] The claim was brought for misleading disclosure in a public

146. Directors have a defense if they reasonably believed that the listing particulars were accurate and fully informative or relied on the advice of expert advisers they reasonably believed were competent. Financial Services and Markets Act, 2000, § 90(2), sch. 10, §§ 1(2), (3), 2. Companies are not expressly prohibited from relying upon this defense, but the defense focuses on beliefs that could not be readily attributed to a company.

147. Gareth Chadwick, *The Blame Game*, THE LAWYER, July 15, 2002, *available at* http://www.thelawyer.com/cgibin/item.cgi?id=77434. An auditor sued for failing to detect financial irregularities might cross-claim against the directors alleging negligence. On Canadian cases where this has occurred, see KEVIN P. MCGUINNESS, THE LAW AND PRACTICE OF CANADIAN BUSINESS CORPORATIONS 790 (1999).

148. HANNIGAN (2003), *supra* note 17, at 311.

149. Nikki Tait, *Costs Pose an Obstacle in Settling Equitable Case*, FIN. TIMES, Sept. 26, 2005, at 6; Nikki Tait, *Equitable Risks Bill of £75m for Legal Costs*, FIN. TIMES, Feb. 4, 2005, at 3.

150. As of May 2006, there were 60 U.K. cross-listings on the New York Stock Exchange, though there were multiple listings for two companies (HSBC and Royal Bank of Scotland). NEW YORK STOCK EXCHANGE, LISTED COMPANY DIRECTORY (May 7, 2006), http://www.nyse.com/about/listed/6.html?country=United%20Kingdom&ListedComp=All. Eighteen were listed on NASDAQ. NASDAQ, NASDAQ INTERNATIONAL COMPANIES (May 7, 2006), http://www.nasdaq.com/asp/NonUsOutput.asp?page=U®ion=europe. For examples of lawsuits brought under U.S. securities law against U.K. companies, see Gareth Mackie, *Cable & Wireless Face Threat of £1.8bn Action*, EVENING NEWS (Scotland), Jan. 28, 2003, at B7; Jill Treanor, *ICI Faces Inquiry after Warning on Profits*, GUARDIAN, Apr. 12, 2003, at 26; Liz Vaughan-Adams, *FSA Censure Strengthens Legal Case Against Marconi Directors*, INDEPENDENT (London), Apr. 12, 2003, at 21.

151. *See In Re* Indep. Energy Holdings PLC Sec. Litig., No. 00 Civ. 6689, 2003 U.S. Dist. LEXIS 17090 (S.D.N.Y. Sept. 29, 2003). For further details on this case, see *Outside Director Liability*, *supra* note 1, at 1072.

offering under section 11 of the Securities Act 1933, under which a plaintiff need only establish negligence rather than any sort of intent or gross recklessness.[152] The company was in receivership and thus could not provide indemnification.[153] Moreover, insurance coverage was low and was being contested by the insurers. The result was a "Perfect Storm" for two outside directors who paid an undisclosed fraction of a $2 million personal payment as part of a larger settlement (the company's former CEO paid most but not all of this amount).

Despite Independent Energy Holdings, our research on the U.S. suggests outside directors of companies cross-listed in the U.S. should face only a remote chance of ending up in a similar predicament. Again, in the U.S., outside directors rarely make personal payments in securities litigation and the risks they face are particularly small if they purchase D&O insurance that meets current norms. Hence, outside directors of U.K. companies cross-listed on a U.S. stock market have little reason to fear out-of-pocket liability, assuming D&O coverage—which we discuss next—has been dealt with properly.

E. Insulation from Potential Liability

A recurring theme in the foregoing discussion is that there is little chance that non-executive directors of U.K. public companies will end up being sued. For those who suffer this misfortune, three mechanisms can reduce the likelihood that they will end up out-of-pocket. First, § 727 of the Companies Act 1985 provides that a judge can excuse directors for a breach of duty if they establish they acted honestly and reasonably and "ought fairly to be excused."[154] Careless directors will struggle, however, to establish that they have acted "reasonably."[155]

Second, a director might benefit from indemnification by the company. The Companies Act 1985 precludes indemnification of a director with respect to a fine, administrative penalty, or a damages payment resulting from a breach of duty owed to the company.[156] Also, in contrast with the

152. On the liability standard under Section 11, see *Outside Director Liability*, *supra* note 1 at 1078.

153. U.K. company law may have precluded indemnification in any event. On this point, see *infra* note 156 and related discussion.

154. Companies Act, 1985, c. 6, § 727.

155. *See* COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK 45 (2000), *available at* http://www.dti.gov.uk/cld/modcolaw.htm. Nevertheless, there have been cases in which a director failed to exercise reasonable care but made a successful application under § 727. *See, e.g.*, Re D'Jan of London Ltd., (1994) 1 B.C.L.C. 561, 564 (Ch.) ("It may seem odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy a court that he acted reasonably. Nevertheless, the section clearly contemplates that he may do so and it follows that conduct may be reasonable for the purposes of [§] 727 despite amounting to lack of reasonable care at common law.").

156. Companies Act, 1985, c. 6, §§ 309A(1), 309B(3).

position in the United States, a director who loses in court cannot be reimbursed for legal expenses.[157] However, amendments to U.K. company law adopted in 2004 in response to the Equitable Life case have liberalized the rules concerning indemnification.[158] Traditionally, companies could indemnify expenses incurred by a director who was successful on the merits, but could not reimburse for legal expenses on an interim basis and likely could not do so for damages payable in cases brought by third parties (e.g. shareholders alleging misdisclosure in a securities lawsuit).[159] As a result of the 2004 reforms, companies can now advance legal expenses incurred as a case proceeds—subject to repayment if the director loses in court. They can also now indemnify their directors for liabilities arising in civil proceedings third parties have launched.[160]

Third, an outside director can rely on D&O insurance.[161] Britain is the largest European market for this product.[162] As of a few years ago, a substantial minority of U.K. companies with annual turnover of over £100 million had not purchased cover.[163] This figure has likely now dropped. Liability fears, sparked in part by the Equitable Life case, have boosted demand for D&O insurance even among smaller public companies that previously did not treat coverage as a priority.[164] Moreover, the Combined Code— a set of corporate governance practices that London Stock Exchange companies must observe on a "comply or explain" basis—was amended in 2003 to urge public companies to provide appropriate D&O insurance to cover legal claims against directors.[165]

Typically, D&O policies in Britain give cover for "losses" arising from culpable acts or omissions committed in the insured's capacity as a director.

157. Companies Act, 1985, c. 6, § 309B(4).

158. Companies Act, 1985, c. 6, §§ 309B(1), 337A, *added by* Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, §§ 19, 20. The Company Law Reform Bill would amend these rules but only in technical respects. H.L. Bill [34], §§ 186, 210, 212–13.

159. *See* DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS 65 (2003) (urging reform to the law that would permit companies to indemnify for legal expenses on an ongoing basis); Baxter (1995), *supra* note 85, at 543–45 (discussing indemnification for liability to third parties).

160. On the effect of the 2004 reforms, see Vanessa Knapp & Jeremy Evans, *Protecting Directors from Liability: The Current Regime*, PRAC. L. COMPANIES, Dec. 2005, at 45, 45–46; Jonathan Ross & Tamar Halevy, *Indemnifying Directors*, 155 N.L.J. 662, 662 (2005).

161. Companies Act, 1985, c. 6, § 309A(5) (authorizing companies to buy D&O insurance).

162. Chris Parsons, *Directors' and Officers' Liability Insurance: A Target or a Shield?*, 21 COMPANY LAW. 77, 78 (2000).

163. *Id.* at 78; *see also* Carolyn Aldred, *Directors in Hot Seat*, BUS. INS., May 6, 2002, at 21 ("Many non-executive directors are inadequately insured by the companies on whose boards they sit . . . .").

164. Sundeep Tucker, *The Risk-Reward Ratio Changes for the Worse*, FIN. TIMES, Apr. 18, 2005, at 4 ("D&O is now high on the radar of those smaller companies which previously devoted little interest to the topic.").

165. *See* COMBINED CODE ON CORPORATE GOVERNANCE ¶ A.1.9 (2003), *available at* http://www.frc.org.uk/documents/pagemanager/frc. The change was made to implement recommendations set out in HIGGS (2003), *supra* note 159, at 65–66.

"Culpable act" will usually be defined broadly to include breaches of duty, breaches of trust, neglect, and wrongful trading. "Losses" will generally be defined to include sums directors pay as damages paid under a settlement or after a trial and legal costs incurred defending claims.[166] D&O policies specifically exclude coverage for dishonest or fraudulent conduct and for the obtaining of a private benefit or profit.[167] Reimbursement under insurance policies also cannot contravene public policy, which means that knowing or intentional misconduct may be uninsurable.[168]

Another relevant concern is coverage limits. Until recently, the liability cover for U.K. directors was typically £5 million or less.[169] Partly because the Equitable Life litigation illustrated legal expenses generated by a lawsuit against directors could readily exceed this sort of amount, U.K. public companies have been negotiating for higher coverage limits. Among the largest 100 or so public companies in the U.K., coverage of £100–200 million (comparable to U.S. levels) is now becoming common.[170]

A shift towards higher policy limits could ironically be a catalyst for more litigation against directors.[171] A coverage ceiling of £5 million made "the risk/reward ratio simply too low" to justify suits against directors.[172] On the other hand, coverage of £100 million could be a sufficiently deep pocket to encourage lawsuits designed to reach that pocket. Still, with regard to out-of-pocket liability, the unfavorable procedural terrain in the U.K. should mean that even well-insured U.K. directors will face much less risk of being sued than their U.S. counterparts.

F. *How Does Corporate Insolvency Affect Matters?*

In Britain, severe corporate financial distress increases non-executive directors' risk of out-of-pocket liability in theory but, thus far, not in practice. One change concerns a company's willingness to sue directors. Ordinarily, a board controls litigation decisions and will rarely sue one of its own. On the other hand, once a company enters a reorganization process under U.K. insolvency legislation known as "administration," the administrator becomes

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166. Parsons (2000), *supra* note 162, at 79. We discuss "wrongful trading" in subpart IV(F), *infra*.

167. DIGBY C. JESS, THE INSURANCE OF COMMERCIAL RISKS: LAW AND PRACTICE 234–35 (3d ed. 2001); THE LAW COMMISSION & THE SCOTTISH LAW COMMISSION, COMPANY DIRECTORS: REGULATING CONFLICTS OF INTEREST AND FORMULATING A STATEMENT OF DUTIES: A JOINT CONSULTATION PAPER 255 (1998), *available at* http://www.scotlawcom.gov.uk/downloads/dp105_reg_conflicts.pdf.

168. John R. Birds, *Directors' Duties of Care and Liability Insurance*, *in* THE REGULATION OF THE BRITISH SECURITIES INDUSTRY 114, 120 (Barry A. K. Rider ed., 1979).

169. *See* Gimbel (2002), *supra* note 140 ("In the UK, liability cover rarely exceeds £5m – well below the hundreds of millions of dollars that back up US directors.").

170. Bolger (2003), *supra* note 141.

171. Parsons (2000), *supra* note 162, at 84–85; Hirt (2005), *supra* note 91, at 159–160.

172. Gimbel (2002), *supra* note 140 (quoting Robin Ellison, a partner at a U.K. law firm).

authorized to bring any action in the name of the company.[173] If a company is being wound up, the company's liquidator has the same power.[174] Also, § 212 of the Insolvency Act 1986 authorizes a liquidator to apply to the court for an order requiring the directors to make a just contribution to the company's assets if the directors engaged in misfeasance or breached a duty to the company.[175] There is, however, no reported decision in which an administrator has exercised its right to bring an action on behalf of the company against a director, inside or outside. Moreover, while there have been some cases brought by liquidators against directors of insolvent companies, we found none involving a public company.[176]

As well as shifting control over the decision about whether a company will sue, financial distress creates an additional source of liability risk for directors.[177] A liquidator may petition a court to rule that the company's directors have engaged in "wrongful trading" and therefore should contribute to the assets available to creditors.[178] A director engages in wrongful trading if (i) the company is in liquidation; (ii) during his time as a director he knew or ought to have concluded there was no reasonable prospect that it would avoid this fate; and (iii) he failed to take every step a reasonably competent director would have taken to minimize the creditors' potential loss.[179]

Some commentators expected wrongful trading to reshape director liability when the concept was introduced in the mid-1980s.[180] Wrongful trading has proved instead to be a "great disappointment" with only a few such proceedings coming to court.[181] A 2005 survey of wrongful trading

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173. Insolvency Act, 1986, c. 45, sched. 1, ¶ 5.

174. *Id.* at sched. 4, ¶ 4. On the appointment of the liquidator in the case of a winding up, see Insolvency Act, 1986, c. 45, §§ 91, 101, 136.

175. Section 212 does not create any new rights or duties but, instead, is a statutory action to enforce wrongs done to the company. Fidelis Oditah, *Misfeasance Proceedings Against Company Directors*, 1992 L.M.C.L.Q. 207, 208–09.

176. To research these points, we searched the Butterworths Company Law Cases series and Westlaw's English case law database. With the Butterworths Company Law Cases, the focus was on cases listed under the heading "Director" and on cases that cited § 212 of the Insolvency Act 1986 and its predecessor, § 333 of the Companies Act 1948. The Westlaw search was carried out under the terms "Insolvency Act 1986" and "212" and "Companies Act 1948" and "333". Individual creditors can also apply for relief under § 212 but our search only uncovered one case of this type: Re Ayala Holdings Ltd., [1993] B.C.L.C. 256 (Ch.). This case also did not involve a public company.

177. Insolvency Act, 1986, c.45, § 214.

178. *Id.* An administrator, unlike a liquidator, does not have standing to apply for a wrongful trading order. HANNIGAN (2003), *supra* note 17, at 779.

179. Insolvency Act, 1986, c. 45, § 214(2).

180. *See* D.D. Prentice, *Creditor's Interests and Director's Duties,* 10 OXFORD J. LEGAL STUD. 265, 277 (1990) (characterizing wrongful trading as "one of the most important developments in company law this century"); *see also* Nicholas Bourne, *Wrongful Trading—The Start of Something Big*, 16 BUS. L. REV. 79, 79 (1995) (highlighting the importance of wrongful trading as an "objective benchmark for directors").

181. VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 513 (2002); *see also* STEPHEN GRIFFIN, PERSONAL LIABILITY AND DISQUALIFICATION OF COMPANY

cases found that none had involved directors of public companies, whether executive or non-executive.[182]

Why has this happened? One problem is that the triggers for liability are ambiguous. Discerning the "moment of truth" when a director knew or ought to have concluded the company's situation was hopeless will often be a fact-intensive enquiry. So, too, for ascertaining whether a director failed to take "every step" to minimize the potential loss to the company's creditors, since Insolvency Act 1986 § 214 gives no guidance on what those steps might be. Measuring damages can also prove troublesome since § 214 provides no method for calculating a director's contribution.[183]

Given the ambiguities of § 214, a trial can easily become complex, lengthy, and expensive.[184] Liquidators thus will often reasonably conclude that even though a wrongful trading action might be sustainable, the delay and expense involved mean suing is not worthwhile.[185] The creditors are unlikely to dissent. If a liquidator sues under § 214 and loses, the liquidator will be able to claim reimbursement for the legal expenses—including an adverse costs order—in priority over unsecured creditors.[186] Another factor that deters liquidators from suing directors under § 214 or, for that matter, any other cause of action, is the defendants' uncertain wealth. A liquidator will only want to proceed against worthwhile targets and, as we have seen, non-executive directors of U.K. public companies are unlikely to be rich.

A final point to remember with wrongful trading is that D&O insurance policies typically cover this type of liability.[187] As coverage available

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DIRECTORS 96–97 (1999); Andrew Keay, *The Duty of Directors to Take Account of Creditors' Interests: Has it Any Role to Play?*, 2002 J. BUS. L. 379, 393–94.

182. RIZWAAN JANEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 289–92 (2005). He reports that in all but three cases brought involving allegations of wrongful trading, the companies were closely held and/or the claims were made against "shadow" directors (e.g., controlling shareholders) rather than actual directors. None of the three exceptions Mokal mentions involved a publicly-quoted company.

183. GRIFFIN (1999), *supra* note 181, at 83.

184. CHEFFINS (1997), *supra* note 91, at 542–43; GRIFFIN (1999), *supra* note 181, at 74–75, 92–93.

185. FINCH (2002), *supra* note 181, at 383–84; *cf.* Barrett v. Duckett, (1995) 1 B.C.L.C. 243, 255 (making the same point about liquidators and litigation generally, not just in relation to wrongful trading). A way around this problem might be for a liquidator to engage counsel on the basis of a conditional fee arrangement, but payment on this basis holds few attractions for lawyers. *See supra* notes 92–94 and accompanying text.

186. Under U.K. insolvency law, secured creditors are entitled to be paid out of the proceeds of their security ahead of all other claims. Buchler v. Talbot, [2004] UKHL 9, (2004) 2 A.C. 298. Litigation expenses incurred by the liquidator rank next. *See* FINCH (2002), *supra* note 181, at 424 (discussing Insolvency Act, 1986, ch. 45, §§ 115, 175(2)(a)). A 2002 amendment to rules supporting the Insolvency Act 1986 made it clear that legal expenses incurred to pursue wrongful trading proceedings fall into this category. Insolvency (Amendment) (No 2) Rules, 2002, S.I. 2002/2712, sched. 1, ¶ 23 (amending Insolvency Rules, 1986, S.I. 1986/1925 art. 4.218, ¶ 1(a)). The liquidator's claim extends to unsuccessful as well as successful proceedings. Fiona Tolmie, *Funding Litigation by Liquidators: A Consideration of the Amendment to Rule 4.218*, 4 INSOLVENCY LAW. 153, 155 (2003).

187. JESS (2001), *supra* note 167, at 215; Parsons (2000), *supra* note 162, at 79.

increases, D&O policies could become tempting targets for a liquidator. On the other hand, the insurability of wrongful trading liability is not free from doubt. Some view this form of liability as penal rather than compensatory, which means reimbursement under D&O policies could contravene public policy.[188] Even if D&O coverage for wrongful trading is valid, a liquidator's desire to wrap matters up without a trial should create substantial momentum for a settlement based solely on the insurance proceeds and thereby ensure the directors do not make an out-of-pocket payment.

G. U.K. Summary

In the U.K., as in the U.S, outside directors face only a remote chance of paying damages or legal expenses out of their own pocket. The reasons, however, differ. In the U.S., directors face a substantial risk of being sued but benefit from an array of shields that ensure they rarely pay out-of-pocket, including: (i) the business judgment rule; (ii) charter provisions that eliminate liability for breach of the duty of care; (iii) indemnification; (iv) the universal purchase of D&O insurance; and (v) settlement incentives which typically lead to settlement within D&O policy limits. In Britain, by contrast, the shields against liability are weaker, but lawsuits are rare. The bottom line risk of an out-of-pocket payment therefore is similar—present but small.[189]

The Equitable Life directors were justifiably distressed to be sued. Yet in the end, Independent Energy Holdings is the only case we know of where non-executive directors of a U.K. public company have ended up out-of-pocket as a result of civil proceedings, and the directors in that case may well have been protected if there had been a better D&O insurance policy in place. Non-executive directors in fact appear to be aware that there is little chance they will have to make out-of-pocket payments. Despite much discussion of growing liability risk, U.K. public companies continue to be able to find suitable candidates to serve on their boards.[190]

The fact that the U.S. and the U.K. have got to the same point by a different route is not coincidental. The layers of protection outside directors enjoy in the U.S. arose in large part because of apprehension about being sued. In contrast, protecting directors in the U.K. from liability has not been a priority because the chances of a lawsuit have been so small. Concerns about director liability have recently been growing, however, due in large part to the Equitable Life litigation, and, consistent with the U.S. pattern,

188. *See* Baxter (1995), *supra* note 85, at 551. On whether the sanction for wrongful trading is primarily penal or compensatory. *Compare* GRIFFIN (1999), *supra* note 181, at 83 (compensatory), *with* MOKAL (2005), *supra* note 182, at 296–99 (penal).

189. CHARKHAM (2005), *supra* note 16, at 364 ("The directors of U.K. companies are seldom sued and on the whole do not fear litigation.").

190. KPMG (U.K.) & LINSTOCK, THE CORPORATE GOVERNANCE REPORT: INVESTOR POLICIES AND CORPORATE PRACTICE 17–18 (2006), *available at* http://www.kpmg.co.uk/news/detail.cfm?pr=2417.

attempts to protect directors have followed.[191] The 2004 amendment to U.K. companies legislation to allow advancement of legal expenses and indemnification in third-party suits, and the purchase of better D&O protection, exemplify this reaction. Thus far, the "bottom line" equilibrium in the U.K. has remained at a level of tiny but non-zero out-of-pocket risk.

What about "send a message" lawsuits? As we will describe in Part VIII.B, the Equitable Life lawsuit can plausibly be explained in these terms. Nevertheless, at least among private litigants, the "send a message" pattern is less likely to find a foothold in Britain than it is in the U.S. Lawsuits are simply harder to bring in the U.K. Britain also lacks shareholders that fit the "send a message" mold as readily. The managers of U.S. public pension funds often are political appointees whose goals can extend readily beyond maximizing investment returns.[192] Politics is less likely to come into play with British public sector pension schemes since the trustees are nominated by members rather than selected by politicians and the trustees delegate the day-to-day management of investments to professional advisors.[193] Thus, while the "send a message" scenario cannot be ruled out, it does not appear to pose a large risk to U.K. non-executives.

V. Germany

Once sued, U.K. outside directors have less protection against out-of-pocket risk than their U.S. counterparts, but they are also much less likely to be sued. In both countries, outside directors' out-of-pocket risk is similar—very small but present. Is there a pattern here? To explore this question, we turn next to Germany, a country with a different legal tradition and a distinctive board structure.

A. The Distinctive Nature of Outside Directors in Germany

In common law countries, important directors' duties derive from judge-made common law—generally later codified—rather than statute.[194] In contrast, Germany is a civil law country where legal duties derive in theory, if not always in practice, solely from statute.[195] Empirical analysis implies

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191. *See supra* notes 158–60, 164 and accompanying text.

192. Karen Donovan, *Legal Reform Turns a Steward Into an Activist*, N.Y. TIMES, Apr. 16, 2005, at C1.

193. G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 248–49 (1996).

194. THE LAW COMMISSION & THE SCOTTISH LAW COMMISSION (1998), *supra* note 167, 23–25; ERMANNO PASCUTTO & CALLY JORDAN, REVIEW OF THE HONG KONG COMPANIES ORDINANCE: CONSULTANCY REPORT 121–24 (1997), *available at* http://www.fstb.gov.hk/fsb/ppr/consult/doc/concmpny.doc.

195. Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp & Mark D. West, *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 799 n.27 (2002) ("[I]n civil law countries courts have at times played a much more proactive role in shaping the

that these different legal traditions shape corporate governance arrangements.[196] It is therefore worth investigating whether the risks for outside directors are appreciably different in a civil law country such as Germany than in common law jurisdictions such as the U.S. and the U.K.

The two-tier board is another feature that distinguishes Germany not only from common law countries, but also from many civil law jurisdictions.[197] All German public companies must take the Aktiengesellachaft (AG) stock corporation legal form, though many AGs do not go public.[198] An AG's board of directors is divided into two tiers: the management board (*Vorstand*) and the supervisory board (*Aufsichtstrat*). The management board has sole responsibility for managing the company and is composed of full-time executives.[199] The supervisory board includes only non-executives, who appoint and monitor the management board.[200] Under a policy of "codetermination," labor representatives must comprise one-third of the supervisory board of an AG with over 500 workers, and one-half of the board of an AG with over 2,000 workers.[201] Labor nominees excepted, the supervisory board of a typical German public company will be

contents of legal rules than the general principle that 'judges interpret, but do not make the law' may suggest.").

196. *See, e.g.*, Thorsten Beck, Asli Demirgüç-Kunt & Ross Levine, *Law and Finance: Why Does Legal Origin Matter?,* 31 J. COMP. ECON. 653, 672 (2003) (using regression analyses to show variations in different countries' legal systems can explain variations in the development of financial markets in those countries); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 59–64 (2001) (explaining the connection between the development of strong equity markets and the common law system); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3, 8–15 (2000) (finding that differences between common law and civil law systems predict differences in the legal rules governing companies and the nature of securities markets).

197. *See* Klaus J. Hopt, *The German Two-Tier Board: Experience, Theories, Reforms*, *in* COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 227, 228 (Klaus J. Hopt et al. eds., 1998) [hereinafter COMPARATIVE CORPORATE GOVERNANCE] (listing the civil law countries where companies are required to have two-tier boards as Germany, Switzerland, Austria, the Netherlands and the Scandinavian jurisdictions). Two-tier boards are optional but uncommon in a number of other countries, including France and Russia. On France, see *infra* notes 410–11 and accompanying text.

198. As of 2004, there were approximately 15,000 AGs, of which 830 were publicly quoted. Ulrich Noack & Dirk Zetzsche, *Corporate Governance Reform in Germany: The Second Decade*, 16 EUR. BUS. L. REV. 1033, 1034 (2005).

199. Aktiengesetz [AktG] [Stock Corporation Act], July 16, 1998, BGB1. I at 1842. For an English translation with supporting commentary, see HANNES SCHNEIDER & MARTIN HEIDENHAIN, THE GERMAN STOCK CORPORATION ACT 85 (Legislation in Translation Series No. 16, 2000).

200. AktG §§ 84(1), 105(1), 111(1). *See* Willi Joachim, *The Liability of Supervisory Board Directors in Germany*, 25 INT'L LAW. 41, 42–46 (1991) (discussing the two-tier board system under the AktG).

201. Mitbestimmungsgesetz [MitbestG, Co-Determination Act], May 4, 1976, BGBl. I at 1153, §§ 1(1), 1(3), 7(1); Betriebsverfassungsgesetz [BetrAVG, Labor Management Relations Act], Dec. 19, 1974, BGBl. I at 3610, § 76(1). The shareholders elect the chairman of the supervisory board of a co-determined company, who retains a tie-breaking vote. MitbestG, § 29(2). As of the late 1990s, there were 1,980 German companies with labor representatives on the board and 740 with "quasi-parity" co-determination. Hopt (1998), *supra* note 197, at 246–47.

a mix of former executives of the company, professional business advisers (e.g., bankers or lawyers), and representatives of key suppliers or customers, with few executives from unaffiliated companies.[202]

The German Stock Corporation Act (Aktiengesetz or "AktG") provides that the management board must report regularly to the supervisory board on the company's affairs and immediately inform the supervisory board chair of developments that may have a material impact on the company.[203] The supervisory board also customarily approves the company's annual audited financial statements and may inspect the company's books and records at any time.[204] In addition, the supervisory board has the discretion to specify transactions that require its approval.[205]

B. Duties Owed by Supervisory Directors to the Company

Now that we have a sense of the role played by outside directors in Germany, we can turn to their liability risk. The order of discussion is the same as for the U.K.: duties owed to the company (IV.B), enforcement by the company under company law (IV.C), direct suits by shareholders (IV.D), shields against out-of-pocket liability (IV.E), and the impact of insolvency (IV.F).

AktG § 116 stipulates that the duties of management board members, specified in § 93, apply analogously to the supervisory board. As a result, supervisory directors must perform their duties with the care of a "diligent and conscientious" businessperson holding such a position.[206] While a supervisory board director is not expected to have expertise in a company's particular industry, general business knowledge is required, and courts likely will impose more exacting standards on directors with special qualifications (e.g., bankers, lawyers and accountants).[207] A director who lacks important information could be in breach of duty by not seeking appropriate advice, yet German courts have been reluctant to accept reliance on others as a defense.[208]

In contrast to the situation in the U.S., should a case go to court and evidence be adduced that acts of the board caused damage, supervisory

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202. Hopt (1998), *supra* note 197, at 243–44, 246, 249; Johannes Semler, *The Practice of the German Aufsichtsrat*, *in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 197, at 269–70.

203. AktG § 90(1).

204. AktG §§ 170–72. As an alternative, under AktG § 173(1), the management and supervisory boards can ask the shareholders to approve the financial statements.

205. AktG § 111(4).

206. AktG §§ 93, 116.

207. Joachim (1991), *supra* note 200, at 60–61; THE LAW COMMISSION & THE SCOTTISH LAW COMMISSION (1998), *supra* note 167, at 262.

208. Theodor Baums, *Personal Liabilities of Company Directors in German Law*, 9 INT'L COMPANY & COM. L. REV. 318, 321 (1996); *see also* Dieter Eckert, *Shareholder and Management: A Comparative View on Some Corporate Problems in the United States and Germany*, 46 IOWA L. REV. 12, 43 (1960) (stating that some obligations of board members are not delegable and that board members retain liability for any mistakes in handling those obligations).

directors bear the burden of proving they were sufficiently "diligent and conscientious."[209] Supervisory board members also traditionally lacked the protection against liability by way of a U.S.-style "business judgment rule".[210] On the other hand, German judges exercised restraint in applying the duties of directors so as not to discourage risk-taking and entrepreneurial activity, and some scholars argued that this restraint was similar to a judicially-created version of the business judgment rule.[211] German directors also now enjoy the protection of a statutory business judgment rule.[212] In 2005, AktG § 93 was amended to provide that directors will not breach the duties they owe to the company if they reasonably believed they was acting for the good of the company on the basis of appropriate information.[213]

The general duty of care is not a supervisory director's only source of liability to the company. German directors, as with their counterparts in the U.S. and the U.K., can face liability if improper dividends are paid.[214] They can also be held accountable for violating rules that govern other specified transactions, including the pledging of company shares as security, the issuance of shares, and the payment of compensation to the management board.[215] Also, under AktG § 117, if a party (likely a dominant shareholder) induces an AG's directors to act to the disadvantage of the company, the directors will be liable to the company unless they were sufficiently diligent and conscientious.

As is the case in the U.K., but unlike in the U.S., an AG cannot use the corporate constitution to limit directors' liability for breach of duty.[216] The law on shareholder ratification is more restrictive than it is in either the U.K.

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209. AktG § 93(1). On the burden of proof, see *id.* § 93(2). On the U.S., see KNEPPER & BAILEY (1998), *supra* note 33, § 2-10 (discussing the burden on the plaintiff in the U.S. to demonstrate that directors do not merit protection from the business judgment rule).

210. Hendrik F. Jordaan, Comment, *A Comparative Analysis of Corporate Fiduciary Law: Why Delaware Should Look Beyond the United States in Formulating a Standard of Care*, 31 INT'L LAW. 133, 150 (1997); *accord* Jürgen Bröhmer, *Germany*, *in* DIRECTORS' DUTIES AND LIABILITIES 51, 56 (Paul J. Omar ed., 2000).

211. Baums (1996), *supra* note 208, at 321. *See also* Erich Schanze, *Directors' Duties in Germany*, 3 COMPANY & FIN. INSOLVENCY L. REV. 286, 291 (1999) (discussing the "ARAG/Garmenbeck" case, Bundesgerichtshof [BGH] [Federal Court of Justice] Apr. 21, 1997, 175 Entscheiungen des Bundesgerichtshofes in Zivilsachen [BGHZ] 135 (244)); York Schnorbus, *Tracking Stock in Germany: Is German Corporate Law Flexible Enough to Adopt American Financial Innovations*, 22 U. PA. J. INT'L ECON. L. 541, 612–13 (2001).

212. Ulrich Seibert, *The Company Law Reform Projects of the German Ministry of Justice*, 69 RABELSZ BD. 712, 717–18 (2005).

213. AktG § 93(1), ¶ 2, *as amended by* Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [UMAG, Integrity of Corporations Improvement and Modernization of Annulment Suits Reform Act], Sept. 22, 2005, BGBl. 1 at 2802.

214. AktG § 93(3). For the key provisions governing dividends, see AktG §§ 57–58.

215. AktG § 93(3); Bröhmer (2000), *supra* note 210, at 56–57.

216. The corporate constitution can only displace provisions in the AktG if this is explicitly permitted. AktG § 23(5). The received wisdom is that limits cannot be imposed on directors' liability under AktG §§ 93, 116. Baums (1996), *supra* note 208, at 322.

or the U.S.[217] Shareholders can vote to waive a claim for damages against a director, but only three or more years after the claim arose, and only if dissenting votes do not exceed 10% of the company's equity capital.[218]

C. Enforcement of Breaches of Duty by the Company (Including Derivative Litigation)

Even before the introduction of a statutory business judgment rule, litigation against supervisory directors of German public companies was highly exceptional and damages awards rarer still.[219] According to a 1997 article on German directors: "A provable and justiciable examination of the *Aufsichtstrat*, which has simply performed its duties poorly, or professionally underperforms, has not to this day ever occurred."[220] As for suits against individual supervisory board directors, as best we have been able to determine, over the past 50 years there have only been two such suits brought by stock corporations in which damages were awarded at trial.[221] In both, the defendant was a single board member closely affiliated with the AG's insolvent corporate controlling shareholder. In one of these cases, damages were awarded but the case was remanded to the trial level and the final outcome is unknown.[222] In the other, there was a damages award of DM 1.5 million and it is possible that this was an instance of out-of-pocket liability.[223] It is unclear, however, whether either of these cases involved a publicly quoted company.[224]

Procedural considerations do much to explain the lack of litigation. The corporate law duties of supervisory board directors are owed to the company, not to shareholders or creditors.[225] The decision to sue supervisory directors

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217. In the U.S., ratifiabilty has traditionally been governed by whether a transaction is "voidable" or "void." HAMILTON (2000), *supra* note 24, at 489.

218. AktG § 93(3).

219. Noack & Zetzsche (2005), *supra* note 198, at 1041; Semler (1998), *supra* note 202, at 267, 279. *See also* Joachim (1991), *supra* note 200, at 61 (noting the paucity of directors' liability cases in German case law); Stefan Prigge, *A Survey of German Corporate Governance in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 197, at 943, 965 (suggesting that the severe liability rules imposed by law are "of little actual significance" because of the manner in which they operate in practice).

220. J. Shearman, *Controlling Directors the German Way*, 18 COMPANY LAW. 123, 124 (1997).

221. We are grateful to Dirk Reidenbach for compiling a list of reported cases where supervisory board members of AGs were sued and to Florian Moselin for gathering background information on the cases. This information is available from the authors on request.

222. Schaffgotsch I/Schaffgotsch II, BGH NJW 1980, 1629/BGH WM 1983, 957.

223. LG Dortmund DB 2001, 2591.

224. German case reports do not normally include the company name—only initials—thus making it impossible to investigate the issue.

225. AktG § 93(3); Baums (1996), *supra* note 208, at 320, 323; Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INT'L & COMP. L. 555, 600 (2000). If directors have "grossly violated" the duty of care a company's unpaid creditors have standing to sue but just as the right to sue becomes potentially valuable – when a company enters bankruptcy proceedings – the right to bring

typically rests with the management board.[226] The management board will understandably be reticent to launch proceedings, since the supervisory board selects and monitors the management board.[227] To be sure, a 1997 decision of Germany's Federal Supreme Court implies that the management board is under a duty to bring a suit if it is in the company's interests to do so.[228] Still, since a lawsuit alleging lax supervisory board oversight could readily incriminate the management board members who authorized the suit, it is hard to imagine such a suit being brought in practice.[229]

What about shareholder enforcement of the duties that supervisory board directors owe to the company? Until 2005, German company law did not permit shareholders to make derivative claims.[230] Shareholders who owned at least 10% of the share capital or shares with a par value of €1 million were permitted to apply to the court for the appointment of a special representative who would sue in the company's name, be reimbursed by the company for legal expenses, and be compensated for his own services.[231] Few claims were brought under the special representative procedure.[232] The ownership threshold was one reason for this.[233] Another deterrent was that, consistent with Germany's "loser pays" civil litigation rules, if the special representative lost the case, the shareholders who applied for the appointment had to pay any costs award made against the company.[234]

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proceedings becomes vested in the hands of the insolvency administrator. *See* AktG § 93(5); Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 388–89 (2001).

226. AktG § 78(1).

227. Hans-Christoph Hirt, *The Review of the Role and Effectiveness of Non-Executive Directors: A Critical Assessment with Particular Reference to the German Two-Tier Board System: Part 1*, 14 INT'L COMPANY & COM. L. REV. 245, 254 (2003) (quoting a German academic who argued that such a decision would amount to "patricide").

228. Schanze (1999), *supra* note 211, at 291 (discussing the ARAG/Garmenbeck case). In this case, the Federal Supreme Court considered the obligations a supervisory board has when deciding whether to sue members of the management board. For such a claim, the supervisory board represents the company. AktG § 112.

229. HIRT (2004), *supra* note 84, at 274-75.

230. JOHANNES ADOLFF, BURKHARDT MEISTER, CHARLES RANDELL & KLAUS-DIETER STEPHAN, PUBLIC COMPANY TAKEOVERS IN GERMANY 44 (2002); Baums (1996), *supra* note 208, at 322; Ángel R. Oquendo, *Breaking on Through to the Other Side: Understanding Continental European Corporate Governance*, 22 U. PA. J. INT'L ECON. L. 975, 1013 (2001).

231. See former AktG, § 147(1)–(2) *translated in* SCHNEIDER & HEIDENHAIN, *supra* note 198, at 160–61.

232. ADOLFF, MEISTER, RANDELL & STEPHAN (2002), *supra* note 230, at 44; HIRT (2004), *supra* note 84, at 281–82.

233. Arndt Stengel & Christine Steven, *Germany*, 17 INT'L FIN. L. REV. 23, 25 (1998). In 1998, the threshold was cut to 5% of the share capital or shares with par value of €500,000 if those applying could establish a serious suspicion of dishonesty or gross violations of the law.

234. *See* HIRT (2004), *supra* note 84, at 302, 305, 309 (noting also that if the action failed the shareholder who applied for the appointment of a special representative had to reimburse the company for the expenses and remuneration of the special representative). On Germany's "loser pays" rules, see Zivilprozessordnung [ZPO] [Code of Civil Procedure] Jan. 30, 1877,

In response, the German government in 2005 liberalized the procedure for shareholder-initiated litigation against directors.[235] The new scheme provides for a full-blown derivative action since shareholders can bring the suit directly rather than relying on a special representative. Also, the threshold to proceed has been reduced to 1% of the share capital or shares with a par value of €100,000. Another innovation is that if the leave petition succeeds, the shareholders bear no further financial risk. In contrast with traditional arrangements, the company will pay the legal expenses to bring the case as well as any adverse costs award if the claim fails at trial.

The 2005 reforms have prompted criticism from industry that the law is now too liberal.[236] Still, an applicant shareholder has a heavy onus to meet before being granted leave, namely establishing at the hearing a reasonable suspicion the directors engaged in conduct amounting to dishonesty or recklessness. Moreover, the applicant will likely be ordered to pay the defendants' legal costs if the application for leave fails. Furthermore, if leave is granted and the matter goes to trial, the company, not the applicant shareholder, will be the beneficiary of any favorable judgment. Taken as a whole, the new rules seem unlikely to foster a wave of derivative litigation.[237]

D. Direct Shareholder Suits

In addition to the potential for derivative suits, shareholders have some scope under German company law to bring suits in their own name.[238] Germany lacks an equivalent to the remedy for unfair prejudice provided by § 459 of the U.K. Companies Act 1985.[239] Nevertheless, when a company law provision is deemed to be specifically geared to the protection of

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Reichsgesetzblatt [RGBl] 83, as amended, § 91; NORBERT HORN, HEIN KÖTZ & HANS G. LESER, GERMAN PRIVATE AND COMMERCIAL LAW 49 (Tony Weir trans., 1982).

235. AktG § 148. For background, see Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 52–53 (2005). The old special representative procedure can theoretically still be invoked by shareholders, but only if a company's shareholders first pass a resolution endorsing the proposed litigation.

236. Seibert (2005), *supra* note 212, at 717.

237. HIRT (2004), *supra* note 84, at 329–32; Baums & Scott (2005), *supra* note 235, at 53.

238. Supervisory board members can theoretically be held liable under tort law, but as in the U.K., this possibility is too remote to merit analysis in the main text. If a company commits a tort, the German Civil Code extends liability to everyone who owes a duty of care and has breached it. Still, since supervisory board directors essentially have a reactive role in German stock corporations, it is unlikely that they will conduct themselves in such a way that liability will arise. *See* Baums (1996), *supra* note 208, at 323. A creditor can also sue directly if a self-interested director has breached a relationship of personal trust and confidence. *See* Thomas Kreifels, *Product Liability*, *in* 4 BUSINESS TRANSACTIONS IN GERMANY 38-1, § 38.08[1] (Dennis Campbell et al. eds., 2005) (discussing German Civil Code § 823(1), which imposes liability on directors who injure the property of another). Again, supervisory directors are unlikely to end up in this position.

239. Matthias Stecher, Anita de Jong, Joren de Wachter & Clare Grayston, *General Report*, *in* PROTECTION OF MINORITY SHAREHOLDERS 1, 13–14 (Matthias W. Stecher ed., 1997).

shareholders, shareholders have standing to sue in the event of breach. For instance, AktG § 400 makes it an offence for directors to approve misrepresentations in a company's annual financial statements. The received German wisdom is that infringement of this provision creates a direct cause of action for shareholders.[240]

AktG § 117 also provides the foundation for a direct shareholder suit. It stipulates that if a party induces a supervisory board's directors to act to the disadvantage of the company and the directors have been insufficiently diligent and conscientious, a shareholder as well as the company has standing to sue for losses suffered.[241] We are aware of one case where a shareholder sued a supervisory board director under AktG § 117 and was awarded damages as a remedy.[242] It is unclear, however, whether this was an instance of out-of-pocket liability since the case was ultimately remanded back to trial level without a subsequent report. Also, there was insufficient detail in the case report to discern whether the company was publicly quoted. Going forward, supervisory board directors faced with lawsuits under AktG § 117 may be able to rely on the new statutory business judgment rule as a defense.[243]

German securities law also creates scope for shareholders to bring a direct claim against company directors. A director named in a defective prospectus for a public offering will be responsible for its contents and will potentially be liable to investors unless the director can establish that he was unaware of the misdisclosure and was not grossly negligent.[244] For misdisclosure other than in a public offering, there is generally civil liability only if there is evidence of intent to mislead.[245]

Despite the theoretical risks directors face, various procedural constraints discourage direct shareholder suits against directors. First, because the "loser pays" rule applies in German civil litigation, a shareholder lacking an airtight case risks bearing the litigation costs of both sides. Second, contingency fees are not permitted, which means a prospective

240. Eckert (1960), *supra* note 208, at 66; Joachim (1991), *supra* note 200, at 64. On the jurisprudential foundation for such a claim, see Eckert (1960), *supra* note 208, at 60–61.

241. AktG § 117(1)–(2). The shareholder can also recover from the party exercising influence over the board.

242. BGH BGHZ 94, 55 (1985).

243. E-mail from Mathias Siems, Assistant Professor, Riga Graduate School of Law, to authors (Feb. 27, 2006) (on file with authors) (citing a forthcoming text on Germany's company law where this argument has been made).

244. Börsengesetz [BörsG, Stock Exchange Act], Dec. 21, 2000, BGBl. I at 1857, § 45, *translated in* HARTMUT KRAUSE, GERMAN SECURITIES REGULATION 53–54 (2001).

245. Noack & Zetzsche ((2005), *supra* note 198, at 1049; Dirk Reidenbach, *Executives' Liability for Incorrect Ad Hoc Announcements—A Comment on the Decision of the German Federal Court of Justice (BGH) in* In re Infomatec AG, *BGH II ZR 217/03, 218/03 and 402/02 of 19 July 2004*, 5 GERMAN L.J. 1081, 1085, 1089–90 (2005).

plaintiff cannot readily shift the risk of losing in court to lawyers.[246] Third, since class action suits are not permitted and there is very limited scope for litigation involving multiple plaintiffs, the risks of suing cannot easily be shared with others.[247] Finally, in the event that proceedings are launched, tight limits imposed on pretrial discovery can make a case hard to win.[248]

As with the U.K., German companies that cross list on a U.S. stock exchange can face U.S.-style securities fraud claims. However, only about 20 German firms are currently cross-listed.[249] Moreover, assuming that cross-listed companies buy D&O insurance with up-to-date terms and customary policy limits, suits under American securities law should generally yield the same outcome as for U.S. companies, namely settlements where outside directors' personal assets are left intact. A 2003 settlement of a U.S. class action arising out of the 1998 merger between Daimler-Benz and Chrysler illustrates. The case settled for $300 million, one of the largest securities law recoveries ever obtained at that time, but D&O insurers covered two-thirds of the settlement and DaimlerChrysler paid the rest.[250] Unless a cross-listed German company goes bankrupt and the other elements of a Perfect Storm fall into place, supervisory board directors of German companies cross-listed on U.S. stock markets should not face significant liability risks under U.S. securities law.

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246. William B. Fisch, *European Analogues to the Class Action: Group Action in France and Germany*, 27 AM. J. COMP. L. 51, 55–56 (1979); Angelika Hoche, *The Legal System*, *in* 1 BUSINESS TRANSACTIONS IN GERMANY 4-1, § 4.05[3] (Dennis Campbell et al. eds., 2005).

247. On the lack of a class action under German law, see Gerhard Walter, *Mass Tort Litigation in Germany and Switzerland*, 11 DUKE J. COMP. & INT'L L. 369, 372–73 (2001). The absence of a class action scheme caused major logistical difficulties with claims brought in the late 1990s by 17,000 individual investors against Deutsche Telekom AG alleging misdisclosure since, in principle, each claim had to be adjudicated individually. In response to this litigation, in 2005 the German government enacted Gesetz zur Einführung von Kapitalanleger-Musterverfahren [KapMuG, Securities Suit Joinder Act], Aug. 16, 2005 BGBl. I at 2437. Under this law, shareholders in AGs can now file actions in groups of ten against companies they say misled them. *See* Smith (2006), *supra* note 142. This modest reform falls well short of a viable class action procedure.

248. *See* Hoche (2005), *supra* note 246, § 4.04[5][a] (noting that there is no formal procedure to force a party to participate in pretrial discovery in Germany). For a comparison of the discovery rules in the U.S. and the E.U. Member States, see Georg Berrisch, Eve Jordan & Rocio Salvador Roldan, *E.U. Competition and Private Actions for Damages* 24 NW. J. INT'L L. & BUS. 585, 596–97 (2004).

249. As of May 2006, there were 17 German companies listed on the New York Stock Exchange. NEW YORK STOCK EXCHANGE, LISTED COMPANY DIRECTORY, (May 7, 2006) http://www.nyse.com/about/listed/6.html?country=Germany. There were only two German companies listed on the NASDAQ. NASDAQ, NASDAQ INTERNATIONAL COMPANIES, (May 7, 2006) http://www.nasdaq.com/asp/NonUsOutput.asp?page=G&previousCount=0®ion=europe.

250. Simon English, *Chrysler Settles Lawsuit for $300m*, TELEGRAPH (London), Aug. 26, 2003, at 33; Tom McGhee, *DaimlerChrysler Pact to Aid Denver Fund*, DENVER POST, Oct. 21, 2003, at C01.

E. Insulation from Potential Liability

German corporate law lacks an equivalent to the U.K. company law provision that authorizes a judge to waive liability for directors who have acted honestly and reasonably and "ought fairly to be excused."[251] Still, both indemnification and D&O insurance can potentially protect supervisory directors. In Germany, as in other civil law countries, indemnification of directors is not explicitly addressed by company law and has traditionally been an exceptional practice.[252] Still, a stock corporation can likely indemnify a director for liability to third parties so long as the director has not breached duties owed to the company.[253] Thus, indemnification should be available in many securities law cases.

D&O insurance is still somewhat novel in Germany, but is growing in significance. Until the 1990s, board liability was not seen as a significant issue, and most companies did not purchase coverage.[254] By the end of the decade, however, growing apprehension in German boardrooms about liability had fostered demand for D&O policies, and coverage is now common.[255] Due to U.S. securities law exposure, German companies that are cross-listed in the U.S. generally bargain for policy limits exceeding €100 million, while other major public companies tend to buy limits of €25–75 million.[256]

Since D&O insurance provides a deep pocket for plaintiffs to aim at, the increased prominence of D&O coverage could foster more litigation involving directors. Still, when an AG has a D&O policy in place, the insurer almost always settles liability claims.[257] Hence, even if the growing popularity of D&O insurance or the new rules on derivative litigation act as catalysts for litigation against directors, the expansion of D&O coverage should ensure that supervisory board directors will rarely end up out-of-pocket as a result of a lawsuit.

F. What Changes if the Corporation Is Insolvent?

For those serving on the management board of an AG, the onset of financial distress creates an additional source of liability. Once a company becomes unable to pay its debts as they fall due, the management board must, "without undue delay but in no event later than three weeks," enter the company into insolvency proceedings and can be held personally liable for

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251. *See supra* note 154 and accompanying text.

252. Donna Ferrera, *Protecting Decisionmakers Abroad*, RISK MGMT., Sept. 1999, at 23, 26.

253. Baums (1996), *supra* note 208, at 322.

254. Matthews (2005), *supra* note 95, at 10.

255. Reinhard Pöllath, *Why Managers Need to be Wary*, 24 INT'L FIN. L. REV. 57, 60 (2005); Don Lewis Kirk, *German Brokers Change With Times*, BUS. INS., Sept. 20, 1999, at 53.

256. Adrian Ladbury, *Action Needed for German D&O Sector*, INS. DAY, May 21, 2004, *available at* 2004 WLNR 7231895.

257. Baums (1996), *supra* note 208, at 319.

failing to do so.[258] While this obligation applies only to the management board, there are some dangers for supervisory board directors since failure to prompt the management board to initiate bankruptcy proceedings could constitute a breach of the duty they owe to act with the care of a diligent and conscientious businessman.[259]

The procedural terrain also changes once a company enters insolvency proceedings. Control over the decision to sue the supervisory board shifts to an insolvency administrator, who will not have the same reticence to sue as would the management board.[260] Still, it is uncommon for insolvency administrators to launch suits against AG supervisory board directors. Indeed, within the past 50 years, there appears to have been only one reported case brought by an insolvency administrator in which the court ruled a supervisory board director of an AG should pay damages as a result of a breach of duty owed to the company, and it is unclear whether this company was publicly traded.[261]

Logistical considerations likely explain the lack of litigation. As in the U.K., fears about time-consuming litigation, doubts about recovery in the event of success, and a probable order to pay the directors' legal expenses if the suit fails all are likely to deter liquidators from pursuing claims against directors. An administrator would also likely need the approval of a creditors' committee to commence litigation.[262] Unless supervisory directors appear highly culpable and have either unusual wealth or a deep pocket standing behind them, a cost–benefit calculus will rarely favor a suit.

D&O insurance could offer a deep pocket that would justify an administrator launching a suit against supervisory board directors. Still, so long as a D&O policy is of a respectable size, an administrator will likely follow the path of least resistance and target the policy alone rather than the directors' personal assets. In fact, this assumption is helping to drive demand for D&O insurance; fears of insolvency-related litigation are cited as a key reason why more German firms are purchasing coverage.[263]

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258. AktG § 92(2); Bröhmer (2000), *supra* note 210, at 58–59.

259. On the duty to act with the care and diligence of a diligent businessman, *see supra* note 206 and accompanying text.

260. Insolvenzordnung [InsO, Insolvency Statute] Oct. 5, 1994, BGBl. I at 2866, §§ 80, 148(1) (English translation), *available at* http://www.iuscomp.org/gla/statutes/InsO.pdf.

261. *See* LG Stuttgart DB 1999, 2462 "ASS AG"/OLG Stuttgart OLGR Stuttgart 2003, 55 (initial judgment for DM 9m, followed by a settlement for DM 1.2m). In LG Hamburg ZIP 1981, 194 "Lenz Brau," another case brought by an insolvency administrator, the court held that in principle the defendant supervisory director should be liable but did not grant damages.

262. This approval is required if there is "considerable value in dispute." InsO, § 160(2), ¶ 3, *available at* http://www.iuscomp.org/gla/statutes/InsO.pdf. On the role of the creditors' committee, see Andreas Remmert, *Introduction to German Insolvency Law*, 13 INT'L COMPANY & COM. L. REV. 427, 429–30 (2002).

263. *Director and Officer Premiums for Insurance are Set to Surge*, WALL ST. J. EUR., May 24, 2002, at M4.

G. Germany Summary

In Germany, as in the U.K., procedural and logistical factors do much to deter the launching of suits against directors. Thus, as in both the U.S. and in the U.K., outside directors of public companies face only a very small risk of out-of-pocket liability. Our investigations have uncovered only a tiny handful of cases in which supervisory board directors of a stock corporation have been held liable for damages, and, in each instance, it is unclear whether the companies involved were publicly traded. This bears out the claim by Theodor Baums and Kenneth Scott that, in Germany "[i]n practice, the most important sanction for business errors and commercial failures is that of not being re-elected to office."[264]

Apprehension about director liability is growing in Germany, due partly to the new derivative litigation procedure and 2004 proposals to expand civil liability for capital market misdisclosure.[265] For supervisory board directors, however, the risk of out-of-pocket liability is unlikely to change significantly. Politics is one mitigating factor. The German government, when introducing the new derivative action procedure, softened the blow for the business community by codifying the business judgment rule as a defense to lawsuits. It also withdrew the 2004 proposals to expand civil liability for misdisclosure due to strong opposition by the business community.[266] Market forces have also been coming into play, with growing fears of liability prompting a rise in D&O insurance. D&O coverage admittedly can attract litigation, but at the same time protects against litigation leading to personal liability.

In Germany, as elsewhere, outside directors can face out-of-pocket risk from a lawsuit brought partly or primarily to send a message to future boards. An ongoing criminal prosecution of the supervisory board directors of Mannesmann, discussed in Part VIII.C, is likely such a case.

It is unlikely, however, that civil litigation designed to "send a message" will occur any with frequency in Germany. Germany's "loser pays" rules, the absence of contingency fees, and the lack of a viable class action mechanism create substantial downside risks for plaintiffs who might want to sue to send a message to future boards. Moreover, there are no obvious candidates to launch "send a message" lawsuits. Due to extensive cross-shareholdings, domestic non-financial companies are the most important

264. Baums & Scott (2005), *supra* note 235, at 45.

265. With the 2004 proposals, the German finance ministry recommended reducing the liability standard for directors in securities lawsuits from gross negligence to simple negligence and channeling misdisclosure claims based on similar facts into a single multiparty suit conducted by the claimant with the largest damages claim. Noack & Zetzsche (2005), *supra* note 198, at 1047–51.

266. On the shelving of the misdisclosure proposals, see Hauke Friederichs, *Regierung verschiebt Stärkung der Aktionäre*, DER STERN, Nov. 9, 2004, *available at* http://www.stern.de/politik/deutschland/:Managerhaftung-Regierung-St%E4rkung-Aktion%E4re/532092.html.

category of shareholders in German public companies, and there will be no appetite for "send a message" litigation within this corporate network.[267] Germany lacks U.S.-style public pension funds since the pensions of state sector employees are provided by employer contributions on a "pay as you go" basis rather than via pension schemes that accumulate assets.[268] Banks sometimes own blocks of shares in German public companies, but since it is common practice for bank appointees to sit on supervisory boards, they have little need to litigate to "send a message" in the boardroom, and likely little appetite as well.[269] Finally, foreign capital is of growing importance in German public companies, but international investors seem unlikely candidates to sue in German courts.

VI. Other Common Law Countries

We have found that out-of-pocket liability is a possible but remote prospect for outside directors of public companies in the United States, the United Kingdom and Germany, despite the significant differences between these countries' legal cultures and legal rules. These similar outcomes suggest that there is a functional convergence on this issue across borders. We test this proposition further by considering in this Part two more common law jurisdictions (Australia and Canada[270]) and, in Part VII, two more civil law countries (France and Japan). So as not to bury readers in an unending mass of details, our analyses of these countries are intentionally less comprehensive than those for the U.K. and Germany.

The pattern we have identified holds up when these additional countries are added to the sample. To anticipate, with Australia and Canada, we found only a small handful of instances of out-of-pocket liability. One was a securities law "Perfect Storm" for outside directors of a Canadian company cross-listed in the U.S. A second was a Canadian case in which outside directors were required to pay hearing costs when they were disqualified by securities regulators from serving as directors. There have also been two Australian instances of out-of-pocket liability involving self-dealing by outside directors. Still, as Part VIII will elaborate upon, the "send a message" scenario emerges as the primary source of the limited risk that

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267. Patrick Jenkins & Richard Milne, *The Coming Powers: How German Companies are Being Bound to the Interests of Foreign Investors*, FIN. TIMES, Apr. 1, 2005, at 17 (noting, however, that the percentage of shares held by such owners declined from 44% in 1993 to 32% in 2003).

268. GORDON L. CLARK, PENSION FUND CAPITALISM 59 (2000).

269. Marco Becht and Ekkehart Böhmer, *Ownership and Voting Power in Germany*, *in* THE CONTROL OF CORPORATE EUROPE 128, 143 (Fabrizio Barca and Marco Becht eds., 2001) (reporting that of 648 publicly notified voting blocks held in 372 companies, 77 were held by banks). On the extent of bank representation on supervisory boards, see Prigge (1998), *supra* note 219, at 959 (reporting that among the 30 largest public companies in Germany, more than one out of four non-labor supervisory directors were from the banking sector).

270. Within Canada, the province of Quebec is a civil law jurisdiction.

exists, accounting for three instances of personal liability from Australia and two from Canada.

A. *Australia*[271]

1. Private Litigation Against Directors.—Since 1981, Australia has been engaged in an ongoing process of corporate law reform which has yielded a highly complex statutory scheme.[272] A recurring reform theme has been the imposition of additional legal obligations on directors.[273] One key change was the codification of core duties formerly dictated by case law. For instance, Australian corporations law now obliges directors to "exercise . . . the degree of care and diligence that a reasonable person would exercise if they . . . were a director . . . of a corporation in the corporation's circumstances."[274]

Australian corporate law protects directors through a statutory business judgment rule that insulates directors from liability if they have acted in good faith, sought to inform themselves sufficiently, and rationally believed they were acting in the company's interests.[275] However, this rule does not protect directors against liability for inaction[276] for which the standard of culpability presumably is the reasonable person standard under the duty of care. Shareholders can ratify breaches of duty in much the same manner as their U.K. counterparts.[277] However, again as in Britain, but in contrast to the U.S., the corporate constitution cannot limit directors' liability for damages for breach of duty.[278]

There does not appear to be a reported Australian case in which a public company has successfully sued an outside director for breach of the duty of

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271. The structure of our discussion of Australia is somewhat different than it is for other countries. This has been done to highlight the primary source of risk for Australian outside directors, namely applications by the Australian Securities and Investment Commission for "civil penalties".

272. Andrew Clarke, *The Business Judgment Rule—Good Corporate Governance or Not?*, 12 AUSTL. J. CORP. L. 85, 91–92 (2000); JOHN FARRAR, CORPORATE GOVERNANCE IN AUSTRALIA AND NEW ZEALAND 141 (2001).

273. CORPORATE LAW ECON. REFORM PROGRAM, TREASURY, DIRECTORS' DUTIES AND CORPORATE GOVERNANCE 21–40 (1997), *available at* http://www.treasury.gov.au/documents/283/PDF/full.pdf; Shaun Ansell, *Directors' and Officers' Liability Insurance – Recent Reforms and Developments in Australia and New Zealand*, 23 AUSTL. BUS. L. REV. 164, 165–67 (1995).

274. Corporations Act, 2001, c. 2D, § 180(1). These duties are owed to the company. SENATE STANDING COMM. ON LEGAL & CONSTITUTIONAL AFFAIRS, COMPANY DIRECTORS' DUTIES 151 (1989), *available at* http://www.aph.gov.au/senate/committee/legcon_ctte/completed_inquiries/pre1996/directors/report.pdf.

275. Corporations Act, 2001, c. 2D, § 180(2).

276. ASIC v. Adler (2002) 168 F.L.R. 253, [349].

277. AUSTIN ET AL. (2005), *supra* note 15, at 643–52, 657–58.

278. Corporations Act, 2001, c. 2E, §§ 199(A)–(C); AUSTIN ET AL. (2005), *supra* note 15, at 652–54.

care.[279] Procedural considerations help to account for the dearth of litigation. Until 2000, Australian courts applied the restrictive U.K. common law rules on derivative suits, so it was hard for a minority shareholder to bring such a suit.[280] Australian corporate legislation now offers more liberal standing rules, with a court being authorized, upon an application for leave, to order that derivative litigation proceed if the applicant establishes that he is acting in good faith, there is a serious question to be tried, and it is in the company's best interests that the suit go ahead.[281]

Despite the relaxed leave requirements, practical obstacles do much to deter derivative litigation.[282] Australia has "loser pays" civil litigation rules, making it likely that a shareholder whose leave application fails will have costs awarded against it.[283] Even if the application succeeds, the company will only be obliged to pay the shareholder's legal expenses if a court orders this payment and Australian courts usually do not make such orders.[284] Moreover, any damages recovered in a successful suit will be paid to the company rather than the shareholder,[285] and there is no U.S.-style provision for recovery of attorneys' fees from the company. Given all of these factors, it is unsurprising that since the introduction of the statutory derivative action there has, on average, been less than one case brought per year involving a public company.[286]

Australian shareholders, like their U.K. counterparts, can potentially bypass derivative litigation by seeking statutory relief on the grounds of unfair prejudice.[287] Most such proceedings involve private companies, and the relief granted is usually an injunction or buy-out order rather than an

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279. *See* Joanna Bird, *The Duty of Care and the CLERP Reforms*, 17 COMPANY & SEC. L.J. 141, 150 (1999). Bird cites four cases in which judgment was entered against a director for a breach of the duty of care, combined with other breaches. None of these involved an outside director of a public company. For an unsuccessful case brought by a public company against outside directors for a breach of the duty of care, see Daniels v. Anderson (1995) 118 F.L.R. 248.

280. CORPORATE LAW ECON. REFORM PROGRAM, *supra* note 273, at 29–32. We discuss the U.K. rules in subpart IV(C) *supra*.

281. Corporations Act, 2001, c. 2F, §§ 236–37.

282. IAN M. RAMSAY & BENJAMIN B. SAUNDERS (2006), LITIGATION BY SHAREHOLDERS AND DIRECTORS: AN EMPIRICAL STUDY OF THE STATUTORY DERIVATIVE ACTION 11–12, 36–38 (2006), *available at* http://cclsr.law.unimelb.edu.au/download.cfm?DownloadFile=FB0AA3A9-1422-207C-BA316D6AF5683523.

283. Lang Thai, *How Popular are Statutory Derivative Actions in Australia? Comparisons With the United States, Canada and New Zealand*, 30 AUSTL. BUS. L. REV. 118, 136 (2002).

284. Corporations Act, 2001 § 242; RAMSAY & SAUNDERS, *supra* note 282, at 35 (finding 19 Australian derivative suits where a leave application was granted; in none did the court require the company to fund the applicant's legal expenses for the substantive litigation to follow).

285. RAMSAY & SAUNDERS (2006), *supra* note 282, at 11–12.

286. *Id.* at 27.

287. Corporations Act, 2001, c. 2F, § 232.

award of damages.[288] Hence, as in Britain the unfair prejudice remedy creates little out-of-pocket risk for outside directors of public companies.

As with other countries we have studied, Australian shareholders who suffer loss because of misleading disclosure in a prospectus have a cause of action against the company's directors.[289] Directors have a "due diligence" defense if they can show that they had reasonable grounds for believing the information contained in the disclosure.[290] Subject again to a due diligence defense, shareholders can also sue directors for failure to disclose price sensitive information in a timely manner, for false or deceptive annual or half-yearly financial reports, and for other misleading corporate reporting.[291]

Despite the various causes of action, shareholder litigation based on misdisclosure has been uncommon.[292] A handful of cases have been brought over the past few years.[293] Nevertheless, Australia's "loser pays" litigation rule, restrictions on contingency fees, and uncertainty about whether a class action is viable unless each member of the plaintiff class has a claim against each defendant all discourage securities lawsuits.[294] Moreover, even when a suit is brought, the possibility of an adverse costs order should help to protect outside directors since lead plaintiffs will tend to focus on deep-pocketed, more culpable defendants and refrain from suing outside directors.

Australia's Corporations Act has provisions similar to U.K. wrongful trading rules under which directors can be held liable for "insolvent trading" if they permit a company to continue in business while having reasonable grounds to believe the company cannot pay its debts as they come due.[295] An individual creditor can, in theory, sue a director for compensation for such

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288. Ian M. Ramsay, *An Empirical Study of the Use of the Oppression Remedy*, 27 AUSTL. BUS. L. REV. 23, 31–37 (1999).

289. Corporations Act, 2001, c. 6D, §§ 728–29.

290. Corporations Act, 2001, c. 6D, § 731.

291. On the obligation of listed companies to disclose price sensitive information, see Australian Stock Exchange (ASX) Listing Rules, 2003, c. 3, ¶ 3.1. On the civil penalty imposed for a breach, see Corporations Act, 2001, c. 6CA, § 674(1)–(2). On the standing that shareholders have to sue for a civil penalty, see Corporations Act, 2001, c. 9, § 1317J. On liability for annual and half-yearly financial reports, see Corporations Act, 2001, c. 2M, § 344. On liability for other forms of misleading continuous disclosure, see Corporations Act, 2001, c. 7, §§ 1041C (false trading and market rigging), 1041E (false or misleading statements), 1041H–I (improper continuous disclosure). Often under the foregoing provisions, directors will only face a sanction if they were "involved" in the disclosure failure. *See* Corporations Act, 2001, c.1, § 79 (defining involvement). For an overview of the provisions, see AUSTIN ET AL. (2005), *supra* note 15, at 489–96, 543–44; James McConvill, *Introducing Personal Liability Under the Continuous Disclosure Regime: The "Essentials" and "Non-Essentials,"* 16 AUSTL. J. CORP. L. 228, 229–33 (2004).

292. Andrew Cassidy & Larelle Chapple, *Australia's Corporate Disclosure Regime: Lessons from the U.S. Model*, 15 AUSTL. J. CORP. L. 81, 88 (2003).

293. JASON BETTS, THE RISE OF SHAREHOLDER CLASS ACTIONS IN AUSTRALIA (2005), http://www.freehills.com.au/publications/publications_4960.asp (observing that a number of class actions have been commenced in Australia since 2000 and discussing four examples).

294. Cassidy & Chapple (2003), *supra* note 292, at 88, 91–92; BETTS (2005), *supra* note 293.

295. Corporations Act, 2001, c. 5, §§ 588G.

misconduct, but liquidators usually launch such claims.[296] Sporadic enforcement has led some to label the insolvent trading regime a "toothless tiger."[297] Proceedings are indeed rare with public companies, and proceedings involving outside directors of such firms are rarer still. Based on a 2004 empirical study of insolvent trading, there appears to be only one reported case where a liquidator sued non-executive directors of a public company.[298] In this case,[299] the non-executive directors were nominees of the company's dominant shareholder, the directors and the dominant shareholder were all held liable for insolvent trading, and the dominant shareholder paid all damages.

2. Shields Against Out-of-Pocket Liability.— If sued, Australian directors can rely on indemnification and D&O insurance as shields against out-of-pocket liability. Australian corporate legislation prohibits corporate indemnification for legal expenses where a director is found liable or is convicted and thus implicitly permits indemnification when a director's defense has been successful.[300] Australian corporate legislation also prohibits indemnification for liability arising from a suit by the company or enforcement proceedings by the Australian Securities and Investment Commission (ASIC), but implicitly permits a company to reimburse a director for damages paid to someone other than the company if the director

296. Paul James, Ian Malcolm Ramsay & Polat Siva, *Insolvent Trading – An Empirical Study*, 12 INSOLV. L.J. 210, 215, 235–36 (2004) (noting, though, that prior to the late 1980s, claims by creditors were common). There has been much debate in Australia about whether directors of financially distressed companies owe fiduciary duties directly to creditors, but a decision of the Australian High Court, Australia's highest appellate court, suggests there are no such duties. *See* Spies v. The Queen (2000) 201 C.L.R. 603, 633–36; Anil Hargovan, *Directors' Duties to Creditors in Australia After* Spies v. The Queen *– Is the Development of an Independent Fiduciary Duty Dead or Alive?*, 21 COMPANY & SEC. L.J. 390, 409 (2003).

297. Andrew Main, *Directors in the Dock*, AUSTL. FIN. REV., May 14, 2003, at 62. For similar verdicts on Australia's insolvent trading regime, *see* John H. Farrar, *Directors' Duties and Corporate Governance in Troubled Companies*, 8 CANTERBURY L. REV. 99, 107 (2001); Abe Herzberg, *Why are There so Few Insolvent Trading Cases?*, *in* COMPANY DIRECTORS' LIABILITY FOR INSOLVENT TRADING 148, 148–49 (Ian M. Ramsay ed., 2000).

A similar result is likely for Corporations Act, 2001, c. 5, § 596AA, first introduced in 2000, under which a director can be held liable to employees if the director authorized transactions with the intent to prevent recovery of employee entitlements. *See* David Noakes, *Corporate Groups and the Duties of Directors: Protecting the Employee or the Insolvent Employer?*, 29 AUSTL. BUS. L. REV. 124, 130–34 (2001).

298. James, Ramsay & Siva (2004), *supra* note 296, at 228. Out of the 103 cases the authors found for their empirical study of insolvent trading, eight involved public companies and four of these cases involved the same fact scenario. We checked the decisions involving public companies to see if outside directors were defendants.

299. Standard Chartered Bank of Australia Ltd. v. Antico [Nos. 1 and 2] (1995) 131 A.L.R. 1.

300. *See* Corporations Act, 2001, c. 2D, § 199A(3); AUSTIN ET AL. (2005), *supra* note 15, at 655.

acted in good faith.[301] Thus, indemnification should be generally available in private suits based on misleading disclosure.[302]

D&O insurance is purchased by most Australian public companies.[303] As elsewhere, a well-drafted policy should cover most risks, but coverage "holes" can pose risks for non-executives.[304] In two recent cases, Australian D&O insurers have successfully refused to advance legal expenses, including one in which a non-executive chairman was denied coverage (the One-Tel case discussed below).[305] Insurers responded by proposing to restructure policies whose language might be problematic.[306] This pattern replicates trends elsewhere. As we have seen, U.K. companies responded to the Equitable Life litigation by negotiating for higher D&O policy limits.[307] Similarly, in the U.S., as gaps in D&O coverage occasionally open up, the standard contract forms change to close the holes on a prospective basis, though sometimes after an unfortunate director or two has fallen through.[308] The Australian experience confirms that coverage disputes can pose some dangers for outside directors, but contracting practice should keep the level of risk low.

3. The ASIC and Civil Penalties.—If private litigation were the only risk Australian outside directors faced, the dangers for them would be minimal. The volume of litigation is low, and a combination of indemnification and D&O insurance provides reasonable, if imperfect, protection in the lawsuits that occur. Indeed, we have not found any Australian cases in which outside directors of a public company have paid out-of-pocket as a result of a privately initiated lawsuit.

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301. *See* Corporations Act, 2001, c. 2D, § 199A(2) (stating that a company must not indemnify a director for liability owed to the company, for a pecuniary penalty or for liability arising from actions not in good faith).

302. AUSTIN ET AL. (2005), *supra* note 15, at 654.

303. *See* CORPS. & MKTS ADVISORY COMM., DIRECTORS AND OFFICERS INSURANCE 15–17 (2004) (concluding that over 90% of Australia's public industrial entities and 80% of public mining entities have D&O insurance), *available at* http://www.camac.gov.au/CAMAC/camac.nsf/0/04A9BFD9B3915EA7CA256ED9000DE5AD/$file/D&O_Insurance_report_Jun2004.pdf. A class action suit brought against insurer GIO Australia Holdings Ltd. (GIO) and a number of its executive and non-executive directors illustrates the utility of D&O coverage. The plaintiffs claimed that there had been a failure to keep shareholders sufficiently informed about a 1998 takeover bid, and the case ultimately settled with the D&O insurers funding the directors' payment of A$20 million. Neil Hodge, *GIO Investors Win Record Settlement*, BUS. INS., Sept. 1, 2003, at 33; Sharon Kemp, *Ex-GIO Directors Up for $20m Bill*, SYDNEY MORNING HERALD, Aug. 18, 2003, at 31.

304. We discuss U.S. examples of this risk in *Outside Director Liability*, *supra* note 1.

305. The case involving the non-executive chairman was Silbermann v. CGU Ins. Ltd. (2003) 48 A.C.S.R. 231, *aff'd* Rich v. CGU Ins. Ltd. (2005) 214 A.L.R. 370. The second case was *Wilkie v. Gordian RunOff Ltd.* (2005) 214 A.L.R. 410, in which the insurer successfully declined to advance legal expenses to an insurance executive in ASIC proceedings.

306. CORPS. & MKTS ADVISORY COMM., *supra* note 303, at 27.

307. *See supra* notes 169–170 and accompanying discussion.

308. *Outside Director Liability*, *supra* note 1, at 1087–88.

Matters, however, cannot be left at this. Instead, the possibility of enforcement proceedings by the ASIC must be taken into account. The ASIC has had since 1993 broad powers to seek civil penalties, including for breaches of corporate law provisions governing the duty of care, the preparation of company accounts, and disclosure in public offerings.[309] Civil penalties are similar to criminal fines but can be imposed in accordance with the lower standards of proof associated with civil litigation.[310] Enforcement by the ASIC merits close analysis because it has resulted in all five instances of which we are aware where outside directors of Australian public companies have paid out of their own pocket as a result of civil litigation.

Throughout the 1990s, civil penalty orders were rare, with only a handful of penalties being imposed each year.[311] In 1999, however, the ASIC was given broader power to work independently from public prosecutors.[312] The following year, the ASIC acquired a new chair, David Knott, who sought to invigorate the somewhat sleepy agency and aggressively pursued civil penalties for corporate misconduct.[313] The number of civil penalty applications grew thereafter, but not dramatically.[314] However, as we discuss in more detail in part VIII.B, the ASIC used the civil penalty regime in high profile corporate collapses to "send a message" to the Australian business community and to investors that corporate misconduct would be punished and did so in a way that posed risks for outside directors.

Two of the five ASIC cases where outside directors of Australian public companies made out-of-pocket payments involved self-dealing. Since such misconduct is uncommon and beyond the scope of our inquiry, they can be dealt with briefly. One involved self-dealing between HIH Insurance, a major Australian insurer which collapsed in 2001, and Rodney Adler, an outside director who was a substantial shareholder in HIH.[315] In proceedings brought by the ASIC, the court imposed on Adler a civil penalty order of A$450,000 and a compensation order under which he was jointly and

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309. *See* Corporations Act, 2001, c. 9, part 9.4B (setting out the various criminal offenses and civil penalties for violating the Corporations Act). On the ASIC's use of its powers, see Michelle Welsh, *Eleven Years On – An Examination of the Australian Securities & Investment Commission's Use of an Expanding Civil Penalty Regime*, 17 AUSTL. J. CORP. L. 175, 176–87 (2004).

310. Neil Andrews, *If the Dog Catches the Mice: The Civil Settlement of Criminal Conduct Under the Corporations Act and the Australian Securities and Investments Act*, 15 AUSTL. J. CORP. L. 137, 150 (2003).

311. Andrews (2003), *supra* note 310, at 151; George Gilligan, Helen Bird & Ian Ramsay, *Civil Penalties and the Enforcement of Directors' Duties*, 22 UNIV. NEW S. WALES L.J. 417, 437 (1999).

312. Welsh (2004), *supra* note 309, at 184–85.

313. Jennifer Hewett, *How Knott Made His Mark*, AUSTL. FIN. REV., Aug. 13, 2003, at 52.

314. *See* Welsh (2004), *supra* note 309, at 188 (of a total of 25 civil penalty applications between 1993 and 2004, 11 were brought between 2000–2001).

315. HIH, unknown to the other HIH outside directors, invested in companies controlled by Adler, leading to losses for HIH. On the other directors' lack of knowledge, see ASIC v. Adler (2002) 168 F.L.R. 253, [386]. Adler was held to be a *de facto* officer for an HIH subsidiary. *Id.* at [55]–[75]. We treat Adler as an outside director because a board position was his only official position with HIH.

severally liable for about A$8 million.[316] The second case arose from insider trading by Stephen Vizard, a media personality who was a non-executive director for Telstra, a privatized telecommunications firm and one of Australia's largest companies.[317] Vizard was ordered to pay a civil penalty of $A390,000 and was disqualified from serving as a company director for 10 years.

In addition to the two self-dealing cases, there have been three instances where the ASIC obtained personal payments from outside directors who failed to exercise sufficient vigilance. The first involved Clifford Corporation, a bankrupt bus and coach maker. When it collapsed in 1998, Clifford was the biggest Australian corporate insolvency in a decade.[318] The ASIC brought proceedings against several inside directors and against Ian Sapier, an accountant who had been Clifford's only outside director. The New South Wales Supreme Court held that, in failing to address management's illicit efforts to inflate Clifford's profits, Sapier had breached Australian corporations law in nine instances, including two in which the court found conscious knowledge of accounting improprieties.[319] The court ruled that Sapier should pay a pecuniary penalty of A$120,000, pay a further $A120,000 as damages for approving an improper dividend, and reimburse up to 30% of the ASIC's trial costs. The case report does not mention D&O insurance. Regardless, the judge clearly contemplated that Sapier would pay from his own pocket since the civil penalty and the compensation order were set so Sapier could satisfy the judgment by continuing to run his accountancy firm.[320]

A second instance of out-of-pocket liability arising from ASIC enforcement against an insufficiently vigilant outside director involved the highly publicized 2001 bankruptcy of One.Tel, a telecommunications company. The ASIC launched proceedings against three executives and One.Tel's non-executive chairman, John Greaves, seeking a penalty based on harm to One.Tel caused by the directors' failure to meet appropriate standards of care. On a preliminary motion, the court upheld the ASIC's view that a non-executive chairman has greater obligations than other non-

316. On the breach of duty, see ASIC v. Adler (2002) 168 F.L.R. 253, [21]–[31]. On the sanction, see Re HIH Insurance Ltd. (2002) 42 A.C.S.R. 80, [11]–[16]. Adler was later criminally charged and convicted based on the same misconduct. *See* Nicolette Casella, *From Penthouse to Outhouse—HIH—The Final Verdict*, DAILY TELEGRAPH (Sydney), Apr. 16, 2005, at 7 and discussion *infra* section VIII(C)(3).

317. ASIC v. Vizard (2005) 219 A.L.R. 714. Technically, Vizard was sanctioned for making improper use of confidential information, but the misconduct amounted to insider trading in shares of companies Telstra was either intending to buy or sell.

318. Samantha Hughes, *Inside David Knott's Trophy Cabinet*, AUSTRALIAN, Jan. 4, 2003, at 21.

319. ASIC v. Loiterton (2004) 50 A.C.S.R. 693, [74]–[82].

320. *Id*. at [92]–[112], [127]–[129].

executives.[321] Greaves then consented to a judicially-approved settlement, with a nominal civil penalty of A$20 million.[322] Greaves could not pay this amount and struck a deal with the ASIC under which he agreed to pay A$950,000 and the ASIC agreed not to push him into formal bankruptcy proceedings.[323]

If an Australian public company collapses financially, the ASIC can seek a civil penalty for insolvent trading.[324] Due to resource constraints, the ASIC does not investigate every instance where insolvent trading might have occurred.[325] Indeed, according to a 2004 study, the ASIC has only brought one insolvency trading case since its inception in 1991.[326] That case, however, gave rise to the third Australian instance of out-of-pocket liability involving insufficiently vigilant outside directors.

Water Wheel Holdings, a publicly-traded company that procured, milled, and distributed rice and wheat, ceased operations in 2000, and the ASIC sought and obtained civil penalties for insolvent trading against one inside and two non-executive Water Wheel directors.[327] William Harrison, a retired accountant who served as non-executive chairman, cooperated fully with the ASIC, and the court ultimately endorsed an agreement between Harrison and the ASIC that he pay compensation of A$300,000 to creditors of Water Wheel.[328] The other non-executive was John Elliott, one of Australia's best known businessmen. He unsuccessfully contested the ASIC's insolvent trading allegations and was held jointly liable with the inside director defendant to pay A$1.43m as compensation to creditors.[329]

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321. ASIC v. Rich (2003) 174 F.L.R. 128, [5], [13]–[15], [27]–[29], [66]–[72], [85]. The complaint did not name the other non-executive directors.

322. ASIC v. Rich (2003) 174 F.L.R. 128. On the need for court approval of such settlements, see Corporations Act, 2001, c. 9, §§ 1317E, 1317F.

323. Formally, Greaves entered into a deed of arrangement under Australian bankruptcy law. He agreed to pay $A600,000 in civil penalties and $A350,000 to cover court costs. For background on the deal, see Vanda Carson, *One.Tel's Greaves to Pay Just 3pc in Settlement*, AUSTRALIAN, Sept. 10, 2004, at 21; Andrew Main, *One.Tel Chairman to Pay Up, Go Bust*, AUSTL. FIN. REV., Aug. 19, 2004, at 7.

324. Corporations Act, 2001, c. 5, §§ 588J, 588M. Individual creditors also have standing under § 588R.

325. David Knott, Deputy Chairman, Australian Securities and Investment Commission, Regulatory Issues Impacting on Insolvency (Oct. 13, 2000), http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/insolvency_speech.pdf/$file/insolvency_speech.pdf.

326. James, Ramsay & Siva (2004), *supra* note 296, at 235 (noting as well that the ASIC's predecessors, the National Companies and Securities Commission and the Australian Securities Commission, had only brought a total of four cases).

327. ASIC v. Plymin (2003) 175 F.L.R. 124.

328. The court did, however, increase the duration of an order banning Harrison from serving as a director from four to between six and seven years. ASIC v. Plymin (No. 2) (2003) 42 A.C.S.R. 662, [112]–[115].

329. *See* ASIC v. Plymin (2003) 175 F.L.R. 124 (liability); ASIC v. Plymin (No. 2) (2003) 42 A.C.S.R. 662, [105]–[110] (sanction); Elliot v. ASIC (2004) 48 A.C.S.R. 621 (trial court decisions

Elliott later declared bankruptcy after the ASIC and other regulators to whom he owed money scuttled a compromise he had proposed, prompting Elliott to say "It was an emotional decision they have made to get John Elliott, not to get the maximum money back to the government."[330]

The out-of-pocket risk to directors posed by ASIC enforcement is heightened because Australian law bars indemnification for civil penalties the ASIC obtains.[331] This leaves D&O insurance as the only available shield, but it is not foolproof. For instance, in the civil penalty proceedings involving One.Tel, the D&O insurer refused to advance funds for defense costs, relying on a provision that gave it "discretion" over the issue. After a judicial challenge failed,[332] Greaves apparently was in the "Can't Afford to Win" scenario that has prompted a number of out-of-pocket payments by outside directors in the U.S. Greaves had already paid over A$1 million in legal fees and was anticipating a long and expensive trial he could not afford.[333]

More generally, it is unclear whether D&O policies can lawfully cover civil penalties. The fact that Australian corporate legislation prohibits a company from buying cover for willful breaches of duty and for having misused their positions for personal gain but does not explicitly preclude insurance for civil penalties implies this sort of coverage is permissible.[334] However, since civil penalties have deterrence and punishment functions akin to fines, a court might well hold that insurance against such penalties is unenforceable on public policy grounds.[335]

B. Canada

1. The General Context.—In a 2004 newspaper article headlined "Corporate Liability May Create a Superstorm", two lawyers from a major Canadian law firm claimed: "One has to ask at what point the corporate boat will be swamped as well-qualified directors jump ship to avoid overwhelming personal liability."[336] This verdict, as we will see, is unduly alarmist since Canadian outside directors are unlikely to pay personally as a

upheld on appeal). Elliot and the inside director were also ordered to pay a pecuniary penalty (akin to a fine) of A$25,000 and 80% of the ASIC's legal costs. *Id.*

330. Blair Speedy, *Creditors Reject Elliott 5% Offer*, AUSTRALIAN, Jan. 29, 2005, at 7.

331. *See supra* note 301 and related discussion.

332. *See supra* note 305 (discussing Silbermann v. CGU Ins. Ltd.).

333. Andrew Main, *One.Tel Roosters Now Eating Humble Pie*, AUSTL. FIN. REV., Sept. 11, 2004, at 13.

334. Corporations Act, 2001, c. 2D, §§199B, 199C.

335. *See, e.g.*, Danielle Hauer, *Is it Time to Indemnify Directors for Civil Penalty Orders for Insolvent Trading?*, FINDLAW, July 30, 2003 (noting that if the ASIC enforces civil penalty orders against directors to promote deterrence, then "as a matter of public policy insurance companies should not cover directors for such orders"), http://www.findlaw.com.au/article/9414.htm.

336. Nicholas Dietrich & Leslie Gord, *Corporate Liability May Create a Superstorm*, LAW. WKLY., Apr. 23, 2004, at 48.

result of lawsuits. Moreover, there seems to be awareness of this in Canadian boardrooms. A 2003 survey of directors in Canada's 300 largest public companies found that only 8% had turned down invitations to join a board because of liability concerns.[337]

In Canada, each province and the federal government have enacted their own corporate statutes.[338] To simplify the analysis, we focus on the federal legislation, the Canada Business Corporations Act (CBCA).[339] The CBCA, which was enacted initially in 1975, has been imitated closely by a majority of Canadian provinces and has also influenced reform initiatives in countries as diverse as South Africa, Singapore, and New Zealand.[340] Thus, studying director liability under the CBCA potentially sheds light on the position both inside and outside Canada.

2. Suits by the Company (Including Derivative Suits).—Under the CBCA, a director owes a duty to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances" as well as a duty to act honestly and in good faith with a view to the best interests of the corporation.[341] The Supreme Court of Canada confirmed in 2004 that courts should apply a "business judgment rule" when assessing whether there has been a breach of duty, though it appears that this involves courts imposing upon themselves a rule of deference to board decisions rather than creating on behalf of directors a U.S.-style presumption of sound business judgment.[342] As is the case in Australia, Germany, and the U.K.,

337. PATRICK O'CALLAGHAN & ASSOCIATES, IS THERE A SHORTAGE OF QUALIFIED CANADIAN DIRECTORS? 10 (2003), http://www.kornferry.com/Library/ViewGallery.asp?CID=551&LanguageID=1&RegionID=23. A majority of respondents agreed that there was a shortage of directors and 20% attributed this to liability risk but only 9% thought reduction of liability risk would solve the problem. *Id.* at 4–5. An earlier survey of Canadian chief executives found similar results—only 15% said that liability was a deterrent to the acceptance of directorships. RUTH M. CORBIN, TORONTO STOCK EXCH. AND INST. OF CORP. DIRS., REPORT ON CORPORATE GOVERNANCE, 1999: FIVE YEARS TO THE *DEY* 18 (1999), *available at* http://www.ecgi.org/codes/documents/5years.pdf.

338. CALLY JORDAN, AN INTERNATIONAL SURVEY OF COMPANIES LAW IN THE COMMONWEALTH, NORTH AMERICA, ASIA AND EUROPE 26–28, 33 (1998), *available at* http://www.dti.gov.uk/cld/jordan.pdf.

339. Canada Business Corporations Act, R.S.C., ch. C-44 (1985, as amended).

340. JORDAN (1998), *supra* note 338, at 33–34.

341. Canada Business Corporations Act, R.S.C., ch. C-44, § 122(1)(a)(b) (1985, as amended). It has traditionally been taken for granted that the duty to exercise care, diligence, and skill is owed only to the corporation. *See, e.g.,* J. ANTHONY VANDUZER, THE LAW OF PARTNERSHIPS AND CORPORATIONS 269 (2nd ed. 2003). However, the law may now have changed. In People's Dep't Stores Inc. v. Wise, [2004] 3 S.C.R. 461, 488, the Supreme Court of Canada said "the identity of the beneficiary of the duty (under § 122(1)(b)) is much more open-ended, and it appears obvious that it must include creditors." On the implications of this extension, see Wayne D. Gray, *A Solicitor's Perspective on* People's v. Wise, 41 CAN. BUS. L.J. 184, 190–92 (2005) (arguing that it would be better if courts continued to treat the duty of care as owed to the corporation exclusively.)

342. People's Dep't Stores v. Wise, [2004] 3 S.C.R. 461, 492; Harry Underwood and René Sorell, Danier Leather Inc. *and the Duty to Update a Prospectus*, 43 CAN. BUS. L.J. 134, 148-50 (2006).

CBCA companies cannot use their corporate constitution to limit a director's liability for breaches of duty.[343] Outside directors stand to benefit, however, from 2001 CBCA amendments made to address concerns about "liability chill."[344]

One change made in 2001 was to replace joint and several liability with proportionate liability.[345] Outside directors are key beneficiaries of this change, since they will usually be less culpable than insiders and less knowledgeable than professional advisers. The 2001 amendments also ensured a "due diligence" defense would be available to directors who otherwise might be held liable for breaching statutory provisions regulating the payment of dividends and other specified transactions. Directors are protected if they have exercised the care, diligence, and skill of a reasonably prudent person.[346]

There have only been a handful of cases brought involving Canadian directors where the core allegation was a failure to meet the duty of care.[347] One explanation for the lack of litigation is that, as in other countries, directors rarely sue one of their own. Also, minority shareholders have not stepped into the breach; derivative litigation suits are uncommon. Canadian corporate legislation explicitly provides that a judge can, under specified conditions (e.g., the complainant is acting in good faith and it is in the company's interests that the suit go ahead) grant a minority shareholder leave to sue on a company's behalf.[348] Use of this statutory derivative action procedure has been sporadic, however, particularly when self-serving conduct has been lacking and a public company has been involved.[349]

The logistical factors that deter the launching of derivative suits will by now be familiar. One is the fact that any recovery will be paid to the

343. Canada Business Corporations Act, R.S.C., ch. C-44, § 122(3) (1985, as amended).

344. For background, see TORONTO STOCK EXCHANGE COMMITTEE ON CORPORATE GOVERNANCE IN CANADA, WHERE WERE THE DIRECTORS? GUIDELINES FOR IMPROVED CORPORATE GOVERNANCE IN CANADA 33–37 (1994); Wayne D. Gray, *Corporations as Winners Under CBCA Reform*, 39 CAN. BUS. L.J. 4, 11–13 (2003).

345. Canada Business Corporations Act, R.S.C., ch. C-44, § 237.3(1) (1985, as amended).

346. Canada Business Corporations Act, R.S.C., ch. C-44, § 123(4) (1985, as amended). Even prior to 2001, a director who relied in good faith on his corporation's financial statements and on professional advice was expressly protected from claims for breach of duty. *See* § 123(5).

347. Lorie Waisberg & Robert Vaux, *Board Governance: The Importance of Process*, *in* THE FUTURE OF CORPORATE LAW: ISSUES AND PERSPECTIVES—QUEEN'S ANNUAL BUSINESS LAW SYMPOSIUM 1997, at 97, 106 (Peter Goode ed., 1999); Martha O'Brien, *The Director's Duty of Care in Tax and Corporate Law*, 36 U.B.C. L. REV. 673, 676 (2003). O'Brien notes there has been "a flood of cases" under the Income Tax Act, R.S.C., 1985, c. 1, § 227.1, which she characterizes as creating a duty for directors to act with reasonable prudence to prevent failures by a company to remit tax. *Id.* at 678, 686. Our understanding is that outside directors of Canadian public companies have thus far not been adversely affected by this provision, primarily because outright default on tax obligations is rare occurrence for public companies.

348. Canada Business Corporations Act, R.S.C., ch. C-44, § 239 (1985, as amended).

349. Cheffins (1997), *supra* note 113, at 227, 234, 241, 255–56.

company rather than the shareholder.[350] Another is that a shareholder who applies for leave and fails will likely face an adverse cost order under Canadian variants of the "loser pays" rule.[351] Also significant is that a shareholder who obtains leave must be prepared to finance the trial since Canadian courts have been reluctant to order companies to pay legal expenses until final disposition of derivative litigation.[352] Moreover, if a derivative suit fails at trial, the court may well invoke loser pays principles to order the shareholder plaintiff to reimburse the defendants' legal expenses.

3. Direct Shareholder Suits.—Shareholders in Canada, like their counterparts in the U.K. and Australia, can seek direct relief on the grounds of unfair prejudice.[353] This form of minority shareholder protection, known in Canada as the "oppression remedy," is popular for privately held companies but is available for public companies as well, and damages are a permitted form of relief.[354] In fact, however, only a small minority of proceedings brought under the oppression remedy involve public companies.[355] Moreover, the success rate is lower in cases involving such firms,[356] with a likely explanation being that the "equitable rights" that often underlie a successful oppression claim are less likely to arise in a public company.[357]

Even if a public company's directors are sued and oppression is found, out-of-pocket liability is unlikely. This is because the remedies a court is most likely to grant in such a case are a buy-out of the applicant's shares by

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350. Edward M. Iacobucci & Kevin E. Davis, *Reconciling Derivative Claims and the Oppression Remedy*, 12 SUP. CT. L. REV. 87, 92–94 (2000).

351. *See* JOHN YUKIO GOTANDA, SUPPLEMENTAL DAMAGES IN PRIVATE INTERNATIONAL LAW 162–63 (1998) (noting that costs will either be awarded on a "party-and-party scale" in accordance with fixed tariffs or on a "solicitor-and-client scale" with the objective of completely indemnifying the successful party's litigation expenses).

352. DENNIS H. PETERSON, SHAREHOLDER REMEDIES IN CANADA §§ 3.5–3.7, 3.10, 17.53, 17.54 (looseleaf volume, 1989); William Kaplan and Bruce Elwood, *The Derivative Action: A Shareholder's "Bleak House"?*, 36 U.B.C. L. REV. 443, 464–68 (2003).

353. VANDUZER (2003), *supra* note 341, at 327. There is some case law authority indicating that minority shareholders alleging breaches of duty by directors amounting to oppression must bring the suit under the oppression remedy but the preponderance of authority supports the idea that this sort of lawsuit can also be brought derivatively. *See* PETERSON (1989), *supra* note 352, §§ 18.101.1, 18.235–18.237.

354. PETERSON (1989), *supra* note 352, §§ 18.144, 18.208.

355. Stephanie Ben-Ishai, *The Promise of the Oppression Remedy: A Review of Markus Koehnen's Oppression and Related Remedies*, 42 CAN. BUS. L.J. 450, 455 (2005); Stephanie Ben-Ishai & Poonam Puri, *The Canadian Oppression Remedy Judicially Considered: 1995-2001*, 30 QUEEN'S L.J. 79, 92 (2004) (of 71 oppression remedy cases launched between 1995 and 2001, only 6 cases, an average of one case per year, involved a public company).

356. Ben-Ishai & Puri (2004), supra note 355, at 92 (finding the success rate when public companies were involved was 33% as compared with 54% for private companies).

357. PETERSON (1989), *supra* note 352, §§ 18.145–18.146.

the company or injunctive relief, not damages.[358] There have been a few oppression cases involving public companies where damages have been sought as a remedy but there does not appear to have been a reported case where this form of relief has been granted against a director.[359]

In Canada, securities regulation is a provincial matter, with Ontario playing the lead role due to having larger and more active capital markets than other provinces.[360] Breaches of assorted provisions in provincial securities laws can leave Canadian directors vulnerable to lawsuits by investors. The Ontario Securities Act regulates prospectuses for public offerings, imposes periodic disclosure obligations on publicly traded companies, and mandates that a target company in a takeover issue a circular to the shareholders.[361] If disclosure is false or misleading, investors can sue for compensation.[362] The defendants may include a public company's directors, though a due diligence defense is available to them.[363]

While provincial securities legislation creates liability risks for outside directors of Canadian public companies, as a practical matter, board members have had little reason to fear being sued. Going back to 1990, we found only two reported decisions—both involving preliminary motions rather than full trials—in which outside directors were named as defendants in lawsuits under the Ontario Securities Act provision that creates liability for a misleading prospectus.[364] Lawsuits involving allegations of misleading periodic disclosure have similarly been scarce. As a committee investigating corporate disclosure on behalf of the Toronto Stock Exchange stated in 1997: "[T]he remedies available to investors in secondary trading markets who are

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358. On buy-outs being the most popular form of relief, see VANDUZER (2003), *supra* note 341, at 354. Injunctive relief has been popular in cases involving public companies. *See, e.g.*, UPM-Kymmene Corp. vs. UPM-Kymmene Miramachi Inc., [2002] 214 D.L.R. (4th) 496; 347883 Alberta Ltd. v. Producers Pipelines Inc., [1991] 92 Sask. R. 81; Catalyst Fund General Partner Inc. v. Hollinger Inc., [2004] 1 Bus. L.R. 4th 186; Palmer v. Carling O'Keefe Breweries of Canada Ltd., [1989] 67 O.R.2d 161; Themadel Foundation v. Third Canadian General Investment Trust Ltd., [1998] 38 O.R. 3d 749; Westfair Foods Ltd. v. Watt, [1991] 79 Alta. L.R.2d 363.

359. Damages were sought as relief against directors of public companies in Stern v. Imasco Ltd., [1998] 1 D.L.R. (3d) 198; Budd v. Gentra Inc., [1998] 111 O.A.C. 288; and Hovsepian v. Westfair Foods Ltd., [2001] 95 Alta. L.R.3d 331. In each of these cases, the proceedings were dismissed. For a regularly updated list of oppression remedy cases brought in Canada, see PETERSON (1989), *supra* note 352, Appendix A.

360. MARY G. CONDON ET AL., SECURITIES LAW IN CANADA: CASES AND COMMENTARY 50 (2005); JEFFREY G. MACINTOSH & CHRISTOPHER C. NICHOLLS, SECURITIES LAW 64–65 (2002).

361. Securities Act, R.S.O., ch. S.5, §§ 56(1), 75(2), 77(1), 78, 99(1) (1990, as amended).

362. *Id.* §§ 130 (prospectus), 131 (takeover circulars), 138.3 (secondary market disclosure).

363. Securities Act, R.S.O., ch. S.5, § 138.4(6) (1990, as amended) (secondary market disclosure); DAVID JOHNSTON & KATHLEEN D. ROCKWELL, CANADIAN SECURITIES REGULATION 181–83 (2d ed. 1998) (discussing prospectuses and takeover bid circulars).

364. CC&L Dedicated Enterprise Fund (Trustee of) v. Fisherman, [2002] 55 O.R.3d 794; Montreal Trust Co. of Can. v. ScotiaMcLeod Inc., [1995] 26 O.R.3d 481. The search for cases was carried out on Quicklaw, the leading electronic database for Canadian law, using the source ID "SECQ", which covers all securities law cases, and the search terms "130(1)" (the relevant section number) and "director".

injured by misleading disclosure are so difficult to pursue and to establish, that they are as a practical matter largely academic."[365] The fact that U.S.-style securities class actions have been virtually unknown in Canada does much to account for the lack of securities lawsuits.[366] Reasons why securities class actions have been rare have included the prevalence of the "loser pays" litigation rule in Canada and difficulties associated with paying plaintiffs' counsel in multiparty litigation.[367]

With allegedly misleading periodic disclosure, an additional major deterrent to litigation has been that plaintiffs could only be brought into the same class if it could be established that they had each relied on the alleged misrepresentations.[368] Due to legislative amendments taking effect in 2006, plaintiffs suing under Ontario securities law have been relieved of the burden of proving reliance in such cases.[369] This has led to speculation that legal risks facing directors of public companies will increase.[370] Canadian lawyers anticipate however, that the "loser pays" rule will preclude any sort of "Armageddon."[371]

Outside directors can also take comfort from the fact that, so long as there was no knowing involvement in a periodic disclosure violation, the 2006 reforms have capped damages for a director at the greater of C$25,000 or half his annual compensation (as of 2005 outside directors at Canada's largest public companies earned on average C$79,000 per year).[372] These

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365. TSE COMMITTEE ON CORPORATE DISCLOSURE, FINAL REPORT: RESPONSIBLE CORPORATE DISCLOSURE—A SEARCH FOR BALANCE vii (1997).

366. John J. Chapman, *Class Proceedings for Prospectus Misrepresentations*, 73 CAN. BAR. REV. 492, 494 (1994); Paul Waldie, *Class Action Suits on Rise: Canadian Firms Feel More Heat*, GLOBE & MAIL, Mar. 2, 1998, at B1. Even though securities class actions have been rare, there has been one trial. *See* Kerr v. Danier Leather Inc. [2005] O.J. 5388 (Ont. C.A.) (the plaintiffs won at trial but lost on appeal). On this being Canada's first securities class action trial, see Sandra Rubin, *Disclosure, Duty and Danier*, NAT. POST, Dec. 21, 2005.

367. *See* Chapman (1994), *supra* note 366, at 509–13 (discussing the position with prospectus misrepresentations).

368. Carom v. Bre-X Minerals Ltd., [1998] 41 O.R.3d 780, 794–95; Waldie (1998), *supra* note 366, at B1.

369. Securities Act (Ontario), § 138.3(1). The reliance requirement had previously been overridden by statute for prospectuses and takeover bid circulars. *See* MARK R. GILLEN, SECURITIES REGULATION IN CANADA 149–61, 209–10, 373 (2d ed. 1998).

370. William Braithwaite & John Ciardullo, *Canada's New Liability Law Focuses First on Deterrence*, 23 INT'L FIN. L. REV. 25, 25–26 (2004); Gloria Gonzalez, *Canadian Securities Law Lowers Bar for Class Actions*, BUS. INS., Nov. 14, 2005, at 28.

371. Ben Maiden, *Canadian Lawyers Take New Look at Due Diligence*, 24 INT'L FIN. L. REV. 37, 40 (2005).

372. Securities Act (Ontario), §§ 138.1 ("liability limit"), 138.1(7). *See also* DAVIES WARD PHILLIPS & VINEBERG, CIVIL LIABILITY FOR SECONDARY MARKET DISCLOSURE 11 (2005), *available at* http://www.dwpv.com/en/16747.aspx (explaining that outside directors in particular stand to benefit from the liability cap). *But see* Sandra Rubin, *Northern Exposure is Set to Explode*, NAT'L POST, Mar. 15, 2006 (citing a senior partner of a U.S. plaintiff law firm who argued it should be possible to plead around the liability cap). For data on director compensation, see SPENCER STUART, CANADIAN BOARD INDEX 2005 25 (2005), *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/CanadianBI-2005c.pdf.

caps should make the potential recovery too small to interest plaintiffs, particularly since the plaintiffs would likely have to pay the defendants' legal costs if the suit fails. Moreover, liability within the statutory caps should be easy to protect against through D&O insurance.

While private securities litigation has thus far not led to out-of-pocket payments by Canadian outside directors, public enforcement creates additional risk and is responsible for the one instance we found where outside directors of a public company paid out of their own pockets as a result of a securities lawsuit arising under Canadian law. The case involved Y.B.M. Magnex International, a maker of industrial magnets allegedly backed by individuals connected with the Russian mafia. Following Y.B.M.'s highly publicized collapse in 1998, an Ontario Securities Commission (OSC) disciplinary panel relied on findings of inadequate disclosure of investment risk by the company to ban a number of Magnex ex-directors from serving as directors, including three non-executives. The three outside directors took a direct financial hit since they were ordered to pay hearing costs amounting to C$400,000.[373]

Another source of risk for some Canadian firms arises under U.S. securities law. It is quite common for Canadian companies to cross-list on U.S. stock markets, with over 160 being listed on the New York Stock Exchange and NASDAQ as of 2006.[374] We lack data on how often outside directors of cross-listed Canadian companies are sued under U.S. securities law. Nevertheless, our research on the U.S. did uncover one "Perfect Storm" in which several outside directors of a bankrupt Canadian cross-listed company paid personally to settle a lawsuit that followed a major accounting fraud.[375]

4. Indemnification and Insurance.—For Canadian directors both indemnification and insurance provide important layers of protection.[376] As part of the 2001 CBCA reforms designed to address "liability chill," the rules on both were liberalized.[377] A corporation can now indemnify a director for legal expenses whether a director wins or loses in court, as well as for

373. Re Y.B.M. Magnex Int'l Inc., [2003] 26 O.S.C.B. 5285, [603]-[619]. In Re Standard Trustco Ltd., [1992] 15 O.S.C.B. 4322, the Ontario Securities Commission ruled that directors of a bankrupt trust company had breached duties of care, skill and diligence but declined to impose the only penalty then at its disposal, namely, an order banning the directors from trading in securities.

374. NEW YORK STOCK EXCHANGE, LISTED COMPANY DIRECTORY (May 7, 2006), http://www.nyse.com/about/listed/1.html?country=Canada&ListedComp=All (101 Canadian companies cross-listed); NASDAQ INTERNATIONAL COMPANIES (May 7, 2006), http://www.nasdaq.com/asp/NonUsOutput.asp?page=C®ion=Northamerica (60 Canadian companies cross-listed).

375. *See Outside Director Liability*, *supra* note 1, at 1070–73. We cannot provide further details due to confidentiality restrictions.

376. Warren Grover, *The Canadian Outside Director: Great Expectations*, 38 CAN. BUS. L.J. 349, 357–58 (2003).

377. 2001 S.C., ch. 14, § 51.

amounts paid by a director pursuant to a settlement or a judgment in civil, criminal, or administrative proceedings.[378] There are qualifications. With derivative litigation, indemnification can only be for legal expenses, and can only be made with court approval.[379] More generally, indemnification can only occur if a director has acted honestly and in good faith,[380] but these are conditions an outside director of a public company should usually be able to meet. As a practical matter, Canadian public companies routinely indemnify directors to the full extent the law authorizes.[381]

The CBCA explicitly permits companies to purchase D&O insurance to cover both damages and legal expenses.[382] Corporate legislation in a number of provinces precludes D&O coverage for breaches of duty where directors have failed to act honestly and in the company's best interests.[383] With the CBCA, amendments made in 2001 eliminated this restriction.[384] Some argue this change has helped to make "the actions of directors virtually zero risk"[385] but this is an exaggeration, in part because D&O policy language will exclude coverage where a director has been dishonest or has obtained a personal profit.

Nearly all Canadian public companies purchase D&O insurance and policy limits of C$50 million or more are common.[386] Various practitioners have argued that D&O insurance is not a complete answer for Canadian directors, citing coverage limits and exclusions.[387] To this point, however, there is little evidence of insurers contesting D&O coverage offered to Canadian public companies. A 2005 lawsuit filed by Chubb Insurance Co. of Canada seeking to rescind the D&O policy of telecommunications giant

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378. Canada Business Corporations Act, R.S.C., ch. C-44, § 124(1), (3), (5) (1985, as amended).

379. *Id.* § 124(4).

380. *Id.* § 124(3).

381. MCCARTHY TÉTRAULT, DIRECTORS' AND OFFICERS' DUTIES AND LIABILITIES IN CANADA 295, 299–300 (1997). For an exceptional instance where a company declined to indemnify a director's legal expenses, see Catalyst Fund General Partner I Inc. v. Hollinger, [2006] O.J. No. 944 ¶¶ 96–107. The director— who was also an officer—sought indemnification for legal expenses he incurred in resisting a successful application to have him removed as a director in oppression remedy proceedings. The company declined and the Ontario Court of Appeal upheld the company's decision.

382. Canada Business Corporations Act, R.S.C., ch. C-44, § 124(6) (1985, as amended).

383. CAROL HANSELL, WHAT DIRECTORS NEED TO KNOW: CORPORATE GOVERNANCE 167 (2003); VANDUZER (2003), *supra* note 341, at 242.

384. Canada Business Corporations Act, R.S.C., ch. C-44, § 124(6) (1985, as amended); Wayne D. Gray, *Corporations as Winners Under CBCA Reform*, 39 CAN. BUS. L.J. 4, 13 (2003).

385. Warren Grover, *The Tangled Web of the* Wise *Case*, 41 CAN. BUS. L.J. 200, 208 (2005).

386. John E. Core, *On the Corporate Demand for Directors' and Officers' Insurance*, 64 J. RISK & INS. 63, 64 (1997) (on the prevalence of D&O insurance); John Gray, *Cover Me*, CAN. BUS., Dec. 26, 2005/Jan. 15, 2006, at 77 (setting out total D&O insurance cover for 20 Canadian public companies; 12 had coverage of C$50 million or more).

387. Christopher C. Nicholls, *The Outside Director: Policeman or Placebo?*, 38 CAN. BUS. L.J. 323, 344–45 (2003).

Nortel on grounds of misrepresentation was reportedly the first of its kind.[388] Also, as in other countries, any coverage gaps are likely to be temporary because once they are known, directors will push for more comprehensive insurance.[389]

5. *Insolvency.*—As has been discussed at various points, insolvency increases the risks an outside director of a public company faces. In Canada, this is again the case, with the only instances we found in which outside directors of a Canadian public company paid damages out of their own pocket occurring after corporate bankruptcy. One was the case discussed above where the outside directors of a cross-listed Canadian company were caught in a "Perfect Storm" under U.S. securities law. The others involved the Canadian Commercial Bank and Northland Bank, two Alberta-based financial institutions that collapsed in the mid-1980s. The federal government's Department of Finance and the Canada Deposit Insurance Corporation, a federal Crown Corporation that provides deposit insurance, bailed out depositors and then, in tandem with liquidators, launched suits against the auditors, officers, and directors (including outside directors) of the two banks, with claims against the directors being based primarily on alleged failures to exercise sufficient vigilance.[390]

In 1990, a settlement was reached with the defendant directors of Canadian Commercial Bank, and in 1998, deals were struck with their counterparts at the Northland Bank.[391] In both instances, the terms were confidential.[392] We have learned from federal civil servants involved with both cases, however, that some outside directors of the two banks did personally pay damages.[393] Our sources indicated that while some outside directors with full-time employment benefited from reimbursement by their

388. *See* Elizabeth Church, *Chubb Suit Against Nortel Rings Alarm Bells*, GLOBE & MAIL, Feb. 25, 2005, at B4 (noting that although there had been some previous efforts to have policies rescinded in the courts, these efforts involved only an interpretation of the insurance contract).

389. Beppi Crosariol, *Litigation Rated Top Legal Trend in 2005*, GLOBE & MAIL, Jan. 3, 2005, at B9; Janet McFarland, *The Soaring Cost of a Boardroom Safety Net*, GLOBE & MAIL, Feb. 23, 2006, at B12.

390. On the array of claims, see Can. Deposit Ins. Corp. v. Prisco, [1990] 115 A.R. 184, *aff'd*, [1991] 120 A.R. 35 (involving a preliminary motion in the case brought against Northland Bank directors and officers); Can. Deposit Ins. Corp. v. Can. Comm'l Bank, [1989] 98 A.R. 353 (involving a preliminary motion in the case brought against Canadian Commercial Bank directors and officers).

391. Northland Bank v. Willson, [1999] 249 A.R. 201, [14]–[19]; Konrad Yakabuski, *Deal Allows Bank Liquidation*, TORONTO STAR, Nov. 3, 1990, at C1.

392. Walter K. Mis, Book Review, 31 ALTA. L. REV. 731, 736–37 (1993) (Canadian Commercial Bank); Cristin Schmitz, *How the Feds Spent Their Money*, LAW. WKLY., Dec. 11, 1998, at 1, 13–15 (Northland Bank).

393. E-mail from Mark Jewett, General Counsel and Corporate Secretary, Bank of Canada to author (Sept. 20, 2004) (on file with author); E-mail from Doug Wyatt, General Counsel, Dept. of Finance to author (Sept. 21, 23, 2004) (on file with author).

employers, others paid out of their own pockets. The amounts involved were not disclosed to us.

Insolvency also brings into play a source of liability that often worries Canadian directors. Through a combination of corporate legislation and employment standards law, directors of an insolvent company that fails to pay its staff can end up being jointly and severally liable for up to six months of unpaid wages and related employment benefits.[394] Many Canadian directors are concerned about statutory liability for unpaid wages, and there has been lobbying for increased protection.[395] The CBCA and corporate legislation in some provinces in fact already permit a director acting with due diligence to escape liability.[396] No such protection is available, however, under provincial employment standards legislation, meaning that even if directors have acted reasonably they can in theory be held liable.[397]

While directors of Canadian companies are concerned about liability for unpaid wages, various defensive steps can be taken that help to neutralize the risk. These include arranging for their company to establish a segregated trust account containing sufficient funds to satisfy any claims for unpaid wages and resigning from the board to prevent the accrual of unpaid wage liability.[398] Moreover, litigation is rare, at least for outside directors of public companies. We did not find a single decision by a Canadian court or employment standards tribunal finding outside directors of a public company liable for unpaid wages.[399] There have been a number of cases where such liability has been imposed on directors, but there is no evidence from the case reports that the companies were public or that the directors were non-executives.[400]

394. For summaries of the law, see JANIS P. SARRA & RONALD B. DAVIS, DIRECTOR AND OFFICER LIABILITY IN CORPORATE INSOLVENCY: A COMPREHENSIVE GUIDE TO RIGHTS AND OBLIGATIONS 89–117 (2002); MCCARTHY TÉTRAULT (1997), *supra* note 381, at 86–96. Directors who breach their obligations can also potentially be fined under employment standards legislation, though prosecutions are infrequent. MCCARTHY TÉTRAULT (1997), *supra* note 381, at 96–97.

395. HANSELL (2003), *supra* note 383, at 146; Ronald B. Davis, *The Bonding Effect of Directors' Statutory Wage Liability: An Interactive Corporate Governance Explanation*, 24 LAW & POL'Y 403, 407 (2002).

396. *See* Canada Business Corporations Act, R.S.C., ch. C-44, § 123(4) (1985, as amended); SARRA & DAVIS (2002), *supra* note 394, at 89–90 (listing, in addition to the C.B.C.A., corporations statutes in Alberta, Manitoba, Saskatchewan, the Northwest Territories and Nunavut).

397. MCCARTHY TÉTRAULT (1997), *supra* note 381, at 98; Davis (2002), *supra* note 395, at 405.

398. HANSELL (2003), *supra* note 383, at 148–49. For a case involving a public company in which such a trust offered protection to directors, see Bell v. British Columbia (Dir. of Employment Standards), [1996] 25 B.C.L.R.3d 297.

399. We searched the Quicklaw "Empq" database, which covers court decisions and employment tribunal standards cases back to the 1980s. A February 2006 search for decisions with the words "unpaid," "wages," and "liability" yielded 1,051 hits. Limiting the search to cases with these words plus "stock" and "market" reduced the number of hits to 20. Of these, none involved the imposition of personal liability on an outside director of a public company.

400. *See, e.g.*, Can. Automatic Data Processing Servs. Ltd. v. CEEI Safety & Sec. Inc., [2004] 192 O.A.C. 152; Proulx v. Sahelian Goldfields Inc., [2001] 55 O.R.3d 775.

In any future case involving a claim for unpaid wages against an outside director of a Canadian public company, a judge would likely construe the liability provisions narrowly since the judiciary has recognized that imposing unpaid wage liability on directors is an extraordinary exception to the general principle that such individuals are not accountable for corporate debts.[401] Also, D&O insurance would probably (but not certainly) offer protection for any damages payments outside directors had to make to resolve such a claim.[402] Thus, liability for unpaid wages poses dangers for outside directors of Canadian public companies, but the risks seem more theoretical than actual.

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Our examination of two additional common law countries—Australia and Canada—verifies that outside directors of public companies rarely end up paying damages and related financial penalties as a result of civil litigation. The only case where outside directors of an Australian or Canadian public company paid damages out of their own pocket as a result of a lawsuit by a private party was a suit under U.S. securities law against a cross-listed Canadian company. In Australia, all of the instances of out-of-pocket liability resulted from ASIC enforcement proceedings. In Canada, the costs award paid by outside directors of Y.B.M. Magnex was the result of proceedings brought by the OSC, and federal regulators were behind the suits in which outside directors of the failed Alberta banks paid out of their own pockets. Hence, experience suggests enforcement by public officials is the primary source of risk for Australian and Canadian outside directors.

VII. Other Civil Law Countries

A. France

1. The General Context.—Our focus now shifts to two major jurisdictions with civil law traditions: France and Japan.[403] It has been said that amongst the larger economies, France imposes the strictest duties on directors.[404] Nevertheless, there remains only a remote chance that an

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401. Re Ezebiz Software (Canada) Inc., [2002] B.C.E.S.T. #D064/02, ¶ 28.

402. *Compare* Davis (2002), *supra* note 395, at 420 (arguing that Canadian D&O insurance can offer valid cover for employee claims under corporate law and employment standards legislation), *with* MCCARTHY TÉTRAULT, *supra* note 381, at 308–09 (noting the risk that an insurer could claim this liability falls within the common policy exclusion for fines and penalties).

403. Comparative lawyers disagree about whether Japan should be included in the same civil law family as Germany and France. Still, the Germanic origins of Japan's Civil and Commercial Codes—the primary sources of Japanese company law—mean that it is appropriate for present purposes to think of Japan as a civil law country. For background, see HIROSHI ODA, JAPANESE LAW 3–6, 8, 216 (2d ed. 1999).

404. Vassil Breskovski, *Directors' Duty of Care in Eastern Europe*, 29 INT'L LAW. 77, 91 (1995).

outside director of a French public company will end up being personally liable.

In France, public companies take the form of *Sociétés anonymes* (SA), although only a tiny minority of SAs are publicly quoted.[405] Such companies can adopt one of three board structures.[406] The first, and most popular, is a one-tier model where executive authority is formally vested in the board of directors (*conseil d'administration*) and the chairman of the board is also the chief executive officer operating under the title *président directeur general*.[407] The second option, added by statute in 2001, involves a one-tier board with an express splitting of the chairman/CEO roles (*structure dissociée*); companies do retain the option to have these functions performed by the same person.[408] By the end of 2003, six of the 40 largest French public companies had adopted this structure.[409] The third option is a two-tier model, similar to Germany's, with companies having a management board and a supervisory board.[410] Fewer than 5% of French public companies have a two-tier board, though this option is somewhat more popular among the very largest French firms.[411]

In public companies with a one-tier board, directors who are also executives cannot exceed one-third of the total number of directors.[412] There is no requirement, however, that the outside directors be independent in the American sense.[413] Indeed, the *président directeur general* has traditionally decided who will serve on the board.[414]

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405. CHARKHAM (2005), *supra* note 16, at 188 (as of 2003, only 739 of 160,000 SAs were publicly quoted).

406. *France*, *in* THE HANDBOOK OF INTERNATIONAL CORPORATE GOVERNANCE: A DEFINITIVE GUIDE 45, 48 (Kerrie Waring & Chris Pierce eds., 2005); Michel Menjucq, *Corporate Governance Issues in France*, 16 EUR. BUS. L. REV. 1003, 1004 (2005).

407. CHARKHAM (2005), *supra* note 16, at 190–91 (noting that 25 of France's 40 largest quoted companies use this format).

408. CODE DE COMMERCE [C. COM.] art. L225-51-1 (English translation available at http://195.83.177.9/code/liste.phtml?lang=uk&c=32); CHARKHAM (2005), *supra* note 16, at 192; Menjucq (2005), *supra* note 406, at 1004–05.

409. CHARKHAM (2005), *supra* note 16, at 192.

410. C. COM. art. L225-58. France does not have German-style co-determination, with labor representatives forming part of the supervisory board. Board meetings, however, do have to include, on a consultative basis, one or two members of a company's works council. CHARKHAM (2005), *supra* note 16, at 198.

411. *France*, *supra* note 406, at 48; CHARKHAM (2005), *supra* note 16, at 191 (saying seven of the 40 largest French public companies had two-tier boards at the end of 2003).

412. C. COM. art. L225-22; KRAAKMAN ET AL., *supra* note 9, at 39. The rule governs directors who have employment contracts, rather than executives as such.

413. Eddy Wymeersch, *A Status Report on Corporate Governance Rules and Practices in Some Continental European States*, *in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 197, at 1102 (discussing a proposal made in the mid-1990s to introduce such a requirement).

414. *Id.* at 1113–14; s*ee also* KRAAKMAN ET AL., *supra* note 9, at 39 (indicating that the French *président directeur-general* often "dominates other directors and may even have the informal power to select them with the aid of controlling shareholders").

2. *Suits by the Company (Including Derivative Suits).*—The legislation governing SAs stipulates that directors are liable to the company for infringements of laws regulating companies and for negligent acts of management.[415] This obligation is not defined, but the received wisdom is that directors are obliged to conduct themselves with the prudence and diligence of a similarly situated director.[416] For outside directors this means they should take an active interest in the company and monitor actions of the *président directeur general* and other executive directors.[417] In fact, French outside directors have a reputation for poor attendance at board meetings and for putting in fewer hours than their foreign counterparts.[418] Nonetheless, individual directors are rarely held legally accountable for mismanagement or other breaches of duty.[419]

Procedural factors do much to explain the rarity of legal sanctions. For duties French directors owe directly to their companies, the board determines when a company will sue, and as elsewhere, will rarely sue any of its own members.[420] An individual shareholder can in theory launch derivative litigation and can do so without being subject to significant procedural hurdles.[421] French corporate legislation does not provide, however, any mechanism to shift the attendant legal expenses to the company.[422] As a result, a shareholder who wants to bring a derivative suit must be prepared to pay for the litigation, even if there ultimately is a judgment in the corporation's favor. To help to collectivize legal costs, shareholders in quoted companies can form an association to launch proceedings in the firm's name (*action sociale*). The minimum ownership threshold for such an action starts at 5% share ownership, but declines to 1% for companies with share capital (calculated by multiplying the number of shares issued by their par value) of over €15 million.

Action sociales are rare in France.[423] The fact that French corporate law does not provide a means for shifting legal expenses to the company, even if

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415. C. COM. art. L225-251.

416. James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT'L L.J. 31, 55–56 (1998). For more background on conduct that will constitute a breach, see EDGAR M. CHURCH, BUSINESS ASSOCIATIONS UNDER FRENCH LAW 386–88 (1960).

417. Fanto (1998), *supra* note 416, at 56.

418. *Id.*, at 57 (discussing two highly publicized reports on French corporate governance issued in the mid-1990s that urged directors of public companies to take their duty of care more seriously); Jenny Luseby, *Plus Ça Change. Elite Still Casts Long Shadow over French Boardrooms*, BUSINESS (U.K.), June 1, 2003, at 12.

419. Luseby (2003), *supra* note 418 (quoting the member of a research group as saying "it is very rare for board members individually to be found guilty").

420. Fanto (1998), *supra* note 416, at 81.

421. C. COM. art. L225-252 ("[S]hareholders may . . . individually . . . bring an action for liability on behalf of the company against its directors . . . ."); Fanto (1998), *supra* note 416, at 81–82 (discussing how directors cannot dismiss a derivative suit once it has begun).

422. Fanto (1998), *supra* note 416, at 81.

423. *Id.* at 82.

the action succeeds, is surely a deterrent. France's "loser pays" rules for civil litigation also plays a role since shareholders know they may have to pay the defendants' legal expenses as well as the company's.[424] The fact damages will be paid to the company and not the plaintiff shareholders constitutes a further deterrent.[425] Hence, the lack of derivative litigation is unsurprising.

3. Direct Shareholder Suits.—In addition to a derivative suit a shareholder can sometimes bring a direct suit (*action individuelle*) to recover losses personally suffered.[426] France lacks a U.K.-style "unfair prejudice" remedy, but French courts can rely on general rules addressing abuse of rights (*abus de droit*) to remedy oppression of a minority by a majority.[427] In practice, judicial intervention under the *abus de droit* doctrine has generally been limited to situations in which dominant shareholders have taken advantage of their position to extract an improper personal profit.[428] Outside directors who are merely careless in their oversight should therefore have little to fear.

Under French securities law, misleading corporate disclosure can also provide the foundation for litigation by shareholders against directors of public companies.[429] However, the Cour de Cassation, the highest French court in non-administrative matters, has held that that to sue a director directly, rather than only sue the company, a shareholder must show that loss resulted from an action or omission separable from functions performed as a director. Negligent oversight does not amount to "separable fault."[430] Thus, outside directors face little risk of being sued directly.

Procedural factors also sidetrack securities suits generally.[431] France's "loser pays" litigation rule, as is the case elsewhere, chills securities litigation.[432] The fact it is not feasible to bring U.S.-style class actions does likewise.[433] French shareholders also cannot offload onto counsel the

424. On the "loser pays" rule in France, see GOTANDA (1992), *supra* note 351, at 151–52 n.42 (discussing the costs arrangements in various European jurisdictions, including France).

425. CHARLES-HENRI DE PARDIEU & NATHALIE WEYD, CORPORATE ACQUISITIONS AND MERGERS IN FRANCE: A PRACTICAL GUIDE TO THE LEGAL, FINANCIAL AND ADMINISTRATIVE IMPLICATIONS 27 (1994); Patrick Peguet et al., *France*, *in* PROTECTION OF MINORITY SHAREHOLDERS, *supra* note 239, at 73, 80.

426. DE PARDIEU & WEYD (1994), *supra* note 425, at 27.

427. P. MEINHARDT, COMPANY LAW IN EUROPE F-13(i) (3d ed. 1981).

428. William Laurence Craig, *Application of the Trading With the Enemy Act to Foreign Corporations Owned by Americans: Reflections of* Fruehauf v. Massardy, 83 HARV. L. REV. 579, 582 (1970) ("Except for cases where the majority has used its position to obtain a personal profit, courts have generally been reluctant to impose their judgments as to the wisdom of corporate action directed by the majority.").

429. Olivier de Précigout, *France*, 4 INT'L COMPANY & COM. L. REV. 461, 465 (1993).

430. Jonathan Wohl & Franck Menand, *Barriers to Shareholder Suits in France Explained*, INT'L FIN. L. REV., Nov. 2004, at 43.

431. Fanto (1998), *supra* note 416, at 82.

432. Glater (2003), *supra* note 20, at 11.

433. *See* Fanto (1998), *supra* note 416, at 82–84.

financial risk of securities litigation. France permits a lawyer to charge an additional percentage of his hourly bill if the client wins but U.S.-style contingency agreements are prohibited.[434]

4. Indemnification and Insurance.—The dearth of shareholder litigation in France has affected the legislative treatment of the shields directors of French public companies potentially have from liability. There are no provisions under French corporate law governing D&O insurance or indemnification for adverse judgments, settlements, or legal expenses.[435] The likely explanation is that the issue has not been pressing since suits against directors have been so rare.[436]

While indemnification is not expressly regulated by French corporate legislation, the received wisdom in France is that a company can indemnify its directors unless the liability is criminal in nature or arises from duties owed to the company itself.[437] Similarly, despite lack of explicit statutory authorization, D&O insurance is available that covers most civil sanctions, except those involving fraud or intentional misbehavior.[438] In the past, many French companies did not bother to purchase coverage, but with fear of liability on the rise D&O insurance is becoming standard for French public companies.[439]

5. Insolvency.—Statutory amendments taking effect as of 2006 reformed considerably the insolvency procedures governing French companies.[440] The circumstances under which directors of insolvent companies can be sanctioned were altered somewhat, but the liability regime was not changed fundamentally.[441] As a result, the experience under the prior regime should be a reliable guide on risks going forward.

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434. Mathias Reimann, *Liability for Defective Products at the Beginning of the 21st Century: Emergence of a Worldwide Standard?*, 51 AM. J. COMP. L. 751, 823 (2003); Bob Calandra, *Shareholder Activism Around the World*, RISK & INS., Sept. 1, 2001, at 22.

435. Fanto (1998), *supra* note 416, at 83. A March 2006 search of the English translation of the Commercial Code, available at http://195.83.177.9/code/liste.phtml?lang=uk&c=32, found no hits using "insurance" and "indemnification" as the search terms.

436. *See* Fanto (1998), *supra* note 416, at 83 (noting that "directors ha[ve] little need for protection against lawsuits and large judgment awards").

437. Jacques Burhart & Anne Grimonet, *Corporate Governance and Directors' Duties: France*, in CORPORATE GOVERNANCE AND DIRECTORS' DUTIES 2006, at Q16 (2006).

438. Fanto (1998), *supra* note 416, at 83; Paul J. Omar, *The Criminal Liability of Company Managers in France*, 12 INT'L COMPANY & COM. L. REV. 101, 103 (2001).

439. Kelly Capell, *Europe's Old Ways Die Fast*, BUS. WEEK, May 17, 2004, at 54 (referring in particular to a lawsuit launched by a shareholders' association against former Vivendi chief executive Jean-Marie Messier in a New York court); telephone interviews with Anker Sørensen, Partner, Medus Devaux & Sorensen, Paris, France (July 18, 2005; Feb. 28, 2006).

440. Omar (2005), *supra* note 15, at 490 (discussing Law 2005-845 of July 26, 2005 on the Preservation of Enterprises) (English translation by Paul Omar on file with the authors).

441. *Id.* at 498.

Prior to the 2006 reforms, an SA that ceased to pay its debts had 15 days to make a formal declaration of insolvency or seek a judicial reorganization and the directors of a company that failed to do either could be held personally liable for the company's debts.[442] A court presiding over a liquidation or judicial reorganization of an insolvent company could also rule that directors who had engaged in *faute de gestion* ("management fault") be held liable for unpaid corporate debts, assuming there was a causal link between such misconduct and the insufficiency of the assets.[443]

Despite theoretical liability, the risks, in practice, were small for outside directors of French public companies. Liquidations of public companies were rare, so there were few instances where a liquidator was in a position to launch proceedings.[444] When a public company was liquidated, due to the attendant publicity, a liquidator might well have felt under an onus to investigate potential claims against the directors.[445] Counterbalancing this, however, would have been concerns about expense, delay and the limited assets to be recovered if the suit succeeded.[446] In the unlikely event of a suit by the liquidator against the outside directors, they could probably rely on D&O insurance for reimbursement.[447] This combination of factors likely explains why, in French financial circles, fears of director liability in the insolvency context relate primarily to a 1986 court decision, subsequently upheld on appeal, rather than to more recent events.[448] In this case, directors acting on behalf of the company owning a majority interest in failed electronics retailer Nasa Electronique were among the defendants in a case where damages of more than 400 million French francs (approximately $60

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442. ANKER SORENSEN & PAUL J. OMAR, CORPORATE RESCUE PROCEDURES IN FRANCE 223–24 (1996).

443. JEAN-PIERRE LE GALL & PAUL MOREL, FRENCH COMPANY LAW 293 (2d ed. 1992); EUROPEAN PRIVATE EQUITY & VENTURE CAPITAL ASS'N, BANKRUPTCY AND INSOLVENCY 54 (S.J. Berwin ed., 2002), *available at* http://www.evca.com/images/attachments/tmpl_9_art_38_att_848.pdf; Anker Sorenson, *Casting the Net Wide: The Liability of Company Officers in French Insolvency Procedures*, 7 INT'L COMPANY & COM. L. REV. 17, 18 (1996).

444. Telephone interviews with Anker Sorensen, *supra* note 439. François-Xavier Lucas and Andrew West claim that under French insolvency law "(w)here a director of a public company acts passively, this is often sufficient to hold the director liable for a contribution to company debt." François-Xavier Lucas & Andrew West, *France*, *in* DIRECTORS' DUTIES AND LIABILITIES 36, 46 (Paul J. Omar ed., 2000). They only cite, however, a single case in support of this proposition—Cassation commerciale, 31 janvier 1995, JCP G 1995, 3865—and it is unlikely that the case involved a public company since the company in question failed to hold any shareholder meetings between 1982 and 1984. *Id.* at 46 n.42.

445. Telephone interview with Anker Sorensen, *supra* note 439.

446. *See supra* notes 184–185 and accompanying text (discussing the situation in the U.K.).

447. Telephone interview with Anker Sorensen, *supra* note 439.

448. Charles Fleming, *Deals & Deal Makers: Venture Firms in Europe Fear Liability Suits*, WALL ST. J., Jan. 16, 2001, at C15. On the rulings on appeal, see Affaire Nasa Electronique (Cour d'Appel de Paris, 18 juin 1991) (Cour de Cassation Chambre de Commercialle, 3 janvier 1995). For the 1995 judgment and other background on the collapse of Nasa Electronique, see http://www.boursilex.com/VIE%20DES%20AFFAIRES/nasa_electronique.htm (in French).

million) were awarded.[449] It is unclear from the case reports whether any of the directors named as defendants were outside directors or whether they paid any damages personally.

The reforms introduced in 2006 law relax the legal requirements somewhat on directors by lengthening to 45 days the period within which a company that is not paying its debts must declare insolvency or seek a judicial reorganization.[450] The power to hold directors liable for unpaid corporate debts in the event of mismanagement remains essentially unaltered, as do the practical factors relating to suits by liquidators.[451] The 2006 amendments to French insolvency law thus are unlikely to affect materially the risks outside directors of French companies face.

B. Japan

1. The General Context.—Boards of large Japanese companies were traditionally composed entirely of full-time or part-time executives.[452] The monitoring function attributed to outside directors in other countries was instead vested with statutory auditors (*shagai-kansayaku*) selected by the shareholders.[453] Over the past decade, however, outside directors have become more common in Japanese boardrooms.[454] For instance, as of 2004, 630 of Japan's 2100 public companies had at least one non-executive director, a 28% increase from 2003.[455]

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449. The directors were appointed by the majority shareholder under C. COM. art. L225-20, which permits a company to be named as a director but requires the company to appoint a "personal representative" to act on the company's behalf.

450. C. COM. arts. L631–4, L640–4 (as amended by Law 2005-845 of July 26, 2005 on the Preservation of Enterprises) (English translation by Paul Omar on file with the authors). The 2006 reforms extend the time available to directors in another way. Directors of a financially troubled company are entitled to postpone seeking liquidation so long as a process known as "conciliation" has been launched under which a court-appointed conciliator is supervising efforts among interested parties to negotiate a compromise. The 45 day clock cannot start to run so long as the conciliation process is underway. The process cannot extend beyond four months and will be deemed to have failed if the conciliator reports to the court that the company has ceased to pay its debts as they fall due. *See* C. COM. arts. L611–6, L631–4, L640–4.

451. C. COM. arts. L651–2.

452. *See* JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 85 (1994); Yoshiro Miwa, *The Economics of Corporate Governance in Japan*, *in* COMPARATIVE CORPORATE GOVERNANCE, *supra* note 197, at 877, 882.

453. SHŌHŌ (COMMERCIAL CODE), arts. 260-3, 273–275. The SEC recognized the monitoring function statutory auditors play by exempting Japanese companies from requirements in the Sarbanes-Oxley Act of 2002 concerning the composition of audit committees. *See* SEC General Rules and Regulations under the Securities Exchange Act of 1934, 17 C.F.R. § 240.10A-3 (2005).

454. *See* Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2117 (2001) (noting that just two years after Sony "undertook significant board reform," including appointing outside directors, about 200 other firms adopted similar reforms).

455. CHARKHAM (2005), *supra* note 16, at 132. In only 30 of the companies did outside directors form a majority.

2. *Suits by the Company (including Derivative Suits).*—The Commercial Code is the primary source of company law in Japan.[456] In tandem with the Civil Code, it obliges directors to manage company affairs with the care of a good manager.[457] This has been interpreted to require directors to use the care, skill, and diligence of a reasonably prudent person acting in the capacity of director.[458] The Commercial Code also stipulates that directors must supervise the performance of directors appointed to represent the company in transactions with third parties ("representative directors").[459] Moreover, the Commercial Code provides that directors who authorize improper dividends, approve a loan by the company to fellow directors, or breach the corporate constitution can be held liable to the company for losses suffered.[460] Shareholders generally can only waive director liability unanimously, a practical impossibility in a publicly quoted company.[461] On the other hand, directors have benefited from general deference by Japanese judges, including a business judgment rule resembling its U.S counterpart.[462]

Litigation alleging a breach of duty by directors traditionally was rare in Japan. As is the case elsewhere, Japanese boards generally refrain from suing their own members, with the trend likely being reinforced because outside directors have been uncommon. The Japanese Commercial Code has included a derivative suit mechanism since 1950, but the mechanism

456. ODA (1999), *supra* note 403, at 216.

457. SHŌHŌ, art. 254, ¶3; art. 254-3; MINPŌ (CIVIL CODE), art. 644. For background, see Janis Sarra & Masafumi Nakahigashi, *Balancing Social and Corporate Culture in the Global Economy: The Evolution of Japanese Corporate Structure and Norms*, 24 LAW & POL'Y 299, 344, n. 38 (2002). In 2005, the Diet (Japan's Parliament) passed a new Corporation Law designed to bring all relevant provisions within a single piece of legislation and to use a modern drafting style. *See* Hiroki Kodate & Norifumi Takeuchi, *Japan*, INT'L FIN. L. REV., (SPECIAL SUPPLEMENT: 2005 GUIDE TO CORPORATE GOVERNANCE) at 51, 53 (2005). Our analysis of Japan nevertheless focuses on rules in the Commercial Code and the Civil Code since at the time of writing the new law was not yet in force and there was no English translation available. The new Act will change the rules on director liability but should not affect materially the liability risk of outside directors (e-mail correspondence with Prof. Hideki Kanda, Feb. 13, 15, 2006, on file with the authors).

458. Ichiro Kawamoto, Masao Kishida, Akira Morita, Yasuhiro Kawaguchi & Yoshiko Iga, *Japan*, *in* INTERNATIONAL ENCYCLOPAEDIA OF LAWS: CORPORATIONS AND PARTNERSHIPS 174 (R. Blanpain & K. Geens eds., 2001).

459. SHŌHŌ, art. 260, para. 1 (setting out the duty to supervise); art. 261, para. 1 (obliging directors to select representative directors). For background, see Kawamoto et al., (2001) *supra* note 458, at 169–71, 176.

460. SHŌHŌ, art. 266, para. 1.

461. SHŌHŌ, art. 266, para. 5.

462. Kenji Utsumi, *The Business Judgment Rule and Shareholder Derivative Suits in Japan: A Comparison with Those in the United States*, 14 N.Y. INT'L L. REV. 129, 160–61 (2001); Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 357 (2002) ("Japanese courts, usually composed of career judges with no business experience, are especially reluctant to second-guess the business judgment of directors.").

remained largely unused until the 1990s.[463] When Japanese directors breached their corporate law duties they were, at most, forced to resign.[464]

Legislative amendments in 1993 changed matters considerably. In Japan, a plaintiff launching a suit has to pay to the court a percentage of the recovery sought and, in the event of losing, must reimburse certain expenses the winning party has incurred, though not legal bills.[465] Filing fees calculated on the basis of the size of the recovery sought posed a serious hurdle to derivative litigation because most damage claims were very large.[466] The 1993 amendments deemed derivative claims to be non-monetary, thus cutting dramatically filing fees.[467] The law was also changed to permit the U.S.-style recovery of attorneys' fees in successful cases.[468] These reforms dramatically increased the number of suits, which soared to from an average of one every two years to nearly 50 per year.[469] The experience in Japan confirms the importance of procedural rules, especially attorney fee rules, in determining whether derivative suits are likely to become a common occurrence.

The increase in derivative litigation probably did not increase the risks to directors as much as the number of suits implies. Unless the misconduct involved is criminal in nature, plaintiffs bringing derivative suits rarely win in court and even settlements are uncommon.[470] Nevertheless, two major suits generated sufficient concern to prompt legislative change in a pattern of political reaction to director risk we have seen in other countries (e.g. the 2004 reforms to U.K. companies legislation as a result of the Equitable Life litigation and the 2001 "liability chill" amendments to the Canada Business Corporations Act).

The first of the two derivative lawsuits was a 2000 trial court ruling ordering eleven inside directors of Daiwa Bank to pay the bank $775 million in damages for failing to oversee properly a New York-based trader who had run up huge losses.[471] This was by far the largest damages award in Japanese

463. Shiro Kawashima & Susumu Sakurai, *Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms*, 33 STAN. J. INT'L L. 9, 14–15, 17–18 (1997).

464. Hiroshi Oda, *The "Americanisation" of Japanese Corporate Law? American Freedom, Japanese Discipline*, 69 RABELSZ BD. 47, 78 (2005).

465. Kawashima & Sakurai (1997), *supra* note 463, at 19–20.

466. *Id.* at 19–20; Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U. L. REV. 1436, 1463 (1994).

467. SHŌHŌ, art. 267, para. 5; Kawashima & Sakurai (1997), *supra* note 463, at 20.

468. SHŌHŌ, art. 268-2, para. 1; West (2002), *supra* note 462, at 355.

469. West (2002), *supra* note 462, at 351–52, 378 (286 suits brought between 1993 and 1999, compared with fewer than twenty between 1950 and 1990).

470. *Id.* at 357–58, 361–62 (examining the outcomes of 73 derivative suits filed between 1993 and 1999 and finding that of the 32 that had been concluded only two cases resulted in outright victory for the plaintiffs while 10 had settled).

471. Nishimura v. Abekawa (Daiwa Bank Case), 199 SHIRYŌBAN SHŌJI HŌMU 248 (Osaka D. Ct., Sept. 20, 2000). For summaries of this case in English, see Milhaupt (2001), *supra* note 454, at 2115–16; Bruce E. Aronson, *Reconsidering the Importance of Law in Japanese Corporate*

corporate history, though pending an appeal a settlement was reached under which the plaintiffs accepted approximately $2 million in return for preservation of the trial court's finding on liability.[472] The Daiwa Bank case elicited a strong reaction, including critical editorials, increased seeking of legal advice, and discussion of legal reform.[473] The second derivative lawsuit, a 2001 settlement involving Sumitomo Corp., reinforced concerns about director liability. Five of the company's former executive directors agreed to pay half their total retirement benefits ($3.58 million) to resolve a duty of care suit following massive copper trading losses.[474]

In 2001, the Japanese government responded to business lobbying by giving companies the option to cap director liability.[475] A company can now amend its charter to limit damages to six years' pay for representative directors, four years' worth for other executive directors, and two years' compensation for non-executive directors.[476] The cap only protects directors if they have acted in good faith, were not grossly negligent and did not breach statutory provisions regulating the payment of unlawful dividends, loans to directors and certain other specified transactions.[477] Also, companies who adopt such provisions must reveal the total compensation paid to their directors, disclosure of which is not otherwise required.[478] Perhaps due to these limitations, only a small minority of Japanese public companies adopted liability caps when they were first given the option to do so.[479]

If concerns about director liability intensify in Japan, widespread adoption of caps could yet occur since, at least in the case of outside directors, a cap could be a significant deterrent to lawsuits. Two years' worth of fees for an outside director in a large Japanese company will be approximately US$80,000 to $100,000.[480] This should be low enough to

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Governance: Evidence from the Daiwa Bank Shareholder Derivative Case, 36 CORNELL INT'L L.J. 11, 26–33 (2003).

472. Aronson (2003), *supra* note 11, at 226–27.

473. Aronson (2003), *supra* note 471 at 47; West (2002), *supra* note 462, at 352.

474. *Former Sumitomo Corporate Executives To Pay 430 Million Yen in Damages*, JAPAN WKLY. MONITOR, Mar. 19, 2001.

475. Oda (2005), *supra* note 464, at 79, 81 (noting, though, that proposals to cap liability were first made in 1997); Luke Nottage, *Japanese Corporate Governance at a Crossroads: Variation in "Varieties of Capitalism"?*, 27 N.C. J. INT'L L. & COM. REG. 255, 275 (2001) (noting the lobbying of business interests for these changes).

476. SHŌHŌ, art. 266, ¶¶ 12–19. For companies without such a provision in the charter, the shareholders can adopt a liability cap on a case-by-case basis by a two-thirds majority vote. *Id.* art. 266, para. 7, art. 343.

477. SHŌHŌ, art. 266, para. 12; Oda (2005), *supra* note 464, at 80.

478. Nagashima Ohno & Tsunematsu, *Corporate Governance Amendments Introduced*, 21 INT'L FIN. L. REV. 70, 70 (2002).

479. As of the end of 2002, approximately 150 companies had adopted liability caps. *Firms Move to Limit Damage from Lawsuit*, NIKKEI WKLY., Jan. 13, 2003.

480. E-mail from Hideki Kanda, Professor of Law, University of Tokyo (Sept. 8, 2004) (on file with author).

ensure that most plaintiffs will not bother to name outside directors as defendants in lawsuits falling within a liability cap's purview.[481]

3. Direct Shareholder Suits.— The Commercial Code stipulates that directors who have performed their duties in bad faith or with gross negligence can be liable to third parties, with obvious candidates being creditors and shareholders.[482] Lawsuits of this sort are in fact brought principally by creditors and litigation involving closely held Japanese companies is common.[483] However, no director of a large Japanese company has ever been held liable under the relevant provision.[484]

Japanese securities legislation theoretically provides a foundation for suits by shareholders against directors. By virtue of reforms carried out in the aftermath of World War II, Japan's securities laws are similar to those in the United States.[485] Hence, subject to a due diligence defense, directors can be held liable for damages suffered by investors if prospectuses for public offerings or the periodic securities reports that public companies must file are false or misleading.[486] Despite this, securities litigation is almost unheard of in Japan.[487] Restrictive rules governing class actions, the illegality of contingency fees, and the requirement that plaintiffs pay a filing fee based on damages claimed all likely deter lawsuits.[488]

*4. Indemnification and Insurance.—*The Japanese Commercial Code does not explicitly address indemnification and D&O insurance. The infrequency of suits against directors, at least until the rise of the derivative suit in the 1990s, probably explains why.[489] The power of companies to indemnify directors remains uncertain. However, the absence of a statutory foundation has not prevented the rise of D&O coverage. Until 1990, insurers

481. *Cf.* Oda (2005), *supra* note 464, at 81 (saying "the ceiling introduced by the (liability cap) is sufficiently high as a deterrent to wrongdoings by directors"). This might be true with representative directors, for whom compensation is higher and the cap is six years compensation. This analysis does not seem correct, however, for outside directors.

482. SHŌHŌ, art. 266-3, para. 1.

483. On the likely parties to such a lawsuit, see ODA (1999), *supra* note 403, at 251; (noting that over 90% of cases are brought by creditors). A 1969 judgment of the Japanese Supreme Court made it clear that the relevant provision was designed primarily to protect those transacting with proprietors of small companies. *See* Kawamoto et al. (2001), *supra* note 458, at 179.

484. KRAAKMAN ET AL. (2004), *supra* note 9, at 90.

485. R. Daniel Kelemen & Eric C. Sibbitt, *The Americanization of Japanese Law*, 23 U. PA. J. INT'L ECON. L. 269, 303–04 (2002).

486. SHŌHŌ, art. 266-3, para. 2; ODA (1999), *supra* note 403, at 282–83.

487. Kelemen & Sibbitt (2002), *supra* note 485, at 306.

488. On class action suits under Japanese law, see ODA (1999), *supra* note 403, at 394, 397. On the impact of the prohibition of contingency fees and of high filing fees, see Jon Choy, *Japan's Legal System on the Stand*, 35 JEI REP. 1 (2000).

489. *See* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 34 (1996).

did not market the product at all in Japan.[490] By the end of the 1990s, things had changed: 70% to 80% of listed companies had policies. Coverage was initially for fairly small amounts ($1 million to $5 million), but higher limits became commonplace after the Daiwa Bank decision.[491]

5. Insolvency—In contrast with various other countries we have considered, corporate insolvency does not give rise to additional liabilities for Japanese directors.[492] The fact a bankruptcy administrator, rather than the board of directors, will make decisions on whether to pursue litigation against the directors increases somewhat the chances a company will launch a suit against its directors.[493] As we have seen with other countries, however, the time-consuming nature of litigation and uncertainties as to whether there will be a meaningful recovery constitute significant deterrents to lawsuits of this sort.

VIII. Outside Directors and Out-of-Pocket Liability: Risks and Responses

A. Civil Liability: The General Pattern

Having surveyed the law and practice in six countries, it is appropriate to draw things together by identifying general patterns and highlighting areas of risk for outside directors of public companies. Those serving as directors are confronted with various legal rules that seemingly pose a threat. In each county considered here, outside directors owe duties of care and skill, the breach of which entitles the company to claim for damages. These duties are generally supplemented by statutory rules that impose liability on directors who approve improper dividends or other specified prohibited transactions. Moreover, directors face at least a theoretical possibility of being held liable in direct lawsuits brought by aggrieved minority shareholders. A cause of action for misleading securities disclosure is available in all jurisdictions. Finally, in a number of the countries considered here, additional duties arise for directors with the onset of insolvency.

While outside directors are confronted with numerous potential sources of liability, in the six countries we have considered, the risks are not substantial in practice. Procedural factors do much to deter litigation. One

490. Kelemen & Sibbitt (2002), *supra* note 485, at 306–07; *see also* Ansell (1995), *supra* note 273, at 167–68 (suggesting that the market began to develop after the Ministry of Finance announced in 1990 that companies could purchase D&O insurance).

491. Aronson (2003), *supra* note 471, at 46–47 (noting that insurers had some difficulty supplying the extra coverage sought); Sarra & Nakahigashi (2002), *supra* note 457, at 329.

492. John I. Gordon, *Insolvency, Restructuring and Bankruptcy of a Global Company: An Issues Checklist from an Asia-Pacific Perspective*, METROPOLITAN CORP. COUNS., Dec. 2001, at 15.

493. HASAN HŌ [Bankruptcy Law], Law No. 71 of 1922, art. 162, *translated in* BUTTERWORTHS INTERNATIONAL INSOLVENCY LAWS 529 (Philip Wood and Peter G. Totty eds., 1994).

crucial factor is that, in contrast with the United States, each of the countries surveyed here has some form of the "loser pays" rule. A "costs follow the event" regime serves generally to deter speculative litigation but outside directors particularly benefit. A plaintiff may believe that naming directors as defendants will lead a company to take a lawsuit more seriously and increase the likelihood of a settlement.[494] Nevertheless, plaintiffs will generally shy away from taking a large number of defendants to trial and focus instead on those more likely to be culpable and having deep pockets—most commonly, the company, its executives, and, depending on the facts, its auditors and investment bankers.

A second procedural factor that deters litigation is that, with duties directors owe to the company, the board generally determines whether proceedings should be launched. Directors will rarely give the green light. The key exceptions are insolvency (discussed below) and a change of the guard scenario akin to that occurring with Equitable Life.[495] Derivative suits are, in some form, theoretically available in each country we studied, but in most, a combination of loser pays rules, lack of any scope for lawyers to claim attorneys' fees, and the company's right of recovery make shareholders reluctant to step forward. Japan is an exception to the pattern; derivative litigation is common. The growth in derivative suits after Japan cut filing fees and permitted the recovery of U.S.-style attorneys' fees highlights the impact of the various constraints on derivative litigation existing in the other countries we have considered.

Difficulties in organizing multi-party litigation are a third procedural factor that deters litigation against outside directors in the countries we surveyed. None of the countries we considered has a well-established class action procedure akin to that in the United States. The scope for grouping individual claims ranges from essentially nil in France, Germany, and Japan to uncertain in Australia, Britain, and Canada. This, together with loser pays rules and bans on U.S.-style contingency fees, have done much to deter securities litigation based on misleading disclosure against anyone, including outside directors.

Practical considerations similarly limit outside directors' risk in the event of corporate bankruptcy. In theory, bankruptcy can pose considerable legal dangers. New causes of action can arise, decisions about whether the company will sue become vested in the hands of the liquidator, the company is no longer available to indemnify directors or to pay damages in a suit in which it would otherwise be named as a co-defendant with its directors, and the company's financial failure may generate facts suggesting serious boardroom deficiencies. Nevertheless, in the countries we studied the only confirmed instances where outside directors of a bankrupt public company

494. HANSELL (2003), *supra* note 383, at 157.

495. On Equitable Life, see s*upra* notes 85–86 and accompanying text.

paid out of their own pockets without a government regulator taking a lead role in the lawsuit involved two "Perfect Storms" affecting cross-listed companies (one from the U.K., one from Canada) facing U.S. securities lawsuits.

The procedural hurdles discussed above, coupled with logistical constraints affecting liquidators, do much to explain our findings. A company's liquidator will generally want to act promptly to draw together the assets and distribute the proceeds to accommodate unpaid creditors. Litigation involving the duties and responsibilities of directors of public companies will probably be drawn out and complex and, due to loser pays rules, creates the risk of expending funds to pay both sides' legal fees under an adverse costs order. Non-executive directors will often have enjoyed a successful business career, but only a small minority are likely to be sufficiently wealthy to justify postponing a liquidation to await the outcome of legal proceedings. The experience in Australia illustrates this. Outside directors facing out-of-pocket liability due to their inattentiveness have ended up bankrupt (Water Wheel), striking a deal to pay only a tiny fraction of the amount due (One.Tel), or continuing to work to pay off a modest judgment structured to be affordable over time (Clifford Corporation).[496]

While various procedural and practical factors generally protect outside directors, concerns about liability risk have been rising lately in the countries studied here. Counter-reactions to such concerns have in turn generated new protections for directors. Legislative reform is one response. In the countries we have studied, there have been numerous examples of provisions introduced to contain director risk, including the introduction of caps on directors' liability under Japanese corporate law and Ontario securities legislation, the creation of a statutory business judgment rule in Germany (though coupled with adoption of a new derivative suit procedure), the expansion of permissible indemnification under UK company law, and the amendment of the CBCA to introduce a statutory "due diligence" defense for specified transactions, proportionate liability for directors, and liberalized indemnification rules.

There has also been a market response to concerns about director liability, namely the rise of D&O insurance. The barriers to litigation in the countries considered here have traditionally been high enough to mute demand for coverage. Nevertheless, events such as the Equitable Life litigation in the U.K., the Daiwa Bank and Sumitomo cases in Japan, and the growth of cross-listings on U.S. stock markets are prompting companies to purchase D&O insurance and to put in place policy limits high enough to cover not only directors' legal expenses but also substantial settlements.

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496. In contrast, Rodney Adler, the HIH outside directors held liable for self-dealing, was able to afford a A$6.5 million house after paying $9 million in civil penalties. *See* Peter Trute, *Long Fall from the Top*, HERALD SUN (Melbourne), Apr. 15, 2005, at 37.

The expansion in D&O coverage could encourage litigation against directors by offering a deep pocket for plaintiffs to aim at. Overall, however, the increased prevalence of D&O coverage should reduce the already small risk of an out-of-pocket payment. Plaintiffs who are motivated to sue due to the presence of D&O insurance will likely focus on recovering from the policy, and will usually settle promptly within the policy limits rather than enduring the delay, expense, and risk involved with going to trial to try to secure a damages award that exceeds available coverage. Thus, even if the growing popularity of D&O insurance increases the number of lawsuits, outside directors' risk of paying out-of-pocket should remain small

B. Litigation Intended to "Send a Message"

While a combination of factors does much to insulate outside directors of public companies from both the risk of being sued and the risk of personal liability if they are sued, the risks are not zero. Instead, this Article has identified a number of instances in which non-executives have had to pay financial compensation and legal expenses out of their own pocket as a result of civil litigation. Self-dealing by outside directors is uncommon, but as two of the Australian out-of-pocket payments we found illustrate, such misconduct poses clear legal risks. The remaining out-of-pocket cases we found—other than the two cases involving companies cross-listed in the U.S.—can be explained largely by reference to what we earlier called the "send a message" scenario. In this situation, the party in control of a lawsuit, often a regulator, is not motivated solely by the costs and benefits of recovery in the immediate case but instead seeks to "send a message" to the directors involved in the case and likely company directors more broadly.

To gain a sense of the risks the "send a message" scenario poses, it is important to distinguish between suits by private parties and by public officials. Typically, private litigants will only be concerned with maximizing their recovery, with due allowance for time and risk, and will be indifferent to the source of payment. Nevertheless, there can be plaintiffs who are willing to pursue out-of-pocket payments by directors so as to make a point. For instance, some U.S. institutional shareholders investing on behalf of public sector employees and public entities reportedly have begun to regard their role as similar to regulators, willing to inflict sanctions on defendants even if this does not maximize the present value of the recovery.[497] The "send a message" rhetoric adopted in the securities lawsuits involving WorldCom and, to a lesser extent, Enron implies that a "send a message" agenda played a role in the extraction of out-of-pocket payments in these two cases.

497. Dave Lenckus, *D&O Settlements Get Personal*, BUS. INS., Jan. 10, 2005, at 1 (quoting William Passannante, a New York lawyer).

Still, despite the outcomes in WorldCom and Enron, publicly-minded U.S. institutional shareholders are unlikely to find many instances in which they can feasibly pursue out-of-pocket payments from outside directors. As we describe in Part III and argue at greater length in our work on the liability of U.S. outside directors, adopting this stance without conditions approaching a Perfect Storm could mean a lead plaintiff or lead counsel will breach fiduciary duties owed to the class. Hence, while send-a-message risk gives U.S. directors something new to fear, well-insured directors should still feel comfortable that their personal assets will rarely be placed at risk.[498]

Among the other countries being considered in this Article, the Equitable Life saga in the U.K. is the only instance in which a private litigant's desire to "send a message" has thus far put outside directors at risk. After Equitable Life's near collapse yielded a boardroom shakeup, the new directors reportedly did consider the cost-effectiveness of litigation and may have only decided to go ahead because one of the former non-executives had a personal fortune of over £300 million.[499] Nevertheless, their motives for suing the non-executives – including those lacking similar financial wherewithal—extended beyond the purely financial, and, as matters turned out, counter-productively so.

The new directors, when they took control of Equitable Life, were determined to take firm action against those allegedly responsible for the original crisis.[500] The defendant ex-directors complained bitterly about the results, labeling the suit against them as a "PR exercise" and alleging that Equitable had "compromised its integrity with its 'win at any price, litigate at any cost' pursuit of the claims."[501] Equitable Life did drop its claim against the ex-directors mid-trial, but only after it was clear its case was going very badly.[502] Doubts were expressed in the business press about the common sense of Equitable Life pursuing the case as far as it did, with some commentators arguing the insurer was motivated partially by revenge and vindictiveness.[503] Certainly, the non-executive directors felt aggrieved, despite ultimately not ending up out-of-pocket. As one complained, "[y]ou can lose four years of your life, not be found guilty and still have absolutely

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498. *Outside Director Liability*, *supra* note 1, at 1127–28.

499. Andrew Bolger, *Equitable Directors Insured for Only £5m*, FIN. TIMES, May 3, 2002, at 6. As of 2005, the personal wealth of David Wilson, the ex-director in question, was estimated at £430 million. Nikki Tait, *Two More Former Directors Reach Settlement with Equitable Life*, FIN. TIMES, Oct. 11, 2005, at 3.

500. Edward Fennell, *Lawyers Line up for Battle as Equitable Life Looks for Redress*, TIMES (London), May 14, 2002, Features Section, at 3.

501. Tessa Thorniley, *Ex-Directors Hit Back at Equitable*, TELEGRAPH, Sept. 25, 2003, at 31; Robert Watts, *Equitable Life's Action is "Flawed and Vindictive*,*"* TELEGRAPH, Oct. 19, 2003, at 2.

502. Ruth Sunderland, *Equitable Ready to Throw in the Towel Over "Disastrous" Dispute*, DAILY MAIL (U.K.), Nov. 4, 2005, at 88; Tait & Felsted (2005), *supra* note 55, at 21.

503. Martin Dickson, *Equitable Life*, FIN. TIMES, Oct. 18, 2003, at M2; Alison Smith, *Equitable Life Bows Out of Long-Running Lawsuit*, FIN. TIMES, Sept. 23, 2005, at 22; Patience Wheatcroft, *Investors Foot Bill of Costly Climbdown*, TIMES (London), Sept. 23, 2005, at 49.

no redress."[504] The outcome provides a counterpoint to Enron and WorldCom, suggesting send-a-message suits are no sure thing and can pose real risks to the reputations of the plaintiffs as well as the defendants.

While private litigants can potentially make it a priority that directors take a financial hit, our cross-country evidence suggests that government regulators are the greater threat. If a public company collapses amidst widely publicized allegations of dishonesty and mismanagement, regulators risk being criticized for being soft on corporate wrongdoing if they fail to act. A potentially potent way to "do something" and "send a message" is to launch proceedings against the directors involved.

Regulators are aware of resource constraints and the costs of legal proceedings.[505] Nevertheless, if a lawsuit against outside directors has sufficient symbolic value, they may go ahead even with a complex and challenging case. Moreover, in the event of a settlement or a damages award at trial, a regulator will be inclined to ensure that the directors pay what they can plausibly afford to, even if significant enforcement costs have to be incurred.[506] Also, if directors have D&O insurance that offers coverage for liability arising from government enforcement, a regulator concerned with symbolism may seek to force outside directors to make some form of personal contribution.

A 2004 settlement the U.S. Department of Labor (DoL) reached with former outside directors of Enron in ERISA litigation illustrates the send-a-message scenario in the U.S. DoL alleged in the lawsuit it brought that the company's ex-directors were ERISA fiduciaries and had breached duties they owed by failing to appoint trustees for two employee pension plans that held Enron shares and suffered $1.5 billion in losses when the company collapsed.[507] Enron's outside directors paid a total of $1.5 million out-of-pocket to resolve the DoL lawsuit, which would have provided only a tiny return to individual Enron employees.[508] Class action litigation launched on behalf of Enron employees had already extracted the directors' $85 million in

504. Seib, *Equitable* (2005), *supra* note 56 (quoting Ms. Jennie Page, a former civil servant); *see also* Tait & Felsted (2005), *supra* note 55, at 21 (quoting Mr. Peter Sedgwick, another outside director, as saying he would "never take another non-executive job. . .(i)t is not worth the risk").

505. KEITH HAWKINS, LAW AS LAST RESORT: PROSECUTION DECISION-MAKING IN A REGULATORY AGENCY 318–24 (2000).

506. This occurred, for instance, with litigation involving the Northland Bank and the Canadian Commercial Bank. E-mail from Doug Wyatt, *supra* note 393. The ASIC litigation involving the Clifford Corporation, One.Tel and Water Wheel likely fell into the same category.

507. *See In re* Enron Corp. Sec., Derivative and "ERISA" Litig., 284 F. Supp. 2d 511 (S.D. Tex. 2003); Complaint for ERISA Violations, Chao v. Enron Corp., 2003 WL 22331359 (S.D. Tex. June 26, 2003).

508. There were approximately 20,000 eligible claimants, so they would have received on average only $75 per employee. On the number of claimants, see Mary Flood & David Kaplan, *The Fall of Enron*, HOUS. CHRON., May 13, 2004, Business, at 1.

insurance cover.[509] This implies the DoL suit was designed primarily to warn directors that their personal assets could be at risk if they fail to fulfill obligations as pension plan fiduciaries. Indeed, the DoL's declared rationale for the suit was to "strengthen the American workforce's confidence in their retirement savings."[510]

Various examples of send a message suits by public officials that have led to out-of-pocket payments by outside directors emerge from our cross-country survey. The settlements by outside directors of Canadian Commercial Bank and Northland Bank illustrate. A civil servant involved with these cases conceded the pursuit of the directors was "uneconomic" since the government's legal costs exceeded the likely recovery. He said, however, that governments sometimes act this way and also argued that they sometimes should.[511]

The manner in which the Australian Securities and Investments Commission has conducted itself over the past few years is also instructive. The ASIC was a somewhat faceless regulator when lawyer David Knott was named chairman in 2000.[512] Upon his appointment, Knott made much of the need for "credible and visible enforcement actions."[513] The ASIC then commenced "Project Icarus," the purpose of which was to target high-profile individuals in both civil and criminal actions.[514] ASIC officials acknowledged their intent to have an "education and market confidence impact."[515] Observers soon labeled Knott as "a very public sheriff"[516] with "a reputation for putting big heads on sticks."[517]

Under Knott's leadership, the ASIC ultimately was criticized for using a disproportionate amount of the regulator's budget chasing a few prominent individuals.[518] He resigned in 2003, prior to the expiration of his term.[519] Some of his rhetoric, however, survived his departure. For instance, following the 2004 court ruling in the Clifford Corporation case, an ASIC official stated: "Today's result sends a clear message to company directors

509. *See* Ellen E. Schultz, *Enron Employees to Settle Retirement Suit for $85 Million*, WALL ST. J., May 13, 2004, at A2; Flood & Kaplan (2004), *supra* note 508.

510. DEPARTMENT OF LABOR, U.S. LABOR DEPARTMENT SUES ENRON, EXECUTIVES AND PLAN OFFICIALS FOR FAILING TO PROTECT WORKERS (June 26, 2003), http://www.dol.gov/opa/media/press/ebsa/EBSA2003350.htm.

511. Email from Mark Jewett, *supra* note 393.

512. Hughes (2003), *supra* note 318.

513. *Id.*

514. Adele Ferguson, *Skewed Priorities*, BUS. REV. WKLY., Aug. 21, 2003, at 35.

515. BERNA COLLIER, CORPORATE GOVERNANCE SUMMIT 2002: THE ROLE OF ASIC IN CORPORATE GOVERNANCE 6 (Nov. 27, 2002), http://www.asic.gov.au/asic/asic.nsf/lkuppdf/ASIC+PDFW?opendocument&key=corporate_governance_summit _pdf.

516. Hughes (2003), *supra* note 318.

517. Anne Lampe, *Good Cop*, SYDNEY MORNING HERALD, Sept. 18, 2004, at 43.

518. *See* Ferguson (2003), *supra* note 514; Jean J. du Plessis, *Reverberations After the HIH and Other Recent Corporate Collapses: The Role of ASIC*, 15 AUSTL. J. CORP. L. 225, 242–43 (2003).

519. Ferguson (2003), *supra* note 514.

that they must act honestly, and ensure that the information they provide in financial records is true and correct."[520]

On the other hand, Knott's replacement, accountant Jeffrey Lucy, adopted a more low key approach than his predecessor. Upon taking up his appointment he said there would be more negotiated settlements and less throwing the book at transgressors. He later said that he would not pursue a policy of prosecuting high-profile individuals for the sake of making examples of them.[521] This pragmatic attitude seems likely to prevail, given that the ASIC lacks the resources to pursue more than a handful of civil penalty applications each year.[522] The regulatory strategy that has been creating out-of-pocket risks for outside directors of Australia's public companies thus could be a passing phase.

More generally, while send-a-message enforcement by regulators does pose risk for outside directors of public companies, liability should nevertheless remain a rarity. Some form of corporate financial crisis is probably a pre-condition; each of the out-of-pocket outside director payments prompted by regulator enforcement in Australia and Canada involved an insolvent company. Among bankrupt companies, due to the publicity motive underlying send-a-message litigation, outside directors of high-profile firms are at greater risk than non-executives of a smaller public company. Even with a widely publicized corporate meltdown, regulators may choose to bypass the outside directors and focus on more culpable and obvious targets, such as the executives. Finally, in those instances where regulators have the option of seeking an order disqualifying an outside director from serving as a director in the future, they may opt to send a message by relying on this remedy instead of seeking a direct financial sanction.

C. Criminal Prosecution

To the extent that public officials are seeking to "send a message" to those serving as outside directors of public companies, civil litigation is not the only option. Another possibility is a criminal prosecution, leading to a fine or perhaps even a jail term. A highly publicized German case illustrates.

In 2000 Mannesmann, a major German telecoms company, was taken over after a controversial bid by Vodafone. The Mannesmann supervisory board members then awarded nearly €60 million in bonuses to senior executives, essentially as a reward for a deal well done. Prosecutors

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520. Trevor Sykes, *17-Year Ban Over $90m Company Crash*, AUSTL. FIN. REV., Oct. 1, 2004, at 4 (quoting ASIC's executive director).

521. Lampe (2004), *supra* note 517; Geoffrey Newman, *ASIC's Prosecutions to Rise Without "Stars,"* AUSTRALIAN, Nov. 21, 2005, at 27. *But see* Cathy Bolt, *ASIC Chief Denies Soft Approach to Targets*, WEST AUSTRALIAN (Perth), Jan, 14, 2006, at 76 (quoting Lucy in an interview in which he rejected criticism the ASIC had been "too soft" on high-profile targets).

522. David Noakes, *Corporate Groups and the Duties of Directors: Protecting the Employee or the Insolvent Employer?*, 29 AUSTL. BUS. L. REV. 124, 139–40 (2001).

subsequently charged two members of the Mannesmann supervisory board, Josef Ackermann, the chief executive of Deutsche Bank, and Klaus Zwickel, the head of a major German union, with breaching a provision in Germany's criminal code making it an offense for those managing property on behalf of another (i.e., Mannesmann) to fail to safeguard that property (by granting the bonuses).[523] The subtext was that compensation practices associated with freewheeling Anglo-American capitalism were not appropriate for a country with strong social democratic values.[524]

At trial, the charges against Ackermann and Zwickel were dismissed. The judge speculated that the defendants may have breached duties under German corporate law, but ruled that any breaches were not criminal in nature.[525] The prosecutors appealed successfully, with Germany's federal appeals court ordering a retrial on the basis that the trial court had incorrectly ruled the defendants' alleged misconduct was not grave enough to be criminal.[526] At the time of writing the new trial had yet to begin.

In each of the countries considered in this Article, criminal penalties can be imposed for various contraventions of corporate legislation and for infringements of a range of other statutes, including those governing health and safety and the protection of the environment. Correspondingly, outside directors could, in theory, face risks of paying out of their own pocket that our survey of civil liability has not captured. In fact, with the exception of prosecutions involving HIH, the failed Australian insurer, prosecutorial activity involving outside directors of public companies has been negligible. We provide a whirlwind summary of the situation in each country below.

1. United Kingdom—U.K. companies legislation precludes indemnification for fines, and D&O policies typically exclude coverage for criminal penalties.[527] As a result, any criminal fines imposed on an outside director of a U.K. public company likely will be paid by the director personally. With U.K. companies legislation alone creating some 250

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523. Tony Major, *Trial to Test German Reform*, FIN. TIMES, Sept. 20, 2003, at 8; Tony Major & Uta Harnischfeger, *German Newspapers Back Ackermann Trial*, FIN. TIMES, Sept. 24, 2003, at 32.

524. Allan Hall, *Defendants "Likely to be Let Off the Hook" in Mannesmann Trial*, EVENING STANDARD, July 21, 2004, at 35 (quoting a German business consultant who said that "[t]he trial was in many ways a politically motivated one, tacitly supported by Gerhard Schroeder [Germany's chancellor at the time] who wants to appear as the conservator of the German way to the unions").

525. Max Phillipp Rolshoven, *The Last Word? - The July 22, 2004 Acquittals in the Mannesmann Trial*, 5 GER. L.J. 935, 939 (2004).

526. Patrick Jenkins, *Mannesmann Affair Called Back to Court*, FIN. TIMES, Dec. 22, 2005, at 28; Mark Landler, *Top Banker to Be Retried in Germany*, N.Y. TIMES, Dec. 22, 2005, at C1.

527. On the law on indemnification, see *supra* note 156–158 and related discussion. On D&O insurance exclusions, see sources cited *supra* note 167. Even if a D&O policy ostensibly covered criminal fines, the coverage might be unenforceable under U.K. law as contrary to public policy. JESS (2001), *supra* note 167, at 235, 239.

offenses, there is certainly scope for punishment of this sort.[528] For instance, in 1978, Nicholas Redmayne, a non-executive of Scottish Universal Investments, a publicly traded industrial holding company, was fined £100 for failing to fulfill statutory requirements to disclose his dealings in the company's shares.[529]

Redmayne's conviction was an anomaly. Prosecutions are undertaken only under a small handful of sections of the Companies Act 1985,[530] and the infractions prosecuted are not of the type directors of a public company are likely to commit. For instance, the most common convictions are for failure to deliver annual accounts or to keep proper accounting records.[531] These issues should not be a problem for a public company, whose staff and professional advisers can ensure that the relevant documents are prepared and filed.

Moving beyond company law, outside directors again have little to fear. The experience with two high-profile regulatory regimes illustrates this. First, the U.K. has various statutes dealing with environmental issues that impose criminal liability on directors when a corporate infraction is attributable to director negligence.[532] There have been repeated warnings directors could become targets for prosecution under such laws.[533] Nevertheless, in practice convictions of directors are very rare, any fines imposed have been tiny, and prosecutions of non-executives are non-existent to our knowledge.[534]

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528. Companies Act, 1985, c. 6, § 730, sched. 24 (listing the offences punishable under the Companies Act); *see also* MARTHA BRUCE, RIGHTS AND DUTIES OF DIRECTORS 47, 284−303 (2000) (stating that the Companies Act 1985 "contains some 250 offences" and reprinting Schedule 24 as an appendix). In many instances, sanctions can be imposed on both a company and its directors. Under other circumstances, directors can commit an offense without reference to the company's position. For a detailed breakdown, see DEP'T OF TRADE & INDUS., CLASSIFICATION OF OFFENCES UNDER THE COMPANIES ACT 1985 AND ASSOCIATED LEGISLATION (2000), *available at* http://www.dti.gov.uk/cld/class_offences.pdf.

529. Ronald Faux, *Sir Hugh Fraser Fined a Total of £600*, TIMES (London), July 15, 1978, at 17 (discussing the verdict in the trial, including the fine imposed on Redmayne); *Sir Hugh Fraser and Others Accused*, TIMES (London), Nov. 19, 1977, at 17 (identifying Redmayne as a non-executive director and describing the charges against him). On the nature of the business conducted by Scottish and Universal Investments Limited, see MONOPOLIES AND MERGERS COMMISSION, LONHRO LIMITED AND SCOTTISH AND UNIVERSAL INVESTMENTS LIMITED AND HOUSE OF FRASER 21 (1979).

530. DEP'T OF TRADE & INDUS., COMPANIES IN 2003−04 45 (2004) (identifying only nine provisions in the Companies Act 1985 under which prosecutions were brought in 2003–04), *available at* http://www.dti.gov.uk/cld/dtiannualreport.pdf.

531. *Id.* at 45–46.

532. *See* STUART BELL & DONALD MCGILLIVRAY, BALL & BELL ON ENVIRONMENTAL LAW 252 (5th ed. 2000) (discussing, the Environmental Protection Act, 1990, c. 43, § 157, and the Water Resources Act, 1991, c. 57, § 331).

533. Brian Smith, *Directors' Environmental Liability in the United Kingdom*, 8 INT'L COMPANY & COM. L. REV. 275, 276 (1995).

534. On the number of convictions, see DAVID HUGHES, TIM JEWELL, JASON LOWTHER, NEIL PAPWORTH & PAULA DE PREZ, ENVIRONMENTAL LAW 512 (4th ed. 2002). On the size of fines, see

The situation is the same with workplace safety laws. A U.K. employer is required to provide employees with safe conditions at work and appropriate training for assigned tasks.[535] Directors who negligently breach these duties commit an offense.[536] Still, while numerous convictions are secured on an annual basis for breaches of health and safety legislation, only a tiny minority involve company directors.[537] Moreover, companies are advised to appoint from their board a director who will have responsibility for health and safety matters, and when this is done only that director is a serious candidate for prosecution.[538] A non-executive director is unlikely to be given such an assignment.

2. *Germany.*—German supervisory directors can be punished by administrative penalties, similar to fines, under a variety of laws.[539] For instance, various breaches of the German Stock Corporation Act are specifically punishable by administrative penalties.[540] Similarly, directors who approve financial statements that fail to conform with German accounting principles can be sanctioned by an administrative penalty under the German Commercial Code.[541] Reckless preparation of a prospectus supporting a public share offering likewise constitutes an administrative offense under German securities law,[542] as does a similar lapse in preparing

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BELL & MCGILLIVRAY (2000), *supra* note 532, at 245–46 (noting that the level of fines under U.K. environmental legislation had been "notoriously low").

535. Health and Safety at Work Act, 1974, c. 37, § 2(1)–(2). This general duty is reinforced by additional legislative provisions and numerous supporting regulations. FRANK B. WRIGHT, LAW OF HEALTH AND SAFETY AT WORK 55–95 (1997).

536. Health and Safety at Work Act, 1974, c. 37, § 37.

537. HEALTH AND SAFETY EXECUTIVE, HEALTH AND SAFETY OFFENCES AND PENALTIES 2001/2002 11 (2002) (of 1494 convictions secured during the relevant twelve-month period, 23 involved directors and managers; the average fine for directors who were convicted was tiny—approximately £3,100).

538. HEALTH & SAFETY EXECUTIVE, HEALTH & SAFETY COMMISSION, DIRECTORS' RESPONSIBILITIES FOR HEALTH AND SAFETY 8 (2001), *available at* http://www.hse.gov.uk/pubns/indg343.pdf.

539. Though administrative penalties (Ordnungswidrigkeiten) can yield substantial fines, they are generally not perceived in Germany as being criminal in orientation. John C. Coffee, Jr., *Corporate Criminal Liability: An Introduction and Comparative Survey*, in CRIMINAL RESPONSIBILITY OF LEGAL AND COLLECTIVE ENTITIES 9, 22–23 (Albin Eser et al. eds., 1998); L.H. Leigh, *The Criminal Liability of Corporations and Other Groups: A Comparative View*, 80 MICH. L. REV. 1508, 1522–23 (1982).

540. AktG, §§ 399–405.

541. Handelsgesetzbuch [HGB] [Commercial Code] May 10, 1897, Reichsgesetzblatt [RGBl] 219, as amended, § 334; Maximilian Bücklers, *Board Members Face Imprisonment Under German or U.S. GAAP*, 21 INT'L FIN. L. REV. 61, 61 (2002).

542. Börsengesetz [BörsG] [Stock Exchange Act], Sept. 9, 1998, BGBl. I at 2682, § 62; Börsenzulassungs [BörzlassV] [Stock Exchange Admission Regulation], Sept. 9, 1998, BGBl. I at 2832, § 71; Wertpapier-Verkaufsprospekt Gesetz [WpvpG] [Securities Prospectus Act], Sept. 9, 1998, BGBl. I at 2701, § 17. For an English language translation of these measures, see HARTMUT KRAUSE, GERMAN SECURITIES REGULATION (2001).

financial statements.[543] Finally, administrative penalties can be imposed for breaches of various other laws, including competition law and environmental legislation.[544]

Despite the wide range of legislation under which German supervisory board directors can face administrative penalties, in practice, punishment is unlikely. Assuming the directors have not been dishonest, the AktG provisions under which they can be fined generally narrow down to those dealing with improper issuances of shares and misrepresentations in financial statements.[545] The former risk should be small for a public company with good legal counsel and the latter should not pose problems for supervisory board directors since they are unlikely to have sufficiently detailed involvement to justify criminal sanctions.

More generally, enforcement of criminal provisions affecting German directors has not been rigorous in practice. A critic observed in 1998: "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."[546] Consistent with this verdict, according to media reports the 2003 conviction of former executives of EMTV, a German media company, was the first conviction in recent history for misrepresentations made in a public company's financial statements.[547] Sanctions are sometimes imposed under competition law and environmental law on company employees and perhaps management board members, but not supervisory directors.[548] Moreover, even when fines are imposed on German managers, their companies typically reimburse them.[549]

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543. BörsG, §§ 44(b), 90; Wertpapierhandelgesetz [WpHG] [Securities Trading Act], Sept. 9, 1998, BGBl. I at 2708, §§ 15, 39. German stock companies are under an obligation to issue an *ad hoc* disclosure statement concerning key new events but the issuer (and thus its directors) is not liable for these statements. WpHG, § 15(6).

544. For potential environmental offences, see Joachim Scherer, *Environmental Law*, *in* 1 BUSINESS TRANSACTIONS IN GERMANY, *supra* note 246, at 9-1, §§ 9.03[6], 9.04[4], 9.04[13], 9.05[2]. On competition law, see Charles Stewart, *Antitrust Law: Competitive Restraints*, *in* 4 BUSINESS TRANSACTIONS IN GERMANY, *supra* note 238, at 35-1, § 35.09[2].

545. AktG, § 400 (financial statements); AktG, § 405(1) (issuance of shares).

546. Gerd Eidam, *Forms of Criminal Responsibility of Organisations: Aspects of Legal Practice in Germany*, *in* CRIMINAL RESPONSIBILITY OF LEGAL AND COLLECTIVE ENTITIES, *supra* note 539, at 59, 64.

547. Bertrand Benoit, *Germans Take Stock of Liability*, FIN. TIMES, Apr. 10, 2003, at 18. Subsequently, two executives of Infomatec AG, a company traded on the now defunct Neuer Markt, were convicted of market manipulation as well as insider trading. Reidenbach (2005), *supra* note 245, 1081–82.

548. Harald Kolz, *Forms of Criminal Responsibility of Organisations: Aspects of the Legal Practice in Germany*, *in* CRIMINAL RESPONSIBILITY OF LEGAL AND COLLECTIVE ENTITIES, *supra* note 539, at 67, 68.

549. *See* Eidam (1998), *supra* note 546, at 64–65.

3. Australia.—In Australia, as with Britain and Germany, there are "numerous offenses for which corporate officials may be held criminally liable."[550] Still, for outside directors of public corporations, the likelihood of being prosecuted is very small.[551] The collapse of HIH Insurance, discussed above in connection with the out-of-pocket payment by non-executive director Rodney Adler, did yield criminal charges against Adler and two other non-executive directors. Adler was convicted in 2005 for self-dealing, as was Brad Cooper, who bribed HIH's chief investment officer to smooth the payment of A$11 million to Cooper and companies Cooper owned.[552] The third HIH non-executive director (ex-chairman Geoffrey Cohen) was charged in the same year with giving misleading information to investors about a joint venture between HIH and another insurance company.[553] HIH, however, is the only Australian public company we found where criminal charges have been brought against a non-executive director.

4. Canada.— Concerns have been expressed in Canada about the criminal liability of directors.[554] There indeed are a large number of statutory provisions under which directors of Canadian companies can be punished by way of a fine or similar financial penalty.[555] Nevertheless, outside directors of public companies have little reason to be concerned. A director convicted and fined in criminal or administrative proceedings can be indemnified by his company so long as he acted honestly, in good faith and with a reasonable

550. JONATHAN CLOUGH & CARMEL MULHERN, THE PROSECUTION OF CORPORATIONS 130 (2002). For a detailed exposition of state and federal legislation creating offenses Australian directors can commit, see BRUCE COWLEY, PERSONAL LIABILITY FOR DIRECTORS (2003), http://www.minterellison.com/public/resources/file/ebd4e74e28b97af/RG-PersonalLiabilityForNomineeDirectors.pdf.

551. Andrews (2003), *supra* note 310, at 137; Tom Howard, *Liability of Directors for Environmental Crime: the Anything-but-Level Playing Field in Australia*, 17 ENVTL. & PLAN. L.J. 250, 252, 254, 257, 259, 262, 265–66, 269 (2000) (describing the small number of directors prosecuted under environmental statutes in each Australian state); Sue Streets, *Prosecuting Directors and Managers in Australia: A Brave New Response to an Old Problem*, 22 MELB. U. L. REV. 693, 703–04, 715–18 (1998).

552. On Adler, *see* Casella (2005), *supra* note 316. On Cooper's conviction, see Vanda Carson, *Ham-Fisted Conman*, AUSTRALIAN, Nov. 1, 2005, at 11. In 2003 Cooper paid A$2.5 million to HIH's liquidator to settle debts Cooper owed to HIH personally. *See* Peter Gosnell, *Cooper Hasn't Lost His Knack for a Deal*, DAILY TELEGRAPH (Sydney), July 4, 2003, at 9; Marcus Priest, *HIH Liquidator Scraps $310m Claim Against APRA*, AUSTL. FIN. REV., July 15, 2003, at 3. This does not qualify as an instance of out-of-pocket liability for our purposes because Cooper's liability was not generated as a result of his activities as an HIH director.

553. *See Charges Over 2000 Address*, DAILY TELEGRAPH (Sydney), Dec. 14, 2005, at 37; Vanda Carson, *Global Business Brief: Big Shot*, AUSTRALIAN, Apr. 19, 2006.

554. Ronald J. Daniels & Susan M. Hutton, *The Capricious Cushion: The Implications of the Directors' and Officers' Insurance Liability Crisis on Canadian Corporate Governance*, 22 CAN. BUS. L.J. 182, 221 (1993).

555. JOHN F. GRIEVE, UPDATE ON DIRECTORS' LIABILITIES AND DUTIES IN COMMERCIAL REORGANIZATIONS (2002), IIC-ART 2002-6 (Westlaw) (estimating that for a director in the province of British Columbia there were 64 federal statutory provisions and 74 provincial statutory provisions contemplating director liability); Daniels & Hutton, *supra* note 554, at 220.

belief that the conduct in question was lawful.[556] Moreover, fines and similar penalties are a rarity. As a federal government working group examining responsibilities of corporate boards has observed: "A review of statute-based liability and the enforcement record of federal regulators indicates that the practical exposure of outside directors to liability is limited."[557]

5. France.—In France, there are again a substantial number of provisions in companies legislation where a breach can create criminal liability.[558] Employment laws, workplace safety legislation, and consumer protection statutes also provide for numerous offences directors can commit.[559] The number of prosecutions of those managing French companies has grown considerably over the past couple of decades. Outside directors, however, have not been the target since prosecutions have centered on intentional misconduct ("abuse of corporate assets") rather than inattentiveness.[560]

6. Japan.—Various provisions in Japanese companies legislation affecting directors are supported by criminal sanctions.[561] Health and safety legislation, workplace safety rules, and antitrust laws also contain financial penalties that can be imposed on directors.[562] Nevertheless, consistent with the pattern elsewhere, directors who are not involved in the day-to-day management of a Japanese public company face little risk of a fine or other criminal sanction.[563]

IX. Conclusion

This paper has identified a pervasive cross-border trend: outside directors of public corporations are unlikely to have to pay damages or analogous financial penalties out of their own pocket for failures of oversight. We have made these points by considering the situation in six

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556. Canada Business Corporations Act, R.S.C., ch. C-44, § 124(1), (3) (1985, as amended). For a case affirming that a corporation can indemnify directors for fines, see R. v. Bata Indus. Ltd., [1995] 25 O.R.3d 321.

557. TORONTO STOCK EXCHANGE COMMITTEE ON CORPORATE GOVERNANCE IN CANADA, *supra* note 344, at 35; *see also* Noralee Gibson, *Business Issues: Directors' Liabilities*, 53 SASK. L. REV. 187, 187–88 (1989) (statute-based claims rarely brought against directors).

558. For an overview of the key provisions, see de Précigout (1993), *supra* note 429, at 463–64.

559. Omar (2001), *supra* note 438, at 102.

560. *Id.* at 104; Joseph Fitchett, *Loosening Corporate Secrecy*, INT'L HERALD TRIB., Oct. 15, 1996, at 21.

561. Takanobu Takehara & Takafumi Nihei, *A Q&A Guide to Corporate Governance and Directors' Duties in Japan*, *in* PLC CROSS-BORDER CORPORATE GOVERNANCE AND DIRECTORS' DUTIES HANDBOOK Q15 (2006).

562. *Id.*

563. Letter from Kensuke Itoh, Keio University Law School (Aug. 2, 2003); e-mail from Masafumi Nakahigashi, Professor of Law, Nagoya University School of Law (Aug. 2, 2003) (on file with the authors).

countries (Australia, Canada, France, Germany, Japan, and the United Kingdom) and by drawing on research we have done on the United States. We have separately studied Korea and have found the outcome to be the same there.[564]

Though liability for self-dealing, including insider trading, is beyond this Article's scope, it is clear that outside directors are at risk if they act in a self-serving or dishonest fashion. The penalties imposed on Rodney Adler (of HIH) and Stephen Vizard (Telstra) illustrate this. Self-dealing aside, the risk is tiny, but not zero, in each country we have studied. Exposure to liability under U.S. securities law is, for example, one source of potential concern. Two instances of out-of-pocket liability we uncovered as part of our investigation of outside director liability in the U.S. involved companies cross-listed in the U.S. (Independent Energy Holdings and the confidential Canadian out-of-pocket payment). Nevertheless, given that U.S. outside directors rarely make personal payments in securities litigation, the risks faced by outside directors of cross-listed companies should be small, particularly if the companies purchase D&O insurance that meets current U.S. norms.

Our study suggests the primary source of risk in fact is where the party in control of a lawsuit—often the government—is prepared to look beyond the financial costs and benefits of seeking recovery in the immediate case and treats extraction of a personal payment from the outside directors as a priority, often in order to send a message to other boards. How often is this situation likely to arise? Our survey suggests the answer is not very often.

Instances where outside directors of public companies have agreed to pay damages or a related financial penalty out of their own pockets discussed in this paper have most often involved a prominent company suffering a massive financial reversal (e.g., Enron, WorldCom, the two failed Canadian banks and HIH, One.Tel, and Clifford Corporation in Australia). When these ingredients are present, those controlling the litigation may be able to "make a statement" by securing an out-of-pocket payment from directors. Still, spectacular corporate collapses are the exception, not the rule, so this sort of opportunity is only likely to present itself on isolated occasions.

Even with a high-profile corporate meltdown, private parties suing those allegedly responsible will normally seek to maximize their expected recovery, making due adjustments for time, risk, and expense. This will usually mean focusing on deep pockets (including D&O insurance) and not seeking personal payments from non-executive directors. In the U.S., as the Enron and WorldCom settlements indicate, public pension funds are potential candidates to "send a message" to outside directors, since those making the litigation decisions can benefit politically from taking a tough stance. This sort of "public-minded" and litigious investor is, however,

564. *Shareholder Suits in Korea*, *supra* note 8, at 29.

uniquely American. Other countries lack private investors likely to treat the extraction of personal payments from outside directors as a priority.[565]

Outside directors of a public company that collapses in a highly publicized manner do face a meaningful risk of personal liability as a result of enforcement by government regulators. The handful of instances identified in this survey in which inattentive outside directors have paid out of their own pockets indicates this. Nevertheless, even non-executives whose inattentiveness was a contributing factor to a major corporate collapse may escape liability since regulators may focus exclusively on more culpable parties (e.g., the executives) or only seek sanctions with no direct financial penalty involved (e.g., disqualification).

Even if we have underestimated the current degree of financial risk that outside directors face, our assessment of the "bottom line" might well still end up being correct. In the litigious United States, when concerns about directors' liability have emerged periodically in the past, legal and market reactions have brought the risk down again. Recent legislative reforms in Britain, Canada, Germany, and Japan suggest the same pattern is at work elsewhere, as does the rise of D&O insurance in all of the countries we have considered. These dynamics give reason to expect that the current equilibrium of very low out-of-pocket liability risk is likely to be restored after future shocks, whatever their source may be.

Suppose we are correct in predicting that the risk of out-of-pocket liability will remain low for outside directors. Would such an outcome be a cause for concern? Or would it be better if there was more of the sort of aggressive enforcement activity that we saw in Australia? It is beyond the scope of this Article to offer a thorough analysis of the policy dynamics involved. Nevertheless, we can offer some tentative arguments that exposing outside directors to a substantially greater risk of out-of-pocket liability than they face at present would likely be counterproductive.[566]

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565. On the position in Britain and Germany, see notes 192–93, 267–69, and accompanying text. On Australia, see STAPLEDON (1996), *supra* note 193, at 248–49, observing that the situation in Australia is much the same as in Britain. On Canada, see Janis Sarra, *The Corporation as Symphony: Are Shareholders First Violin or Second Fiddle?*, 36 U.B.C. L. REV. 403, 410 (2003), noting that "Canada's institutional shareholders have exercised a different form of activism from those in the United States. Canadian institutional investors have a history of collaborative intervention or 'quiet voice . . . .'" On France, see James A. Fanto, *The Transformation of French Corporate Governance and United States Institutional Investors*, 21 BROOK. J. INT'L L. 1, 45 n.137 (1995), saying: "There are no public or private pension funds in France in the U.S. sense, because pension obligations are covered by the state and funded by contributions from employers and employees." On Japan, see Mariko Sanchanta, *Japan's PFA Plans to Sue Seibu*, FIN. TIMES, Mar. 31, 2005, at 28, saying a planned lawsuit by Japan's Pension Funds Association against Seibu Railway would be the first time a Japanese institutional investor had sued a company in which it had invested.

566. Various points raised here are considered in more detail in Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability: A Policy Analysis,* 162 J. INSTITUTIONAL & THEO. ECON. 5 (2006).

Various commentators praised the settlements reached in the Enron and WorldCom securities lawsuits, predicting that the message that inattentive outside directors could suffer adverse financial consequences if a major corporate fraud occurs on their watch would induce greater vigilance in the boardroom.[567] Outside directors who face a meaningful risk of out-of-pocket liability will indeed be likely to work harder and worry more about how good a job they are doing. It is important to remember, however, that outside directors have incentives other than liability that motivate them to be vigilant monitors of managerial conduct. For instance, an outside director who owns a substantial number of shares in a company will have a tangible incentive to be attentive and vigilant. In practice, it is rare for there to be a strong correlation between corporate performance and an outside director's wealth.[568] Still, in the U.S., director pay has been rising steadily over the past few years and equity-based compensation (shares and share options) now outweighs cash compensation in a typical large public company.[569] If this pattern continues in the U.S. and spreads to other countries, outside directors may well in the future have meaningful financial incentives to do their job well.

Reputational concerns can also motivate outside directors. Given recruitment patterns, most individuals taking up such posts will be known for having good judgment and for dealing successfully and prudently with complex, challenging matters. An outside director will want to keep this track record intact as a matter of pride and as a means for securing future business opportunities, including board appointments. This, in turn, matters in the boardroom. To protect their good names, outside directors have an incentive to take their responsibilities seriously.[570]

Significant out-of-pocket liability risk also has potential drawbacks. For instance, outside directors could end up being excessively cautious. A high

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567. Diane Francis, *At Long Last, Directors May be Liable for Actions*, NAT'L POST, Jan. 11, 2005, at FP 2; Gretchen Morgenson, *If Directors Snooze, Now They May Lose*, N.Y. TIMES, Jan. 9, 2005, § 3, at 6.

568. CHEFFINS, *supra* note 91, at 101 (discussing the U.K.); STUART, *supra* note 372, at 27 (giving the breakdown for the average annual board fee for a large Canadian public company as C$53,000 in cash and C$11,000 in equity grants); Sanjai Bhagat, Dennis C. Carey & Charles M. Elson, *Director Ownership, Corporate Performance and Management Turnover*, 54 BUS. LAWYER 885, 902 (1999) (in a sample of U.S. public companies, the median value of shares owned by directors as a percentage of shares outstanding was 0.02%; the mean was 0.57%).

569. PEARL MEYER & PARTNERS, 2005 DIRECTOR COMPENSATION: STUDY OF THE TOP 200 CORPORATIONS 3–7 (2005), *available at* http://www.pearlmeyer.com/resdir.html. *But see* Chad Terhune & Joann S. Lublin, *Coke Directors Agree to Give Up Pay if Company Misses Earnings Goal*, WALL ST. J., Apr. 6, 2006, at A1 (discussing Coca-Cola Co.'s plan to pay directors nothing unless the company hits prescribed financial targets, but noting that large U.S. companies have been moving away from tying director compensation closely to performance because of concerns about compromising director independence).

570. *See* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1268 (1999) (noting the threat to a director's reputation posed by media and institutional investor scrutiny of boardroom performance).

degree of care can be desirable when policing conflict-of-interest transactions involving management or a controlling shareholder, but too much caution could be bad when overseeing business decisions generally.[571] For an outside director, unless he has a substantial percentage of his personal wealth tied up in his company's shares, potentially lucrative but risk initiatives offer little upside. Thus, assuming the potential for devastating liability if something goes wrong, the asymmetry of risk and reward could well prompt outside directors to reject the bold gambles that are often crucial to corporate success.

Fear of out-of-pocket liability risk could also result in a counterproductive effort by directors to formalize boardroom procedures and create a paper record for everything they do.[572] Up to some unquantifiable point, the threat of a lawsuit will beneficially induce careful deliberation. Beyond that point, fear of liability will do more harm than good by diverting the board's limited attention to activities designed to protect against personal risk and away from activities with greater potential to increase company value. In this context, it is important to bear in mind that outside directors tend to overestimate the legal hazards they face. Surveys conducted prior to the WorldCom and Enron settlements indicated, for instance, that a substantial majority of U.S. outside directors were concerned about personal liability even though out-of-pocket payments were rare.[573] Given how jittery directors can be, even objectively small risks could induce detrimentally defensive board decision-making.

An additional potential adverse consequence of increased out-of-pocket liability risk is that able people will be less willing to serve as outside directors.[574] The potential dangers on this count are especially acute with wealthy individuals, since they will be particularly attractive targets for plaintiffs and plaintiffs' lawyers. If such people decline to serve as outside directors corporate governance could suffer. Those successful enough in business to become rich are likely to offer the boardroom expertise corporate executives will value most. Also, rich individuals are ideal candidates to be impartial monitors of management since their wealth means they can stand

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571. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 50 (2002); *see also* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1482 (1984).

572. *See* Bainbridge (2002), *supra* note 571, at 50.

573. BOB FELTON & MARK WATSON, MCKINSEY & COMPANY, THE NEED FOR INFORMED CHANGE IN THE BOARDROOM 7 (2002), *available at* http://www.mckinsey.com/clientservice/organizationleadership/service/corpgovernance/pdf/DirectorOpinion.pdf (finding that 22% of respondent directors felt they faced a very significant risk of being held personally liable and 62% were "somewhat" concerned).

574. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 455–56 (2002); Marc I. Steinberg, *Application of the Business Judgment Rule and Related Judicial Principles—Reflections from a Corporate Accountability Perspective*, 56 NOTRE DAME L. REV. 903, 905 (1981).

up to the CEO and other senior executives without fear of the financial consequences of losing their directorship.

A final consideration is that those individuals who agree to serve as outside directors despite a significant risk of out-of-pocket liability may well demand higher fees to compensate for that risk. If companies do raise director pay substantially to recruit and retain quality outside directors, the change could impair the quality of corporate governance. Typically, for an outside director to be a vigilant and effective monitor of management, he will have to be fully independent, which means he needs to be ready to give up his position if his concerns are not heeded. Higher pay could create a substantial group of directors who, fearing the loss of their lucrative board positions, would be reluctant to rock the corporate boat or quit when resignation was called for.

Current arrangements are not necessarily optimal. It may be that an incremental increase in the risk of outside directors paying out of their own pockets combined with liability caps designed to ensure innocent (if inattentive) directors will not end up bankrupt would create better incentives.[575] Nevertheless, our assessment of the potential costs and benefits of out-of-pocket liability leads us to believe that, self-dealing aside, it is likely good policy for personal payments to remain a rare outcome for outside directors of public companies. The countries we have surveyed likely have gotten the risk level about right—not zero, but small.

575. We plan to consider this possibility further in future research.