Outside Directors, Liability Risk and Corporate Governance: A Comparative Analysis (English Version)[†]

Brian R. Cheffins

Bernard S. Black

Michael Klausner

German Version: **Nicht-geschäftsführende Direktoren, Haftungsrisiko und Corporate Governance: Eine rechtsvergleichende Analyse**

in Stefan Grundmann, Hans-Peter Schwintowski, Reinhard Singer & Martin Weber eds.

Anleger- und Funktionsschutz durch Kapitalmarktrecht
(forthcoming 2005)
(Investor and Market Protection through Capital Market Laws)

European Corporate Governance Institute
Law Working Paper No. 48(Eng)/2005

University of Texas Law School
Law and Economics Working Paper No. 31

[†] This chapter is a revised version of a lecture given by Professor Brian Cheffins at Humboldt University, Berlin in January 2005. The authors are grateful for feedback offered at that event and for comments by Dirk Reidenbach.

ECGI Working Paper Series in Law

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Working Paper N°.48(Eng)/2005

August 2005

Bernard Black
Brian Cheffins
Michael Klausner

This paper, prepared for a German audience, is a shortened version of Black, Cheffins, and Klausner, Liability Risk for Outside Directors: A Cross-Border Analysis 11 European Financial Management 153-171 (2005), available at http://ssrn.com/abstract=682507, and also draws on the discussion of Germany in Black & Cheffins, Outside Director Liability Across Countries, Texas Law Review (forthcoming 2005), available at http://ssrn.com/abstract=438321. The German version of this paper is available at http://ssrn.com/abstract=800604.

Abstract:

Outside directors constitute a key component of most prescriptions for good governance of public companies. Given that outside directors are important corporate governance players, one is led to wonder what will motivate the individuals serving in this capacity to carry out their responsibilities in an effective manner. An obvious possibility is that concerns about being held personally liable will push them to perform effectively. This chapter correspondingly considers the scope of outside director liability in seven countries (Australia, Britain, Canada, France, Germany, Japan and the United States). The chapter indicates that outside directors of public companies are at some risk when litigants are seeking to "send a message" to those serving in the boardroom of public companies. Generally, however, such individuals only very rarely pay damages or legal expenses out-of-their own pocket. The chapter offers a brief assessment of the costs and benefits of current arrangements and concludes that, consistent with the current cross-border pattern, out-of-pocket liability should remain a rare outcome.

Keywords: outside directors, corporate governance, Germany, supervisory board, director liability, securities law, corporate law

JEL Classifications: G30; G34

Bernard Black
University of Texas at Austin - School of Law
727 East Dean Keeton Street
Austin , TX 78705
United States
Phone: 512-471-4632
e-mail: bblack@law.utexas.edu

Brian Cheffins
University of Cambridge - Faculty of Law
10 West Road
Cambridge CB3 9DZ
United Kingdom
Phone: +44 1223 330084, fax: +44 1223 330055
e-mail: brc21@cam.ac.uk

Michael Klausner
Stanford Law School
559 Nathan Abbott Way
Stanford , CA 94305-8610
United States
Phone: 650-723-6433, fax: 650-725-0253
e-mail: klausner@leland.stanford.edu

I. Introduction

"Outside" directors are individuals who serve on the board of a company but do not act in any sort of executive capacity.[1] In Germany, the law governing stock corporations (Aktiengesellschaften, or "AGs") assigns outside directors a pivotal constitutional role. The board of directors in a stock corporation is explicitly divided into two tiers, the management board (Vorstand) and the supervisory board (Aufsichtsrat). The management board has sole responsibility for the management of the stock corporation.[2] The supervisory board, for its part, is supposed to monitor and otherwise exercise control over the management board.[3] Members of the supervisory board must be outside directors, since the law requires the supervisory board to be composed of individuals who do not act in an executive capacity for the stock corporation.[4]

While some smaller European countries have a two-tier board system akin to that in Germany (e.g. the Netherlands), Germany stands alone amongst major capitalist economies in requiring the boards of publicly quoted companies to be divided into two levels.[5] Elsewhere, the norm is a "unitary" board with the underlying presumption being that all directors are equally responsible for decisions

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1 For more detail on who qualifies, see Brian R. Cheffins, Company Law: Theory, Structure and Operation 97 (1997).

2 German Stock Corporation Act (Aktiengesetz or AktG), § 76(1).

3 AktG, §§ 111(1).

4 AktG, §§ 105(1).

5 In France, use of a two-tier board is optional with the SA but the system is rarely used: James A. Fanto, The Role of Corporate Law in French Corporate Governance, 31 Cornell Int'l L.J. 31, 55 (1998).

taken. Under this format outside directors are not assigned a formal constitutional role. Nevertheless, they constitute a key component of most prescriptions for good governance of public companies. The core assumption is that outside directors can make a pivotal contribution by monitoring the performance and conduct of senior executives, thereby enhancing managerial accountability.[6] For instance, in Britain, since the early 1990s companies listed on the London Stock Exchange have been subject to a "comply or explain" corporate governance code that urges publicly quoted companies to appoint "non-executive" directors[7] and offers extensive guidance on the supervisory role such individuals are supposed to play.[8] Similar trends in favor of formalizing the corporate governance role of outside directors are evident in a wide variety of additional countries.[9]

Given that outside directors are key corporate governance players, one is led to wonder what will motivate the individuals serving in this capacity to carry out their responsibilities in an effective manner. One obvious possibility – that there will be a direct correlation between corporate performance and the financial return an outside director receives – can be safely discounted. This is because it is uncommon for outside directors of public companies to receive meaningful performance-oriented remuneration or to own enough equity in companies they serve for their wealth to be

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[6] Cheffins, Company Law, *supra* note xx, 605-6, 621.

[7] The "non-executive" terminology is preferred in the UK: Cheffins, Company Law, *supra* note xx, 97, n. 211.

[8] For the current requirements, see Financial Reporting Council, The Combined Code on Corporate Governance. Available at http://www.frc.org.uk/about/combined.cfm .

[9] The Way We Govern Now, *Economist* (U.S. edition), January 11, 2003, 59.

affected significantly by share price movements.[10] Moreover, non-executives on company boards are not particularly well-paid, at least by the standards of large and successful business organizations. The situation with supervisory board directors of publicly quoted German companies illustrates the point. According to a recent study, their pay ranges only from €5,000 to €102,000 annually and the directors who serve as workers' representatives under the system of co-determination operating in major German companies must give most of what they are paid to a trades-union foundation.[11]

If outside directors of public companies do not have major financial incentives to work hard and pay attention, what will motivate such individuals to be vigilant? An obvious possibility is that concerns about being held personally liable will push them to perform effectively. But, to the extent this is right, a concern that can arise is that there can too much of a good thing. It is often said that publicly quoted companies are struggling to recruit able people to serve as outside directors since leading potential candidates are increasingly declining such appointments.[12] There are several reasons for the growing reluctance to take up outside directorships, including the increased workload imposed by new corporate governance rules and the risk of a damaged reputation if problems arise. A dominant concern, however, is that

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10 Cheffins, Company Law, *supra* note xx, 101.

11 A Model Out of Time, Economist (U.K edition), January 29, 2005, 71.

12 See, for example, David Elias, Seat on Board Isn't so Cosy Anymore, Sydney Morning Herald, May 20, 2004, 34; Kit Bingham, Businessmen Spurn Non-Executive Roles as Risks Mount, Financial News, May 17, 2004, available at http://www.efinancialnews.com/ .

lawsuits could expose outside of public companies directors to major financial risks.[13] As two lawyers from a major Canadian law firm claimed in a 2004 newspaper article headlined "Corporate Liability May Create a Superstorm":

> "One has to ask at what point the corporate boat will be swamped as well-qualified directors jump ship to avoid overwhelming personal liability".[14]

The concerns expressed about the impact of liability on boardroom recruitment imply that outside directors of public companies face a significant risk of paying out of their own pockets as a result of lawsuits. But, as this chapter will indicate, the opposite is true; personal payments are very much a rarity. Given this, does liability in fact provide meaningful incentives to outside directors to carry out effectively the key corporate governance functions they perform? If the law does not perform this sort of function, should it? This chapter, which is based on a series of papers where the authors have considered the liability risk of outside directors of public companies,[15] examines these questions and related issues.

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13 Bingham, Businessmen, *supra* note xx; James Cox, Boards Find it Harder to Fill Hot Seats; Scandals, Legal Threats Make Many Decline Slot, USA Today, July 31, 2002, A1.

14 Nicholas Dietrich and Leslie Gord, Corporate Liability May Create a Superstorm, Lawyers Weekly, April 23, 2004, available via the Quicklaw electronic database.

15 For detailed analysis, including full footnotes, see Bernard Black, Brian R. Cheffins and Michael Klausner, Outside Director Liability, working paper (2004), available at http://ssrn.com/abstract=382422, Bernard Black and Brian R. Cheffins, Outside Director Liability Across Countries, working paper, (2004), available at http://ssrn.com/abstract=438321). See also Bernard Black, Brian R. Cheffins and Michael Klausner, Liability Risk for Outside Directors: A Cross-Border Analysis, European Financial Management (forthcoming 2005) (this offers a synthesis of the preceding two papers for a finance audience).

II. Scope of the Chapter

The research on which this chapter is based is comprised of an analysis of law and practice in seven major industrialized countries, including Germany. To understand the basic contours of outsider director liability in the various jurisdictions, it is helpful to distinguish between "out-of-pocket liability", which occurs where directors personally pay financial penalties (e.g. damages) and legal expenses, from situations where liability is merely nominal since all will be paid on a director's behalf by the company and/or the company's directors' and officers' (D & O) insurance policy. As this chapter will discuss, with the exception of the United States, outside directors of publicly quoted companies rarely encounter either form of liability. In the U.S. outside directors quite often end up as defendants in lawsuits but D & O insurance is almost universal and the law gives companies broad power to indemnify directors for legal expenses and damages. So, whatever liability there is almost invariably ends up being nominal rather than actual.

Admittedly, blatant self-serving behavior will expose outside directors of public companies to significant legal risks. Such individuals, however, rarely have sufficient knowledge or leverage to line their own pockets. Moreover, outside directors know they can protect themselves against being held accountable for self-dealing by steering clear of self-serving transactions and other dicey arrangements. They have no such comfort, however, with the various supervisory functions they are supposed to perform, and it is liability for events beyond their control that most concerns them. Still, contrary to the chorus of dire warnings concerning the hazards of being an outside director of a public company, the risk of out-of-pocket liability in fact is very small. Moreover, the situation is the same across borders.

While the legal obligations outside directors of public companies face rarely translate into out-of-pocket liability, there are isolated exceptions to the pattern we describe. Indeed, the exceptions are sufficiently numerous to identify a cross-border trend, this being that the risks involved are greatest for outside directors when parties conducting a lawsuit are operating in a "public-minded" fashion. More precisely, outside directors have reason to be worried when litigants are seeking to "send a message" to those serving in the boardroom of public companies rather than focusing on maximizing compensation, having due regard for negotiation and enforcement costs, in the particular case.

The received wisdom is that directors of public companies face greater legal risks in the United States than they do anywhere else. As a result, the U.S. constitutes the toughest test for our thesis that outside directors almost never encounter out-of-pocket liability. Correspondingly, we address the American situation first, and we do so in more detail than for the other six countries we consider. The chapter then surveys in a summary way the situation in the other jurisdictions, with the primary emphasis being on Germany. After this, we discuss instances which constitute the "send a message" exception to the basic trend we have identified. The chapter's concluding section analyzes succinctly the policy implications of outside director liability.

III. Outside Director Liability in the United States

A. The Risk of Liability: in Theory

Individuals serving as outside directors of U.S. public companies face a seemingly daunting array of legal obligations. To start, under corporate law, directors owe duties to the company that can be divided into two broad categories: care and loyalty.[16] *Smith v. Van Gorkom*, a well-known Delaware decision from the mid-1980s,[17] indicated to the surprise of many that there are breaches of the duty of care which are not insulated from scrutiny by a protective doctrine known as the "business judgment rule".

Turning to U.S. securities law, directors are liable if they fail to exercise "due diligence" in verifying the information that a company provides to investors in connection with a public offering of securities, assuming that information turns out to be materially false or misleading.[18] Directors are also liable for errors in corporate disclosures unrelated to the issuance of securities if they had knowledge of, or were reckless in failing to prevent, a materially false misstatement or omission.[19] Finally, those serving as directors of U.S. public companies can potentially be penalized under various additional legal regimes, including those governing the administration of pension funds and discrimination in the workplace.[20]

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16 Robert W. Hamilton, The Law of Corporations 444 (5th ed. 2000).

17 488 A. 2d 858 (1985) (Del. Sup. Ct.).

18 Securities Act of 1933, s. 11.

19 Securities Exchange Act of 1934, Rule 10b-5.

20 For a survey of laws under which directors can be held liable, see William A. Knepper, and Dan A. Bailey, Liability of Corporate Officers and

Also noteworthy is that various features of the American legal system serve to encourage litigation against directors. First, in contrast with the practice elsewhere, litigants pay their own legal expenses, win or lose.[21] This means a plaintiff bringing a marginal case does not have to worry about paying the defendant's costs in the event the claim is dismissed. Second, again in contrast with the practice elsewhere, the class action suit and the "derivative" suit (litigation brought by shareholders on behalf of the company) are well-established devices for solving collective action problems that otherwise discourage shareholders from launching proceedings against directors.[22] Third, to a unique extent, the U.S. legal system treats a plaintiff's attorney as an entrepreneur who performs a socially useful function by seeking out legal violations and suitable clients rather than waiting passively for a prospective litigant to come to them.[23] To illustrate, if a class action suit or derivative suit is successful or settles out of court, the judge supervising proceedings will generally award "attorney's fees" to the lawyers who brought the case, with the amount being based on time expended or a percentage of the damages recovered.[24]

B. The Small Risk of Out-of-Pocket Liability: Data

Directors, volume 1 (6th ed., 1998).

21 See John C. Coffee, Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Columbia L. Rev. 669, 674 (1986); Neil Andrews, English Civil Procedure: Fundamentals of the New Civil Justice System 1001 (2003).

22 Reinier R. Kraakman *et al.*, The Anatomy of Corporate Law: A Comparative and Functional Approach 116-17, 211-13 (2004).

23 Coffee, Understanding, *supra* note xx, 678-79.

24 Coffee, *ibid.*; Douglas G. Cole, Counsel Fees in Stockholders' Derivative and Class Actions – Hornstein Revisited, 6 University of Richmond Law Review, 259, 260-61 (1972).

There are dozens of proceedings launched every year naming outside directors of American public companies as defendants. Many of these cases are successful, at least in the sense that plaintiffs and defendants settle. Our research indicates, however, that the cases brought almost never translate into out-of-pocket liability for outside directors.

Consider first federal securities lawsuits, which are the largest source of risk. Between 1991 and 2003, 2930 securities cases were filed in U.S. federal courts.[25] Of these, only three culminated in trials and in none of these was judgment granted against an outside director.[26] Of the remaining lawsuits, a majority settled. After extensive inquiry, we have only become aware of two securities law settlements where the ultimate outcome involved outside directors making an out-of-pocket payment.[27]

With other types of lawsuits, we know of only two instances where outside directors of a U.S. public company have ended up being "on the hook" to pay damages out of their own pocket. One, which arose from allegations of pension fund mismanagement at the scandal-ridden energy giant Enron, will be discussed in Part V

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[25] For data see Elaine Buckberg *et al.*, Recent Trends in Securities Class Action Litigation: Will Enron and Sarbanes-Oxley Change the Tides? (NERA Economic Consulting, 2003); Cornerstone Research, Post-Reform Act Securities Case Settlements: Cases Reported Though December 2002, available from Stanford Law School Securities Class Action Clearinghouse at http://securities.stanford.edu.

[26] The three cases were In re Apple Computer Securities Litigation (N.D. Cal. 1991); In re Biogen Securities Litigation, Fed. Sec. L. Rep. ¶ 90,206 (1997); Howard v. Everex Systems (N.D. Cal. 2002).

[27] One is the Enron settlement, to be discussed in Part V. The other is a confidential settlement in which four directors paid $500,000 each to settle. We are not at liberty to divulge the details.

of the chapter. The other was the *Van Gorkom* case, where the Delaware Supreme Court ruled that outside directors had failed to use sufficient care in approving a proposed merger transaction and ordered them to pay damages well in excess of the D & O coverage in place.[28]

C. The Small Risk of Out-of-Pocket Liability: Explanations

The fact that outside directors of U.S. public companies rarely pay damages or legal expenses personally is to some extent a product of procedural hurdles. In a derivative suit, a corporate charter provision will normally eliminate director liability for all but the most egregious breaches of the duty of care since virtually every U.S. public company takes up the option provided by state corporate law to adopt such a clause.[29] Moreover, suits brought under federal securities law will be dismissed unless the plaintiffs support their claim by pleading facts suggesting liability with sufficient particularity,[30] and many claims brought against outside directors fail to meet the relevant standard.

With cases that that are sufficiently meritorious to satisfy relevant procedural tests, most settle, and do so on terms where outside directors do not pay damages or legal expenses personally. The fact that settlement is a common outcome should not

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28 After the merger the acquiror voluntarily satisfied the judgment against the outside directors, so the directors did not pay damages in fact.

29 See, for example, Del. Gen. Corp. L. § 102(b)(7). The Delaware Chancery Court has held that a director cannot rely on this provision if his conduct reflects "knowing or deliberate indifference...to his or her duty to act faithfully and with appropriate care": In re The Walt Disney Company Derivative Litigation, 825 A.2d 275, 287 (Del. Ch. Ct. 2003).

30 Federal Rules of Civil Procedure, Rule 9(b).

be surprising, since in any legal dispute there is an inherent bias in favor of an out-of-court deal since both the plaintiff and defendant can save time, hassle and expense by avoiding a trial.[31] What is pivotal for our purposes is that matters almost inevitably resolve themselves in a way that ensures outside directors of public companies do not make personal payments as part of the deals struck. For present purposes, the key dynamics can be illustrated by reference to the most important class of lawsuit, namely class actions under federal securities law.

With a securities class action the momentum in favor of settlement will come from several directions. Beginning with the plaintiffs and their lawyers, settling out of court is potentially appealing since a trial and the probable appeals of a successful judgment will mean delayed recovery and uncertain success. Turning to outside directors named as defendants, a settlement makes good sense for them since they are unlikely to suffer adverse financial consequences. The reason is that, so long as the company involved is healthy financially, it will take the directors out of the firing line by satisfying the claim out of its own resources and by paying any legal expenses. This is all fully permissible because under state corporate law a corporation can indemnify a director involved in a securities lawsuit for damages and legal fees so long as the director acted in good faith and in the best interests of the corporation.[32]

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[31] Frank B. Cross, In Praise of Irrational Plaintiffs, 86 Cornell L. Rev. 1, 3-4 (2000).

[32] Del. Gen. Corp. L. § 145(a). The Model Business Corporation Act, which provides the departure point for state corporate legislation in a majority of jurisdictions, is broader than Delaware law. A company's charter may permit or require indemnification and advancement of expenses for all actions except "(A) receipt of a financial benefit to which [the director] is not entitled; (B) an intentional infliction of harm on the corporation or its shareholders; (C) [an improper dividend or share repurchase]; or (D) an intentional violation of criminal law." Model Bus. Corp.

The company will then seek to recover most or all of what it has paid out from directors' and officers' (D & O) insurance. Virtually all U.S. public companies purchase liability coverage of this sort.[33]

As and when plaintiffs and defendants settle a federal securities lawsuit, the D & O insurers will likely go along. Typically, an insurance company will have insufficient leverage to veto a deal struck since there are legal rules that make it risky for an insurer to turn down a negotiated settlement[34] and since an insurer will not want to acquire a reputation for failing to provide coverage for seemingly meritorious claimants. Indeed, we know of no instances since 1990 -- as far back as we looked -- where insurers have forced a securities fraud trial rather than settling. Insurers aren't prejudiced by all of this because they know securities fraud settlements falling within D & O policy limits will occur commonly, and set premiums accordingly.

What if a public company is insolvent and thus cannot protect the outside directors? For them, the saving grace is that the D & O policy will still be in place and a settlement where the policy is sufficient to provide cover for any damages and legal expenses remains by far the most likely outcome. The pressure to settle on these terms is, in some ways, stronger when a company is insolvent than when it is in good

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Act § 2.02(b)(5), *see also id.* §§8.51(a), 8.53, 8.58(a).

Neither Delaware corporate legislation nor the Model Business Corporations Act permits a corporation to indemnify a director for damages payable in derivative litigation.

[33] *See* Tillinghast Towers Perrin, 2002 Directors and Officers Liability Survey 17 (2002) (finding 98% of U.S. firms with over 500 shareholders respondents had D & O insurance).

[34] For background, see Kent D. Syverud, The Duty to Settle, 76 Va. L. Rev. 1113 (1990).

financial health. Certainly, since the company cannot offer a bailout, it is obvious why defendant outside directors will be prepared to strike a deal where D & O insurance pays the legal expenses and outstanding damages.

The plaintiffs, meanwhile, face an odd dynamic. If they pursue a case through to trial, the directors will spend lavishly on their own defense on the presumption that the D & O policy will cover the legal costs. If the plaintiffs win at trial, an appeal is highly likely, with defense costs again being paid for out of the policy. Prolonged litigation correspondingly could shrink substantially the principal “deep pocket” from which the plaintiffs are hoping to collect.

Furthermore, if a securities fraud case goes to trial, the plaintiffs might prove “too much”, in the sense they might convince a judge that the directors knowingly participated in the wrongdoing. This, in turn, would give grounds for the insurer to deny coverage based on common exclusions in D & O policies for fraud and dishonesty. With the insurer out of the picture, recovering much, let alone all, of the judgment could be impossible unless some or all of the directors held liable are very wealthy.[35] So, assuming that a valid D & O policy is in place, the plaintiffs and the defendants should be keen to strike a deal and the insurers will again probably “play ball.”

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[35] Moreover, proportional liability rules unique to U.S. securities law may make outside directors liable for only a fraction, perhaps a small fraction, of total damages. The rules in question focus on relative culpability, and since the outside directors' involvement in securities fraud typically involves only failures of oversight their share of proportionate liability is likely to be low. See Securities Act of 1933, § 11(f)(2), 15 U.S.C. § 77k(f)(2) (2005), Exchange Act of 1934 § 21D(f), 15 U.S.C. § 78u-4(f) (2005).

To be sure, under the scenario just sketched out, the liability risk of an outside director of an insolvent public company will not be zero. Outside directors will potentially be vulnerable if they are collectively very wealthy since they might well be a deep pocket worth pursuing.[36] The risks the directors face will increase further if there is ample evidence of their culpability, since all concerned will know the plaintiffs can make a credible threat to go to trial and win.[37] The final piece of the puzzle will be a problem with the D & O insurance coverage, thus potentially taking this deep pocket out of the equation. For instance, D & O policies have technical features that can create "holes" that might let an insurer deny coverage entirely.[38] Another possibility is that the company will have only contracted for a small amount of coverage, meaning legal expenses will largely or completely exhaust the available funds. Still, while it is possible to envisage how a combination of corporate insolvency, substantial director wealth, director culpability and problems with insurance coverage could amount to a "Perfect Storm" for outside directors, our data indicates that Perfect Storms are indeed rare.

D. Forces Supporting the Current Equilibrium

The equilibrium consisting of frequent suits against directors and protections designed to preclude out-of-pocket liability has been stable in the U.S. over time.

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[36] Due to the securities law rules that cap liability based on proportionate fault, the presence of just one rich outside director may not change the plaintiffs' calculus.

[37] Culpability is also relevant since the proportionate damage rule will attribute a large amount of damages to directors whose misconduct is serious.

[38] Insurers, due to reputational pressures, in fact tend to avoid using potential coverage holes to deny coverage entirely and instead seek to negotiate a reduced coverage amount.

Underlying the process has been a consistent pattern, this being that as concerns about legal risks faced by directors have emerged, markets and lawmakers have responded so as to preserve the incumbent equilibrium. For instance, gaps in insurance coverage have periodically become evident, but contracting practices have generally been revised before any outside directors have been caught out. This is because U.S. public companies, being keen to recruit and retain able directors, have typically proved willing to pay generous premiums to obtain additional coverage to close D & O insurance holes that have become apparent.

On the lawmaking front, lawyers and organizations representing U.S. business leaders have proved to be effective at lobbying for reforms designed to alleviate the fears that have arisen periodically concerning director liability. For instance, in the mid-1980s the *Van Gorkom* decision served as the catalyst for the enactment of the statutory provisions that permit companies to adopt corporate charter provisions eliminating liability for breaches of the duty of care.[39] Similarly, a decade later a surge in securities litigation prompted the enactment of the Private Securities Litigation Reform Act of 1995, which was designed to reduce directors' exposure along several dimensions.[40]

IV. Outside Director Liability Outside the United States

A. Scope of Our Research

[39] Hamilton, *supra* note xx, 459-60.

[40] For a succinct overview of the changes brought in by the Act, see Hamilton, *supra* note xx, 562-72.

We have undertaken, in tandem with our research on the United States, a survey of outside director liability covering three representative common law countries (Australia, Britain and Canada) and three civil law jurisdictions (France, Germany and Japan).[41] The legal terrain, including the conduct for which outside directors can be found liable and the procedural obstacles to a suit against directors, varies substantially in these six countries. But for outside directors of public companies the bottom line ultimately is the same as in the United States: out-of-pocket liability is extremely rare.

B. Director Liability: Sources

In our six sample countries, there are three basic sources of civil liability for directors. First, there is the set of duties directors owe to their companies. For instance, with those serving on the supervisory board of a German stock corporation, section 116 of the German Stock Corporation Act (Aktiengesetz or "AktG") sets down the basic norms. It stipulates that section 93 of the same Act, which spells out the duties and responsibilities of those serving on the management board, applies analogously to supervisory board directors. Taken together, sections 93 and 116 of the AktG require members of the supervisory board to perform their duties with the care of a diligent and conscientious businessperson who has been appointed a director.

Second, in each jurisdiction, investors can have a cause of action against directors of a public company that has engaged in misdisclosure. For instance, in Germany a director named in a defective prospectus as an individual assuming

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41 See Black and Cheffins, *supra* note xx.

responsibility for its contents will, subject to potential reliance on a due diligence defence, be personally accountable to investors adversely affected.[42] German shareholders may soon have greater scope to bring suits against supervisory board directors based on allegations of misdisclosure. As matters currently stand, when a stock corporation publicly disseminates false or misleading information other than via a prospectus there generally can only be civil liability if there is evidence of criminal intent.[43] The German government, in a 2004 proposal on the law pertaining to the liability for capital market information, indicated it favored establishing civil liability for directors with a negligence standard.[44]

Third, the onset of severe financial distress can create additional legal responsibilities for a company's outside directors. In Germany, this occurs in a somewhat roundabout way. Once a stock corporation 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", have the company enter proceedings under Germany insolvency legislation.[45] As mentioned, by virtue of section 116 of the German Stock Corporation Act, the general duties and responsibilities of those serving on the management board apply analogously to supervisory board directors. The statutory rules creating an obligation to put a financially troubled company into bankruptcy apply exclusively, however, to the management board. This reduces substantially the

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42 BörsG (Börsengesetz), § 44.

43 Ulrich Noack and Dirk Zetzsche, Corporate Governance Reform in Germany: The Second Decade, AZW Series on German & International Civil and Business Law Working Paper No. 2005_01_02, available at SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=646761, 23 (2005).

44 Noack and Zetzsche, *ibid.*

legal hazards faced by supervisory board members. Still, a breach of duty can be found if a supervisory board has failed to use reasonable means to prompt the management board to initiate bankruptcy proceedings, so the statutory rules requiring prompt action when a stock corporation becomes unable to pay its debts do pose some risks for supervisory board directors.[46]

C. Layers of Protection

In our six sample countries, indemnification and D & O insurance both potentially provide some level of protection to outside directors of public companies. Due to legal factors and market demand, however, the assistance offered is less substantial than is the case in the United States. Germany illustrates that the layers of protection are less robust. For instance, with indemnification there are some doubts about its legality and it is an exceptional practice in stock corporations.[47] Similarly, with D & O insurance, its legal status is not entirely free from doubt and the market for coverage is not nearly as lucrative or well-established as it is in the United States.[48] Nevertheless, concerns about growing risks are in fact fostering increased demand for D & O cover by German stock corporations.[49]

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45 AktG, § 92(2).

46 Note, for instance, a successful 5 million DM suit brought by an insolvency administrator against a supervisory board member in LG Bielefeld, ZIP 2000, 20.

47 Theodor Baums, Personal Liabilities of Company Directors in German Law, 9 Int. Co. Comm. L. Rev. 318, 322 (1996); Donna Ferrera, Protecting Decisionmakers Abroad, Risk Management, September 1999, 23.

48 Baums, "Personal", *supra* note xx, 324; Elizabeth Souder, Executive Insurance Takes Off, Wall St. J., February 7, 2003, M3.

49 Souder, "Executive", *supra* note xx; "D & O Growth", Lloyd's List

The expansion in D & O coverage ironically could serve as a catalyst for litigation against directors. As more companies take out D & O policies, and as coverage limits rise, it becomes increasingly likely that insurance cover will constitute a potential deep pocket for plaintiffs in civil suits to aim at. This, in turn, could foster additional litigation against directors. The out-of-pocket liability "bottom line" should not change, however, for them. Assuming the settlement incentives discussed as part of our analysis of the United States come into play, with suits that are launched the insurer should step into the breach and satisfy claims against outside directors within the policy limits.

D. Obstacles to Litigation

A key reason why outside the U.S. indemnification and D & O insurance are not fully developed as layers of protection is that demand has been less acute since suits against directors have been rare.[50] A combination of procedural hurdles and practical considerations discourage litigation, as an analysis of German securities law illustrates. One key consideration is that in Germany, as is the case with most civil law countries, full-blown class actions are not feasible.[51] Instead, those claiming damages have to proceed on an individual basis.[52] The procedural inconvenience involved has in all likelihood discouraged securities litigation to some degree.[53]

International, March 21, 2001, 10.

[50] Fanto, "Role", *supra* note xx, 83; Curtis J. Milhaupt, A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law, 37 Harvard J. of International Law 3, 34 (1996).

[51] Gerhard Walter, Mass Tort Litigation in Germany and Switzerland, 11 Duke J. of Comparative & International Law 369, 372-73 (2001).

[52] Walter, Mass, *supra* note xx, 372-73; see also Corinna Budras,

The German government, in proposals issued in 2004, indicated its intention to facilitate the collectivization of disclosure-related claims arising from the same set of facts, with the idea being to channel matters through a single suit conducted by the claimant with the single highest damages claim.[54] Even if this change to the law is made, however, supervisory board directors are still unlikely to become regular targets in securities lawsuits. One key consideration is a significant downside risk for plaintiffs that is absent in the United States, namely ending up on the wrong side of the "loser pays" civil litigation rule that operates in Germany.[55] Due to the rule, if a suit brought against outside directors is dismissed then, even if the plaintiffs are successful against other defendants, the outside directors should be able to seek an order compelling the plaintiffs to reimburse their legal expenses. With the stakes raised in this way, leaving outside directors out of the picture will often be sensible, especially when defendants are available who are more likely to be culpable (e.g. the inside directors) and/or deeper-pocketed (e.g. auditors and other professional advisers).

Should the German government follow through on its 2004 proposal to establish negligence-oriented civil liability for directors of stock corporations that engage in misdisclosure, yet another factor will deter lawsuits against supervisory

Litigation Logjam, National Post, November 24, 2004, FP 10 (describing the work being done by a Frankfurt Regional court to sort through and rationalize 15,000 separate claims brought by shareholders alleging they had been misled by alleged misdisclosure by Deutsche Telekom AG).

53 Ángel R. Oquendo, Breaking on Through to the Other Side: Understanding Continental European Corporate Governance, 22 University of Pennsylvania J. of International Econ. Law 975, 1014 (2001).

54 Noack and Zetzsche, *supra* note xx, 24-25.

board members. This is that, under the current proposal, liability of board members would be limited to four years' income.[56] Given the low pay of German supervisory board directors (again between €5,000 to €102,000 annually),[57] if the cap is implemented "as is" the maximum damages recoverable will be too low for plaintiffs to find it worthwhile to add the directors as defendants.

E. Public Enforcement

Even if civil lawsuits pose little risk to directors outside the United States, public officials might step into the breach and seek sanctions against alleged wrongdoers. Indeed, in our six sample countries there are numerous statutory provisions under which directors can be fined.[58] For outside directors, though, the saving grace has been that prosecutorial activity has typically been negligible, at least in relation to individuals not involved in day-to-day management.[59] It appears that this is the case in Germany as much as elsewhere. As one critic of current arrangements in Germany said in 1998:

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55 Code of Civil Procedure (Zivilprozessordnung or ZPO), § 91.

56 Noack and Zetzsche, *supra* note xx, 23.

57 *Supra* note xx and related discussion.

58 See, for example, Martha Bruce, Rights and Duties of Directors 47 (2000) (saying that there are approximately 250 offences directors can commit under U.K. companies legislation); Jonathan Clough and Carmel Mulhern, The Prosecution of Corporations 130 (2002) (discussing Australia); Ronald J. Daniels and Susan M. Hutton, The Capricious Cushion: Implications of the Directors' and Officers' Insurance Liability Crisis on Canadian Corporate Governance, 22 Can. Bus. L.J. 182, 220 (1993) (discussing Canada).

59 See, for example, Toronto Stock Exchange Committee on Corporate Governance in Canada, Report: Where Were the Directors? Guidelines for Improved Corporate Governance in Canada 35 (1994); Neil Andrews, If the Dog Catches the Mice: The Civil Settlement of Criminal Conduct Under the Corporations Act and the

> "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."[60]

V. Exceptions

While a combination of factors insulates outside directors of public companies from liability, the risks are not zero. Despite the factors weighing heavily against the likelihood of such individuals paying out of their own pocket, they are not fully insulated. Instead, in each jurisdiction there have been isolated instances where outside directors of public companies have ended up paying damages or a related financial penalty, or could have been in this position with a minor adjustment of the facts. To appreciate fully the risks those serving in this capacity face it is necessary to take into account a scenario that can pose genuine dangers, this being one where the party in control of a lawsuit is motivated by concerns extending beyond the costs and benefits of recovery in the immediate case. On this count, settlements reached following the Enron and WorldCom corporate governance scandals are instructive.

In the opening months of 2005, out-of-court settlements were announced under which former outside directors of WorldCom and Enron agreed to pay a total of $35 million out of their own pockets in securities class action lawsuits. With Enron, an energy company whose 2001 bankruptcy was the largest to that point in U.S. history, ten former Enron outside directors agreed to pay personally $13 million as

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Australian Securities and Investment Act, 15 Aust. J. Corp. L. 137, 137 (2003).

60 Gerd Eidam, "Forms of Criminal Responsibility of Organisations: Aspects of Legal Practice in Germany" in Albin Eser, Günter Heine and Barbara

part of a \$168 million settlement.[61] With WorldCom, a telecommunications company whose 2002 bankruptcy was even larger than Enron's, eleven ex-directors agreed to pay \$20 million of their own money as part of a \$55 million settlement, with the remainder being paid by insurance.[62] The two settlements were widely acknowledged as path-breaking, with many observers noting out-of-pocket payments Enron's and WorldCom's ex-outside directors agreed to make were extraordinary in the American context.[63] Richard Breeden, former chairman of the Securities and Exchange Commission, said of the WorldCom agreement that "(i)t will send a shudder through boardrooms across America and has the potential to change the rules of the game".[64]

What happened with Enron and WorldCom? Why, contrary to the standard pattern, were the directors at risk of paying personally? Part of the explanation is that elements of the Perfect Storm described earlier were present. For instance, since Enron and WorldCom both ended up in bankruptcy, they could not bail out their outside directors. Moreover, investigations conducted into the collapse of the two companies uncovered substantial evidence suggesting that the directors had been lax

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Huber (eds.), Criminal Responsibility of Legal and Collective Entities 59, 64 (1999).

[61] Ben White, Former Directors Agree to Settle Class Actions, Washington Post, January 8, 2005, E1.

[62] The WorldCom settlement was initially side-tracked by a January 2005 court ruling: In re WorldCom Securities Litigation, 02 Civ. 3288 (D.L.C.), 2005 WL 335201. The deal was successfully revived in March. See Ben White, WorldCom Ex-Leaders Reach Deal in Lawsuit, Washington Post, March 19, 2005, E1.

[63] See, for example, Joann S. Lublin, Theo Francis and Jonathan Weil, Directors are Getting the Jitters, Wall Street Journal, January 13, 2005, B1; Ben White, Directors Run Risk of Paying Penalties Out of Their Pockets, Washington Post, January 20, 2005, E1.

[64] Quoted in Brooke A. Masters and Kathleen Day, 10Ex-WorldCom Directors Agree to Settlement, January 6, 2005, Washington Post, E6.

in performing their duties.[65] The outside directors were also at risk because with WorldCom the insurers had plausible grounds to deny the claim and because with Enron the coverage available was being rapidly eroded by escalating legal costs.[66]

In both WorldCom and Enron, however, there was more—namely an explicit agenda on the part of plaintiffs to get outside directors to pay out of their own pocket. With the Enron securities litigation, the rationale the lead plaintiff used in treating extraction of personal payments by the outside directors as a priority was to retrieve allegedly ill-gotten trading gains derived from the sale of Enron stock when share prices were high as a result of the fraud afflicting the company.[67] With WorldCom, the New York State Common Retirement Fund, acting as lead plaintiff for the securities class action, made it a condition of settlement that WorldCom directors would have to pay at least some of the damages out of their own pocket.[68] This was

65 On Enron, see Permanent Subcomittee on Investigations of the Committee on Governmental Affairs, United States Senate (Report), The Role of the Board of Directors in Enron's Collapse, 107th Congress, 2d session, Report 107-70, (July 8, 2002). On WorldCom, see Dick Thornburgh, Second Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, In re WorldCom Inc. *et al.*, (June 9, 2003).

66 White, Directors, *supra* note xx (discussing WorldCom); on Enron, see Former Outside Directors' Brief in Support of Application for Preliminary Injunction Against All Persons Named as Party Defendants in the Interpleader Action, filed in relation to In Re Enron Corporation Securities, Derivative & ERISA Litigation (Nov. 2, 2004), available on the Westlaw electronic database, document 2004 WL 2495139.

67 Kurt Eichenwald, Ex-Directors at Enron to Chip in on Settlement, New York Times, January 8, 2005; Dale Kasler, Enron Board Members Settle California University-Led Lawsuit for $168 Million, Sacramento Bee, January 8, 2005 (quoting James Holst, general counsel for lead plaintiff, who said of the deal, "it's especially significant that these outside directors were made to disgorge some of their insider trading proceeds").

68 White, Directors, *supra* note xx.

apparently done "to send a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent."[69]

Private litigants are not the only parties that can create liability risk for outside directors by making it a priority that directors take a financial hit. A 2004 settlement the U.S. Department of Labor reached with ex-directors of Enron in litigation relating to alleged mismanagement of the company's pension plans illustrates the point. The directors agreed under the deal reached to pay personally $1.5 million. Given Enron's large workforce, the settlement would have yielded only a tiny pay-out to individual employees,[70] which indicates it was essentially symbolic in orientation. Compensation, on the other hand, apparently was the primary motive with civil lawsuits based on a similar cause of action that settled simultaneously with the Department of Labor case. With these proceedings, the settlement was for $85 million, with Enron insurance policies providing the money.[71]

It should not be surprising that public officials will, under certain circumstances, make it a priority to inflict a financial penalty on outside directors. If a public company collapses financially amidst widely publicized allegations of dishonesty and mismanagement, regulators and prosecutors run the risk of being criticized for being soft on corporate wrongdoing if they fail to act. A potentially potent way to "do something" and "send a message" will be to launch proceedings

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[69] Press Release, Office of New York State Comptroller, Jan. 7, 2005, http://www.osc.state.ny.us/press/releases/ jan05/010705.htm .

[70] Mary Flood and David Kaplan, Up to 20,000 Could Split $69 Million, Houston Chronicle, Business, May 13, 2004, 1.

[71] *Ibid.*

against the directors involved. Public officials are aware of resource constraints and the costs of legal proceedings.[72] Nevertheless, when a lawsuit has symbolic value, there will be a potent incentive to go ahead even with a complex and challenging case. Moreover, in the event a judgment is obtained, a regulator or prosecutor apprehensive of criticism for letting wrongdoers escape liability will be inclined to ensure that, despite potential inconvenience and delay, the directors are held financially accountable for wrongdoing committed.

Amongst the countries we have analyzed for the purposes of our research, Australia is the jurisdiction where public officials have proved the most willing to seek to penalize outside directors financially. The Australian Securities and Insurance Commission (ASIC) is authorized to apply for civil penalties for a list of breaches of Australian companies and insolvency legislation. This sanction resembles a fine but has a compensatory aspect and is not imposed through the criminal process but rather with the lower standards of proof associated with civil litigation.[73] Traditionally, civil penalty orders have been rare.[74] In 2000, however, a new ASIC chairman, labeled by the press as "a very public sheriff"[75] with "a reputation for putting big heads on

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[72] See Keith Hawkins, Law as a Last Resort: Prosecution Decision-Making in a Regulatory Agency 318-24 (2001).

[73] Andrews, If the Dog, *supra* note xx, 150.

[74] Andrews, *ibid.*, 151; George Gilligan, Helen Bird and Ian Ramsay, Civil Penalties and the Enforcement of Directors' Duties, 22 Univ. New South Wales Law J. 417 (1999).

[75] Samantha Hughes, Inside David Knott's Trophy Cabinet, Weekend Australian, January 4, 2003, 21.

sticks",[76] ensured the ASIC targeted high-profile individuals involved in the collapse of major Australian companies.

Subsequently, three outside directors of Australian public companies were subjected to out-of-pocket liability in three separate proceedings, with the first being sanctioned for breach of duties of care owed to the company,[77] the second for infringing statutory obligations concerning corporate disclosure[78] and the third for improperly allowing trading to continue when insolvency was inevitable.[79] The ASIC chairmanship changed hands again in 2003, with the incoming chairman striking a more conciliatory tone.[80] It thus remains to be seen whether ASIC enforcement will be an enduring exception to the general pattern of minimal risk this chapter has identified.

What about Germany? There is one recent much-publicized instance where public officials have sought to inflict financial penalties on the supervisory board directors of a stock corporation. Following Vodafone Group plc's controversial 2000 takeover of Mannesmann, the telecoms company, German prosecutors laid charges against two prominent members of Mannesmann's supervisory board -- Josef Ackermann, chief executive of Deutsche Bank, and Klaus Zwickel, the head of a major German union -- citing the supervisory board's decision to authorize $60

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76 Anne Lampe, "Good Cop", Sydney Morning Herald, September 18, 2004, 43.

77 ASIC v. Rich [2003] NSWSC 85; ASIC v Rich [2004] NSWSC 836.

78 ASIC v Loiterton *et al.* [2004] NSWSC 897.

79 ASIC v Plymin [2003] VSC 123, ASIC v. Plymin, Elliott & Harrison (No. 2) [2003] VSC 230.

80 Lampe, "Good", *supra* note xx.

million in executive bonuses as a reward for a deal well done. The prosecution argued that the bonus payments breached a provision in Germany's criminal code making it an offence for those managing property on behalf of another (i.e. the Mannesmann directors on behalf of the company) to fail to safeguard that property.[81]

The charges against the Mannesmann directors were ultimately dismissed. Nevertheless, the outcome was still something of a nightmare for the supervisory board directors. The trial attracted much media attention, the judge speculated that the defendants may have breached duties owed under German corporate law and in 2005 Germany's most senior federal public prosecutor launched efforts to secure a retrial.[82] Supervisory board directors of German stock corporations can take comfort, however, from the fact that the Mannesmann prosecution was highly exceptional. According to press reports, the trial constituted the first prosecution ever of individuals serving in this capacity.[83]

VI. Conclusion

Our analysis of law and practice in seven major jurisdictions indicates outside directors of public companies rarely pay damages, financial penalties, or legal expenses out-of-pocket.[84] There could, however, be a counter-trend emerging, with

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81 Tony Major, "Trial to Test German Reform", Fin. Times (US edition), September 20/21, 2003, 8; Tony Major and Uta Harnischfeger, "German Newspapers Back Ackermann Trial", Fin. Times, September 24, 2003, 32.

82 Bönisch/Domen, Gravierende Verstöße, Der Spiegel, May 9, 2005, 103.

83 Max Phillip Rolshoven, The Last Word? The July 22, 2004 Acquittals in the Mannesmann Trial, (2004) 5 German Law Journal 935, 939-40.

84 We have also considered the situation in Korea and found the outcome

"public-minded" regulators and plaintiffs seeking to send a message to those serving on company boards. An initial reaction might be to welcome the increased threat of financial sanctions, with the logic being that outside directors will be more vigilant if they fear ending up out-of-pocket as a result of lax supervision of corporate executives. Certainly, media pundits and corporate governance experts hailed the Enron and WorldCom securities class action settlements as a victory for investors, saying that the deals struck should induce directors to perform better.[85]

Despite this reaction, for various reasons it is far from clear that exposing outside directors to a substantial risk of out-of-pocket is a sensible move. First, individuals serving in this capacity have various incentives to do a good job even if the risk they face of ending up out-of-pocket is tiny. For instance, norms of good corporate governance and proper boardroom conduct help to foster director vigilance, in large part because directors risk forfeiting their hard-earned reputations as respected business figures if they fail to meet accepted standards.[86] Moreover, lawsuits entangle directors in time-consuming and aggravating work. Desire to avoid these nuisance costs provide those serving on company boards with incentives to be diligent, even if out-of-pocket liability is only a remote possibility.

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to be the same there: Bernard Black, Brian Cheffins and Michael Klausner, Shareholder Suits and Outside Director Liability: The Case of Korea, forthcoming in Young-Jae Lim, (ed.), Corporate Governance and the Capital Market in Korea.

[85] Gretchen Morgenson, If Directors Snooze, They May Lose, New York Times, January 9, 2005; Diane Francis, At Long Last, Directors May be Liable for Actions, National Post, January 11, 2005, FP 2.

[86] Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Columbia L. Rev. 1253, 1268 (1999).

Second, a substantial increase in the risk of out-of-pocket liability could generate counter-productive effects in the boardroom. For instance, outside directors legitimately fearing financial ruin could well begin to act defensively and decline to endorse sensible business gambles that shareholders would applaud.[87] Moreover, board meetings might become longer and more frequent, as directors seek to increase the likelihood that their deliberations will pass muster in the event of a suit.[88] Up to some unquantifiable point, careful deliberation and awareness of potential risks is beneficial. But if out-of-pocket liability were common, boards might spend too much time fussing over perfectly reasonable business decisions and sacrificing time that could be devoted to debating crucial long-term strategy issues.

Third, a dramatic increase in liability risk could have an adverse impact on the quality of board appointments.[89] The available evidence suggests outside directors substantially overestimate the likelihood they will have to pay damages out of their own pockets.[90] Correspondingly, high-profile cases where private litigants or public officials seek to "send a message" to those serving in the boardroom by extracting

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[87] Bayless Manning, The Business Judgment Rule and the Director's Duty of Attention: Time for Reality, 39 Bus. Lawyer 1477, 1481-86 (1984); Stephen M. Bainbridge, Why a Board? Group Decisionmaking in Corporate Governance, 55 Vanderbilt L. Rev. 1, 50 (2002).

[88] Jay W. Lorsch (with Elizabeth MacIver), Pawns or Potentates : The Reality of America's Corporate Boards 104 (1989).

[89] William T. Allen, Jack B. Jacobs and Leo E. Strine, 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. Univ. L. Rev. 449, 455-56 (2002).

[90] For example, though there were virtually no instances of out-of-pocket liability prior to the Enron scandal, a 2002 survey of U.S. directors found that 22% of respondents felt they faced a very significant risk of being held personally liable and 62% were "somewhat" concerned. See McKinsey & Co., The Need for Informed

personal payments could have a dramatic and counterproductive impact on an already skittish group and lead well-qualified individuals to steer clear of directorships of public companies. Corporate governance could then suffer markedly, since outside directors play a central role in overseeing management in these important firms.

Companies seeking to recruit top-flight boardroom candidates theoretically could increase directors' fees to compensate for fears generated by instances of out-of-pocket liability. It is hard to imagine, however, how high directors' fees would have to be in order to change the minds of individuals seriously fearing financial ruin. Moreover, if director remuneration becomes genuinely lucrative, some directors might become too dependent on their positions and lose the independence that is felt to be critical to good corporate governance.[91]

We are not arguing that current arrangements are necessarily optimal. If there was a reasonable likelihood of outside directors paying damages or legal expenses they might indeed worry more about doing a good job than they do at present. Correspondingly, from a purely theoretical perspective, increasing the risk of outside directors paying out of their own pockets while using liability caps to ensure innocent (if inattentive) directors did not end up bankrupt could improve incentives without causing an exodus from the boardroom.[92] Nevertheless, our assessment of the potential costs and benefits of out-of-pocket liability leads us to believe that, consistent with the cross-border pattern we have identified in this paper, out-of-pocket

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Change in the Boardroom 7 (2002).

91 Cheffins, Company Law, *supra* note xx, 101.

92 We will be considering this possibility further in future research.

liability should generally remain a rare outcome for outside directors of public companies.

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Financial assistance for the services of the editorial assistant of these series is provided by the European Commission through its RTN Programme on European Corporate Governance Training Network (Contract no. MRTN-CT-2004-504799).

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