Private Enforcement of Corporate Law:
An Empirical Comparison of the US and UK

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Abstract: It is often assumed that strong securities markets require good protection of minority shareholders. This implies not just "good" law, but "good" enforcement as well. Yet there has been little empirical analysis of enforcement. Accordingly, we study private enforcement of shareholder rights under corporate law in two common law jurisdictions with strong securities markets, the US and the UK. For both countries, we examine the extent to which inside and outside directors of public companies are targeted by lawsuits under corporate law, and the outcomes of those suits. We find while numerous lawsuits are launched in the US, private enforcement is rare in the UK. We explain why this disparity exists and draw attention to potential substitutes for private enforcement in the UK. We also find that even in the US only a small fraction generate a judicial decision, let alone a trial. Given this, and given that damages are paid principally by the company and D&O insurers, even in the US private enforcement of corporate law may not be a key foundation for its strong securities markets.

[Note to discussant and readers: The collection and analysis of data is still ongoing. As a result, different tables sometimes have slightly different numbers of cases, because some have been updated more recently than others, or because inconsistencies emerged too late to be resolved.]

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Private Enforcement of Corporate and Securities Law: An Empirical Comparison of the US and UK

Nearly a century ago, Roscoe Pound memorably drew attention to the divide between "law in books" and "law in action".[1] The distinction between substantive legal doctrine (the "law in books") and enforcement ("law in action") is belatedly emerging as an important element in a lively ongoing debate about the extent to which law explains differences in corporate governance arrangements around the world. Beginning in the late 1990s, a group of financial economists known collectively as "LLSV" reported in a series of widely cited studies that corporate laws which protect minority shareholders are associated with deep and liquid securities markets.[2] The research, though path-breaking, suffers from important limitations. Recoding of corporate law by lawyers has cast doubt on the results.[3] Also, the focus was almost entirely on "law in books". Enforcement, in this first wave of comparative research, was left to one side.

The fact there is now a live public debate on the desirability of private lawsuits in the corporate context underscores the limitations of comparative corporate governance research that fails to account for the "law in action". Many in Europe, keen to expand domestic capital markets and improve corporate governance, view the institutions that facilitate private enforcement in the US as a potentially desirable import, and are seeking to change the procedural rules that inhibit private suits.[4] Recent reforms in various countries have moved in this direction. Some in the US see active enforcement as a core strength of US markets, which helps to explain a US cross-listing premium -- the tendency for firms cross-listed in the US to trade at

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[1] Roscoe Pound, *Law in Books and Law in Action*, 44 AMER. L. REV. 12 (1910).

[2] "LLSV" is short-hand for Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and Robert Vishny. In more recent projects, Vishny has dropped off and Simeon Djankov has sometimes joined the group. See, for example, Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer & Robert Vishny, *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-97 (1999); Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer & Robert Vishny, *Law and Finance* 106 J. POL. ECON. 1113 (1998); see also sources cited in note xx infra.

[3] The predictive value of the initial LLSV index of shareholder rights (which they called "antidirector rights") disappears when the relevant laws are recoded by lawyers. See Priya Lele & Mathias Siems, *Shareholder Protection: A Leximetric Approach* (working paper 2006), at http://ssrn.com/abstract=897479 (US had notably weak shareholder rights prior to adoption of Sarbanes-Oxley Act in 2002); Holger Spammann, *On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' Under Consistent Coding* (working paper 2006), at http://ssrn.com/abstract=894301 (finding only a 0.41 correlation between original LLSV index and his own recoding). This criticism does not extend to their later effort to code securities laws. Rafael La Porta, Florencio Lopes-de-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. Fin. 1 (2006).

[4] See, e.g., Jonathan R. Hay & Andrei Shleifer, *Private Enforcement of Public Laws: A Theory of Legal Reform*, 88 Am. Econ. Rev. 398 (1998) (advocating use of private enforcement in transition economies where public enforcement agencies cannot be relied upon); Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The* Parmalat *Case*, in John Armour & Joseph A. McCahery (eds.), After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US, 159, 194-206 (2006) (advocating increased use of private enforcement given limitations of public enforcement in Italy); *cf.* Paul Davies, Davies Review of Issuer Liability: Final Report (2007), at http://www.hm-treasury.gov.uk/independent_reviews/davies_review/davies_review_index.cfm (concluding that significant expansion in private liability of UK issuers for securities misdisclosure is undesirable).

higher prices than similar non-cross-listed firms.[5] Yet others in the US lament allegedly excessive litigation against companies and directors, and worry that lawsuit-friendly rules harm the competitiveness of US markets and US firms.[6] In contrast, the UK is conventionally thought to be less litigious, perhaps providing a competitive advantage.[7]

While the need to study enforcement is obvious, measurement is a non-trivial task. Enforcement can be by public agencies or private individuals, if public it can be civil or criminal, and enforcement can occur through formal lawsuits or through more informal channels. Reliable data are not readily available for many of these means of enforcement, especially across jurisdictions. Academics have begun to address the gap but thus far the scholarship has largely focused on measuring formal enforcement powers—a version of "law in books"—or on input measures, such as the budget levels and staff of enforcement agencies, rather than outputs, such as actions brought and penalties levied.[8] Moreover, results differ, with some concluding that private enforcement is central for the development of stock markets,[9] but others reporting that

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5 See, for example, Coffee (2007), supra note xx; Craig Doidge, G. Andrew Karolyi & Rene M. Stulz, *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time*, working paper (2007), at http://ssrn.com/abstract=982193 (foreign firms which cross-list in the US enjoy a significant cross-listing premium, even after Sarbanes-Oxley Act; London listing provides no premium).

6 Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership*, available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf (2007); Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* available at http://www.capmktsreg.org/research.html (2006); Joseph A. Grundfest, *The Class-Action Market*, Wall St. J., February 7, 2007, at A15 (op-ed) (securities fraud class actions are "an expensive, wasteful and unnecessary sideshow" that should be abolished); Peter J. Wallison, *Capital Complaints*, Wall St. J., March 20, 2007, at A19 (op-ed). On the possible effect of the US Sarbanes-Oxley Act on corporate risk taking, see Kate Litvak, *Defensive Management: Does the Sarbanes-Oxley Act Discourage Corporate Risk-Taking*, working paper (2007), at http://ssrn.com/abstract=994584.

7 Bloomberg and Schumer (2007), *supra* note xx, exhibit 20 (63% of respondents to survey on New York's status as a financial center thought the UK was less litigious than the U.S; 17% thought the US less litigious; 20% thought the two about the same) Coffee (2007), *supra* note xx, at 35; Peter Montagnon, *The Cost to Europe of America's Class Action Addiction*, FIN. TIMES, Jan. 5, 2007, 15 ("UK shareholders find themselves less inclined to sue companies").

8 See John C. Coffee, *Law and the Market: The Impact of Enforcement* Columbia Law School Law and Economics Working Paper No. 304, , at http://ssrn.com/abstract=967482, at 16-17, 23-24, 29-37 (2007). For efforts to study actual enforcement, see Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Legal Penalties for Financial Misrepresentation* (working paper 2007), at http://ssrn.com/abstract=933333 (sanctions against insiders); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. Fin. 75 (2002) (share prices are higher in countries with enforced insider trading laws than in countries without such laws or with unenforced laws).

9 Simeon Djankov, Rafael La Porta, Florencio Lopes-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, NBER Working Paper 11883 (2005), at http://ssrn.com/abstract=864645, Tables VIII-X; La Porta, Lopes-de-Silanes & Shleifer (2006), supra note xx.

differences in public enforcement are of greater significance.[10] One study even asserts that no law is better than an unenforced law.[11]

While empirical research has begun on enforcement of corporate and securities law, debate over the merits of private enforcement has proceeded in the absence of comparative data on outputs. This paper constitutes a break with the trend, presenting new evidence, based on hand-collected datasets from the UK and the US, on the number and outcome of lawsuits brought against directors of publicly traded companies under corporate law.[12] Our study is, we believe, the first comparative quantitative analysis of the private enforcement of corporate law.

In the US, there has been some prior empirical work on shareholder litigation, though the work done has generally focused on particular jurisdictions (often Delaware) and has not dealt specifically with the risks directors face. We extend this work by using Westlaw case report databases to search judicial decisions from throughout the US and by examining in detail outcomes of cases where directors have been named as defendants. The empirical work done on the UK is scant, so our British research constitutes a pioneering effort. Our principal research strategy for the UK is to search court filings in the Chancery Division, the venue in which most litigation involving directors of publicly-traded companies will be brought under corporate law.

At one level, our findings confirm and quantify the conventional wisdom -- the US is more litigious than the UK. Both in terms of cases filed and judgments generated, lawsuit activity involving directors of publicly traded companies is much more substantial in the US than in the UK. But our findings also indicate that only a small minority of cases filed where directors of publicly traded companies are named as defendants meet a sufficiently high threshold of seriousness to generate a court judgment, whether interlocutory or at trial (most often the former).

Our findings raise a variety of questions, a number of which we take the opportunity to address in the paper. In the corporate context, is the pattern we find restricted to corporate law cases? A brief survey of available evidence on the related field of securities law indicates matters are much the same as with corporate law. Is private enforcement of corporate law necessary for the development of robust securities markets? The experience from the UK suggests not, but with the qualification that substitutes may be required. What substitutes can help to address the agency cost problem when lawsuits against directors are rare? We identify a number of plausible candidates in the UK and assess the extent to which they perform as substitutes in practice.

The paper proceeds as follows. Part 1 of the paper indicates why the UK and the US provide good countries to choose to compare, noting that while they share key

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[10] Howell E. Jackson & Mark J. Roe, *Public Enforcement of Securities Laws: Preliminary Evidence*, Working Paper (2007), at http://ssrn.com/abstract=1000086, at 36-37.

[11] Utpal Bhattacharya & Hazem Daouk, *When No Law is Better than a Good Law* (working paper 2006), at http://ssrn.com/abstract=558021.

[12] By 'publicly-traded', we mean companies that are listed, and traded, on a stock exchange. Such firms are often simply called 'public' companies in the US; however in the UK, 'public' companies refer to those which are legally permitted to be publicly-traded—only a small minority of which in fact are. In the UK, publicly-traded companies are usually referred to as 'listed' or 'quoted' companies. The term 'publicly-traded' is chosen for its intelligibility to readers from either jurisdiction.

similarities there are also important differences between them. Part 2 focuses on the United States. It describes the sources of litigation risk for US directors under corporate law, reviews prior empirical studies of shareholder suits, and discusses our findings on lawsuits brought against directors of US publicly-traded companies. Part 3 of the paper examines the situation in the United Kingdom. It summarizes the likely potential causes of action against UK directors, discusses the limited data currently available on private enforcement of corporate and securities laws and describes our results. Part 4 briefly summarizes research done on securities lawsuits, indicating the patterns we find are replicated in this related context. Part 5 discusses reasons for the different level of shareholder litigation in the US and the UK. Part 6 describes substitutes for private enforcement in the UK. Part 7 concludes.

1. Why the UK and the US?

In a variety of respects, the US and the UK stand out as good choices for this initial comparative study of private enforcement of corporate law. Again, there are concerns in the US that over-enforcement will cause the loss of stock market business as companies seek to trade their securities in more congenial markets. The UK stands out as the rival most often cited as the potential beneficiary, with the thinking being that companies will find the combination of London's highly sophisticated capital market and lighter regulatory touch to be attractive.[13]

A comparison between the US and the UK is also apt because they share various key features. After all, if their systems of corporate governance differed radically on all important dimensions a finding there were significant differences in levels of private enforcement would not be particularly surprising. One similarity is that both jurisdictions have active corporate control markets. The countries also share an "outsider/arm's-length" system of corporate governance, in the sense that most large business enterprises are widely held companies lacking a blockholder minded to exercise "insider" control.[14] This means that in both jurisdictions the primary corporate governance issue that needs to be addressed is ameliorating managerial agency costs, since diffuse shareholders tend to be ill-equipped to constrain potentially wayward executives.[15]

With the containment of agency costs standing out as a key corporate governance concern in both the UK and the US, law might be expected to play a similar role in both countries, namely keeping managers in check so investors can buy shares with confidence. There are indeed various noteworthy similarities on the legal side. Both countries are common law jurisdictions. Both also both offer a congenial environment for contractual performance. LLSV, in their pioneering study on the

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[13] Bloomberg and Schumer (2007), *supra* note xx, 12-17.

[14] See La Porta et al. (1999), *supra* note xx, at 497 ("in the United States and the UK . . . [even medium-sized] firms remain mostly widely held—a testimony to the attractiveness of selling out in the United States and the UK"). John Armour, *et al.* "Corporate Ownership and the Evolution of Bankruptcy Law: Lessons from the United Kingdom" (2002) 55 Vanderbilt Law Review 1699, 1704, 1715, 1750-52. *Cf* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, *Review of Financial Studies* (forthcoming 2007), available at http://ssrn.com/abstract=991363 (US firms are on average no more diffusely held than in many other countries, but that ownership of UK firms is the most diffuse in the world).

[15] These are the costs arising from the fact that managers have both discretion to make decisions affecting corporate assets and superior information to shareholders as to the circumstances surrounding the decisions taken.

impact corporate law has on the strength of securities markets, illustrate the point. They report not only that the US and the UK score better than most other countries but also score much the same as each other: the efficiency of the judicial system (10 out of 10 for both countries), the rule of law (10 for the US and 8.57 for the UK), corruption (9.10 for the UK and 8.63 for the US), the risk of expropriation of assets by the government (9.98 for the US and 9.71 for the U.K) and the risk of contract repudiation by the government (9.98 for the UK and 9.00 for the US).[16]

There are also key similarities in terms of corporate and securities law. In both countries directors owe duties to their companies that require them to act with due care, to act in the best interests of the company and to avoid conflicts of interest. Both jurisdictions provide scope for a derivative suit, thus enabling an individual shareholder to bring an action on behalf of the company against miscreant directors when the board declines to do so. There is also in both countries potential liability to outside investors for misstatements made in documentation distributed in support of public offerings of shares.

While the US and the UK resemble each other in various ways, the milieu within which publicly traded companies operate in the two countries differs in important ways. It is impractical and unnecessary to identify all of the distinctions here. The point can instead be made by identifying in tabular form differences concerning corporate and securities law (Table 1) and general civil litigation procedure (Table 2) we discuss in more detail in subsequent parts of the paper.

Table 1: Contrasting US and UK Corporate and Securities Law

Further details and supporting authority provided in subsequent parts of the paper.

Subject matter of regulation	**US**	**UK**
Directors' duties owed directly to shareholders	Commonplace	Rare
Authorization of companies to waive liability for breaches of duty of care	Commonplace	Prohibited
"Whitewashing" of problematic transactions by disinterested directors/shareholders	Effects uncertain, particularly when the transaction is with those controlling a company	Can be done reliably
Standing to sue in a derivative action	Fairly easy to obtain	Very difficult (up to 2007); perhaps somewhat easier now
Statutory relief available for oppressed/unfairly prejudiced shareholder in a public company	No	Yes
Scope for litigation in the context of takeovers	Extensive	Highly constrained
Scope for shareholder dismissal of directors by majority vote	Can be circumscribed fairly readily (e.g. staggered boards)	Few constraints
Liability for misdisclosure in the context of secondary trading	Provided for under SEC Rule 10(b)-5	Statutory liability for companies but not directors
Authoritative guidance on corporate governance "best practice"	None	"Combined Code"

[16] La Porta *et al.* "Law and Finance", *supra* note xx, 1140-43.

Table 2: Differences Between Civil Litigation Procedure in the US and UK

Further details and supporting authority provided in subsequent parts of the paper.

Litigation procedure	**US**	**UK**
Launching multi-party litigation	Certification readily available if criteria in federal civil procedure rules met	Recovering damages difficult in "representative action"/"group litigation order" is "opt in" scheme
Allocation of legal expenses of the party that prevails in court proceedings	Parties pay their own legal expenses regardless of the result	"Loser pays"
Contingency fees	Widely used	Prohibited; "conditional fee arrangements" a poor substitute
Provision made to account for the fact that a public company shareholder who launches a lawsuit will typically be entitled to a tiny pro rata recovery	"Common fund" doctrine	None

2. The United States

2.1 Sources of Litigation Risk for Directors of US Public Companies under Corporate Law

Under US state corporate law, a director's primary fiduciary duties are the duty of loyalty and the duty of care, supplemented by a duty of disclosure and a duty of special care when one's company is a takeover target.[17] Cases brought against directors alleging self-dealing, preferential treatment of a controlling shareholder, and other conflicts of interest are litigated as breaches of the duty of loyalty. A shareholder can seek enforcement for breach of duties directors owe to their company through a derivative suit, meaning the shareholder will be suing on the corporation's behalf. Another possibility is a "direct" suit seeking recovery based on the premise that directors have breached owed duties owed by directors directly to shareholders. These lawsuits are typically organized as a class action with the plaintiff shareholder suing on behalf of himself and other similarly situated shareholders.

Directors of US companies are beneficiaries of a series of protective devices that insulate them from paying damages personally in a trial for breach of duty or – much more commonly – where payments are made in a settlement with plaintiffs. State corporate law statutes typically contain a provision equivalent to Delaware's s. 102(b)(7), which authorizes companies to adopt an exculpatory provision protecting directors from personal liability for breach of the duty of care and the vast majority of publicly traded companies adopt such provisions.[18] For other breaches of duty, damages otherwise payable by a director can and often will be indemnified by the company or another source (e.g. a controlling shareholder) or covered by directors' and officers' (D&O) insurance. The result is that with lawsuits brought against directors of publicly-traded companies for breach of corporate and securities law there

[17] *See* Bernard Black, *The Core Fiduciary Duties of Outside Directors*, ASIA BUS. L. REV., July 2001, at 3, *available at* http://ssrn.com/ abstract=270749.

[18] Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability* 58 STAN. L. REV. 1055, 1090-91 (2006)

is an important distinction between "nominal" and "out-of-pocket" liability.[19] Nominal liability occurs when a director acknowledges liability in a settlement or is held liable in court proceedings. Due to various liability shields directors can rely upon, nominal liability rarely translates into "out-of-pocket" payments.

2.2 Literature Review

There have been a small number of empirical studies that offer a statistical picture of lawsuits brought under corporate law against directors of US publicly traded companies. The earliest study, published by Wood in 1944, focused on key state and federal courts in New York. He found nearly 600 derivative lawsuits brought against publicly-traded corporations between 1932 and 1942 but reporting only 13 resulted in judgments with recoveries for the plaintiffs and only 93 resulted in settlements.[20]

A 1980 study by Jones examined the volume of derivative suits, shareholder class actions and individual shareholder lawsuits affecting a sample of 190 Fortune 500 companies between 1971 and 1978. According to the study, while an average of 29 lawsuits were filed per year involving the sample companies, the distribution was highly skewed, with more than two thirds of the companies in the sample having no involvement with any shareholder lawsuit throughout the entire period.[21] A majority of the cases settled, and Jones reported a few instances where personal defendants, including directors, made payments in the settlements.[22] He did not offer, however, any systematic data on how often directors were sued or paid out of their own pocket.

Romano, in a 1991 study, examined shareholder litigation affecting a sample of 535 publicly-traded companies between the late 1960s and 1987. As with Jones, she found only a minority of the companies experienced a shareholder suit and that the lawsuits brought were clustered around a fairly small number of companies. She also found most lawsuits settled, with just over half involving monetary recovery and with the vast majority of settlements ultimately being paid by D&O insurance.[23] Romano did not offer any direct evidence on how often directors were sued or paid damages.

For the purposes of two related 2004 studies, Thompson and Thomas examined all complaints filed in the Delaware Court of Chancery in 1999 and 2000.[24]

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[19] On the distinction, see Black, Cheffins and Klausner, *ibid.*

[20] F. Wood, Survey and Report Regarding Stockholders' Derivative Suits (1944). A 1985 analysis of empirical research on the derivative suit reports on four studies, two of which are not discussed here because they focused primarily on securities fraud litigation and focused on cases arising in a single court in a single state: Bryant G. Garth, Ilene H. Nagel and Sheldon J. Plager, *Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate* 48 LAW & CONTEMP. PROBLEMS 137, 142-48 (1985).

[21] Thomas J. Jones, An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits, 1971-1978 60 B.U. L. Rev. 306, 313-14, 319 (1980).

[22] Thomas M. Jones, An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits, 60 B.U. L. REV. 542, 545-56 (1980)

[23] Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 60-62 (1991).

[24] Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004a) {below, Thompson & Thomas, *Delaware Class Actions*]; Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative*

Delaware was the logical choice for such a study, since about 60% of US publicly-traded companies are incorporated under Delaware law.[25] Thompson and Thomas found a large flow of suits against companies, 1280 complaints over the two years, of which 923 involved publicly traded companies and included claims based on breaches of fiduciary duty. After eliminating multiple complaints involving the same facts or transaction, they found 294 lawsuits involving publicly traded companies were breaches of fiduciary duty were alleged. Of these 213 were class actions (mostly related to takeover bids), 56 were derivative suits and 25 were other "direct" suits. Thompson and Thomas did not offer data specifically on the number of cases filed where damages were claimed but since a breach of duty was being alleged this relief was likely often sought.

Weiss and White, in a 2004 study, examined takeover-related class actions filed in Delaware. They, as with Thompson and Thomas, found the majority of complaints are filed very soon after announcement of the transaction and are dismissed without a settlement. Weiss and White reported an absence of trials where the plaintiffs prevail on the merits and evidence of attorney reluctance to press claims hard if time and effort is likely to be required to yield results.[26]

2.3 Our US Sample

In relation to corporate law cases, we sought to complement and build upon Thompson and Thomas' work on Delaware corporate litigation in two ways: 1) by investigating litigation launched elsewhere 2) by examining in greater depth lawsuits that met a threshold standard of seriousness. Since we are interested in the liability risk directors of public companies face, we deal only with lawsuits where directors have been named as defendants and the company involved is publicly traded. We examine suits against inside directors (those also serving as executives) as well outside directors.[27]

It is not practical to find, let alone examine, every corporate or securities law complaint in 50 states plus federal courts. So as to give our search nationwide reach we chose to search for suits brought in Delaware, other states and federal courts involving public companies where one or more directors was named as a defendant and which produced at least one judicial decision reported on Westlaw between Jan. 1, 2000 and July 31, 2007. Our core idea was that directors are most likely to contest strongly those cases filed where there is a serious prospect they will have to pay out of their own pocket. Hotly contested cases in turn are most likely to be the ones to generate judgments since for a judge to decide that issuing a written opinion is

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Lawsuits, 57 VAND. L. REV. 1747, 1772-77 (2004) [below, Thompson & Thomas, *Delaware Derivative Suits*].

[25] Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate* 46 J.L. & ECON. 383, 388, 391 (2003) (data as of 1999).

[26] Elliot J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797 (2004).

[27] In theory, one could imagine a suit that names officers but no directors. In practice, the executives most likely to be sued are typically also directors. Our search found no such cases.

merited both sides will likely have supported their case through extensive legal argument.[28]

Prior research done by Black, Cheffins and Klausner supports this logic. For a 2006 paper they found seven corporate cases with personal payments by outside directors of public companies since 1981. Six involved prior judicial decisions, and thus are consistent with our expectation. The seventh was a confidential case, so it is unknown whether the payment was preceded by a decision.

For the purposes of this paper, our search strategy was as follows. We began with all cases in the Westlaw DEBUS database (Delaware business cases) in our sample period which included the term "director" or "board." This produced 368 decisions, which we read. We excluded cases not involving suits launched by shareholders or creditors (for simplicity, we refer to these as "shareholder suits"), and suits involving private companies. If the opinion did not state whether the company was public, we verified its status using the SEC's EDGAR database of filings by public companies. In corporate litigation, a single set of facts often prompts multiple lawsuits, brought by different law firms, so we defined a "case" as a single set of facts prompting one or more lawsuits. In the end, we located 73 discrete Delaware cases on DEBUS which fit our sample criteria.

In theory, the DEBUS database should include all business law cases under Delaware law that result in a publicly available preliminary or final written judgment, in either state or federal court. We discovered, however, that DEBUS is incomplete, both in missing some corporate cases altogether, and in being slow to include recent cases. We therefore supplemented the DEBUS search by a combination of searching the Delaware Chancery Court website, and being attentive to various other sources that were likely to report significant Delaware decisions. This produced seven additional older Delaware cases, plus five recent cases not yet on DEBUS, giving us a total of 85 Delaware cases.[29]

For cases outside Delaware, we relied on the Westlaw MBUS database, which is the multi-state analogue to DEBUS, offering coverage of all states other than Delaware. The broad search for (director or board) returned 5,300 cases. In a test read of 250 cases, only a small fraction (10 cases, or 4%) fit the profile we were focusing on (again shareholder suits where directors of public companies have been named as defendants). We therefore experimented with more restrictive searches. We ended up requiring that the case also include (i) "public" or "stock" or "exchange" or "NASDAQ"; (ii) "shareholder or stockholder" in the same paragraph as "derivative" or "consolidat!" or "class action" and (iii) "fiduciary" or "care" or

[28] An exception where a director may face a serious risk of making a personal payment without a written opinion being generated is where the director is not insured (or insurance coverage is contested) and the company is insolvent, leaving no one to pay legal defense costs. Under such circumstances, a director might well be willing to pay out of his own pocket to settle early so as to avoid paying substantial legal expenses and perhaps a major damages payment after a trial.

[29] There were also another 15 instances in which one decision in a particular case was not on DEBUS, but another decision was. Overall, 20/145 (14%) of the Delaware decisions in our dataset were not on DEBUS, yet should have been.

"Revlon" or "fair dealing" or "buyout".[30] This search returned 183 decisions, including all 10 cases in our test sample of 250 cases.

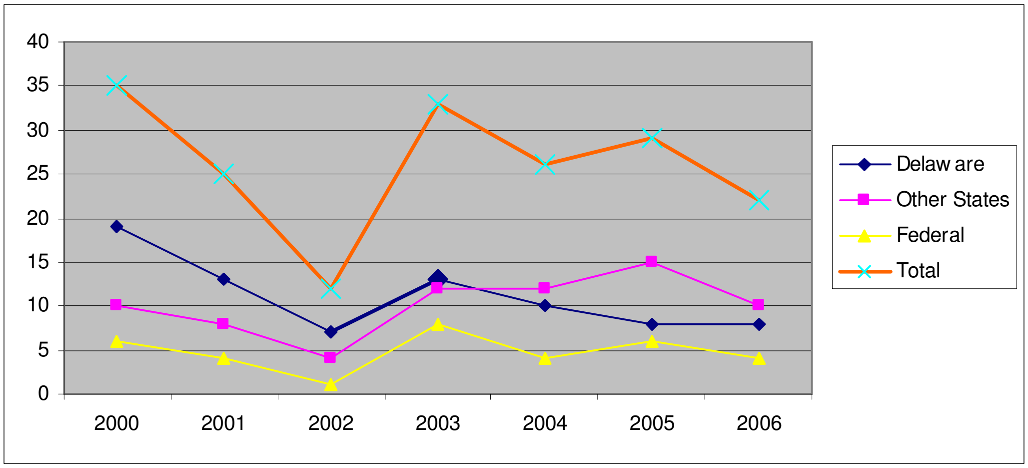
We read the 183 decisions and after filtering for disputes generating multiple opinions found a total of 77 cases states other than Delaware where directors of publicly traded companies had been named as defendants in a suit brought under corporate law. We added a couple of cases which came to our attention in other ways, but did not have a practical way to look systematically for cases that might be missing from the MBUS database. The DEBUS and MBUS database also includes corporate law decisions handed down by federal courts, and our searches uncovered 33 cases fitting our search criteria arising in federal courts.

Whenever we found a case through our DEBUS, MBUS, Delaware Chancery searches or other sources, we located and read all prior or subsequent decisions involving the same case through July 2007. When a case in our initial dataset referred to another case that seemed as if it might belong in our dataset, we read the other case and added it to the dataset if appropriate. When a shareholder sued successfully to see corporate books and records, we checked to see if there was a later suit against directors, but did not include the books-and-records case itself in our dataset because such cases do not, in and of themselves, implicate director liability. If a case produced more than one decision, we assigned the case to a particular year based on the first decision in the case.[31]

Figure 1 shows the annual totals for cases from Delaware, from other states and from federal courts (2007 is omitted because we have only partial year data). The overall flow is about 25 cases per year, including about 10 Delaware cases.

Figure 1. Corporate Cases: Annual Totals

Corporate law cases in database with one or more decisions on Westlaw over 2000-2006, in Delaware state court, other state courts, or federal court. If one case produces several decisions, we use the year of the first decision. See section 1.3.1 for search method.



[30] We used "Revlon" in our search because duties imposed on directors when a board is on the verge of selling the company are often labelled "Revlon duties", after *Revlon Inc. v. MacAndrews & Forbes Holdings,* 506 A.2d 173 (Del. 1986).

[31] If the first decision was in 1999 or earlier, we excluded the case from the dataset, as outside our target time frame.

Of the 194 cases in our dataset, 80 involved companies listed on the New York Stock Exchange (NYSE) and another 55 involved companies listed on the NASDAQ National Market (NASDAQ). The rest were smaller companies, traded on other markets. As of July 31, 2007, there were 1,800 US companies listed on the New York Stock Exchange and 2,800 on the NASDAQ National Market.[32] So the odds that such a company would end up in our dataset were about 3% (135/4,600), and the annual odds were 0.4%, or about 1 in 250.

The risk of directors paying out of their own pocket is greater when their company is insolvent since the company will not be able to pay damages to settle the case and since the directors cannot rely on the company for indemnification of damages payments or legal expenses.[33] As a result, we searched to find out if the companies involved in the cases had gone bankrupt. Of the companies involved, 23 were bankrupt. **[Discussion of bankruptcy search procedure and further results to come].**

In the end, we likely missed a few Delaware cases that generated some form of judgment, but not many. With other states and federal court cases, our hit rate was surely somewhat lower, because we relied on more restrictive search criteria and did not run backup searches akin to the one we ran with the Delaware Court of Chancery. Nevertheless, our efforts constitute the first systematic attempt to find out how often directors of publicly-traded companies nationwide are involved in lawsuits serious enough to generate a judgment, and thus offer new insights into the litigation risks such individuals face.

Our results reveal a significant discrepancy between cases filed and cases yielding a publicly available judgment. Again, Thompson and Thomas report nearly 300 cases filed over a two year period involving claims for breach of fiduciary duty where a public company was involved. In contrast, we find only about 10 Delaware cases per year with a director defendant that generates a publicly available judicial opinion.

There are various reasons why claims brought fail to generate a publicly available judgment. A partial answer is that about 40% of the cases Thompson and Thomas found were dismissed without prejudice and with no relief.[34] Though a judicial ruling would have been involved, under such circumstances a written opinion is unlikely. In addition, with settlements -- comprising another 25% of their sample – a judge usually must approve the deal struck but many of these cases will be sufficiently straightforward that an order is made without any supporting written opinion. Moreover, there are some cases that generate a written opinion where the relevant court does not authorize its public distribution.

Since cases generating a judgment are only a small proportion of cases filed, our data can at best provide only a partial picture of the litigation risk directors of US public companies face. Nevertheless, if our assumption is correct that suits which lead to a publicly distributed judicial decision are those most likely to be contentious and thus are most likely to involve a significant risk of directors facing liability, our

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[32] World Federation of Exchanges, Focus Report (Sept. 2007), at **[url to come]**

[33] See Black, Cheffins & Klausner (2006), *supra* note xx.

[34] Thompson & Thomas, *Delaware Class Actions* (2004a), *supra* note xx, Table 6.

database should include most suits brought where directors faced a serious risk of personal liability.

2.4 Who Was Sued/Types of Claims

Table 3 offers a breakdown of our cases along two dimensions. First, because we are interested in directors' financial exposure, we separate damages claims from cases where only other remedies were sought (principally injunctions or declaratory relief, but occasionally for appraisal relief or another remedy other than damages). Of the 194 cases, 85% (164/193) involve claims for damages against directors. Of the 164 cases, **[xx]** involved bankrupt companies, which again is an instance where the risk of director liability is more acute than usual.

Second, we identify whether the directors were inside or outside directors. The judicial opinions often indicated whether the defendant directors were insiders (and, if so, provided their titles) or outsiders. Some opinions named the defendants but did not indicate their status, and for these we verified matters by checking proxy statements on EDGAR. Some opinions referred to "directors" collectively and neither named them nor indicated their status. We treated these directors as having "undetermined" status. In those cases where some directors are named and some are not, those explicitly identified are usually insiders. This implies that unnamed directors will usually be outside directors. We so assume below, unless otherwise specified.

Table 3. Corporate Cases: Summary Data

Nature of claim for corporate law cases resulting in one or more decisions on Westlaw over 2000-July 2007, in Delaware state court, other state courts, or federal court.

Nature of Claim	Insiders Only	Outsiders Only	Undetermined Directors Only	Insiders & Outsiders	Insiders & Undetermined	Outsiders & Undetermined	**Total**
Damages	26	2	3	100	9	2	**142**
Damages plus another claim	3	0	2	16	1	0	**22**
Other claims only	2	0	0	22	6	0	**30**
Total	**31**	**2**	**5**	**138**	**16**	**2**	**194**

Almost all suits name insiders as defendants (184/194; 95%). In 162 out of the 194 cases (84%) outside directors or directors whose status is uncertain are named as defendants and in 154 of these 162 cases inside directors are named as defendants as well. When a case involves both inside and outside directors, the insiders are often the primary targets. The complaint will often allege various misdeeds by insiders, in rich detail, coupled with approval of the misdeeds by the outside directors, or allegations they failed to notice or respond appropriately to the insiders' actions. There is little likelihood of outside directors facing personal liability in this sort of scenario due to the exculpatory "due care" provisions publicly traded companies universally adopt.[35] Given this liability shield, we anticipate that outside directors have often been named as defendants to put collective pressure on the board to settle or, if matters do not settle quickly, to facilitate the gathering of evidence through discovery.

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[35] *Supra* note xx and related discussion.

2.5 Outcomes in Damages Cases

Again reflecting our focus on the liability risk facing directors, when studying outcomes we restrict our focus to the 164 cases raising damages claims since only these can result in directors facing risks out of paying of their own pocket. Table 4 sets out the principal outcomes, based on the results set out in the decisions in our dataset. In 75 of the cases (45.7% of the total), the defendants applied for a motion to dismiss or for summary judgment and were successful.

For the remaining 89 cases we read all opinions relating to the dispute to locate the final outcome. For Delaware cases, we also checked the Chancery Court's online records for a settlement or other outcome. For federal cases, we did the same using the PACER (Public Access to Court Electronic Records) system for electronic access to US District, Bankruptcy, and Appellate court records system.[36] For other states, the online availability of court records varies. We found some outcomes through online searches of court records, and some through searches for news stories. In the end, we have outcomes for **[xx]** of the 89 cases which were not struck out on a motion to dismiss or for summary judgment.

Among the 89 cases, trials are uncommon, with only six occurring in our sample. Of these, only two, the ICN case discussed in the next section and *Emerging Communications*, a freezeout and appraisal case, produced a verdict for the plaintiffs.[37] The four trials where the defendants prevailed include the highly publicized *Disney* case, one other Delaware case, a Kansas case, and a Texas case (applying Delaware law).[38] Our results are similar to those in a study Black and Cheffins did with Klausner on outside directors. They found 17 corporate trials over 25 years and we found six over 7-1/2 years.[39]

Table 4. Outcomes in Damages Cases

Principal outcome of reported decisions for corporate law cases with damages claims which result in one or more decisions on Westlaw over 2000-July 2007, in Delaware state court, other state courts, or federal court. Totals for outside directors include directors with undetermined status. See Section 1.3.1 for search method.

Principal Content of Decision	**Insiders Only**	**Insiders & Outsiders**	**Total**
Defendants' motion to dismiss or for summary judgment granted	13	62	**75**
Defendants' motion to dismiss or for summary judgment denied or partly denied	5	50	**55**
Plaintiffs' motion for summary judgment granted	1	0	**2**

[36] Available at http://pacer.psc.uscourts.gov/.

[37] Valeant Pharmaceuticals Intern. v. Jerney, 2007 WL 1500025 (Del. Ch.); *In re* Emerging Commc'ns, Inc. S'holders Litig., 2004 WL 1305745 (Del. Ch. 2004).

[38] *In re* Walt Disney Co. Derivative Litigation, 907 A.2d 693, (Del. Ch. 2005), *aff'd*, 906 A.2d 27, (Del. 2006); Benihana of Tokyo, Inc. v. Benihana, Inc., et al., 2005 WL 3462255, (Del. Ch.); Waddell & Reed Financial, Inc. v. Torchmark Corp., 337 F.Supp.2d 1243 (D. Kan. 2004); Havens v. Pate, Cause No. 2002-16085 (Harris County, Tx., 2005) (jury trial without opinion, but for a prior decision in this case, see Pate v. Elloway, 2003 WL 22682422 (Tex. Ct. App. 2003)).

[39] Black, Cheffins & Klausner (2006), *supra* note xx, at 1065. Of the four post-2000 cases in the BCK study, three are in our sample, the fourth involves a claim only against the company, not its directors, see Parnes v. Bally Entm't Corp., 2001 WL 224774 (Del. Ch. 2001).

Trial verdict for defendants	0	4	**4**
Trial verdict for plaintiffs	1	1	**2**
Settlement Approved	1	11	**12**
Settlement Denied		2	**2**
Stay Granted	1	2	**3**
Other	3	7	**10**
Total	**25**	**138**	**164**

[discussion of settlements and other outcomes to come once search for outcomes is completed]

2.6 Personal Payments: The Case of Outside Directors

When plaintiffs recover in lawsuits against directors of public companies, in most cases a D&O insurer ultimately pays. Unfortunately, settlement agreements and other court filings are not always clear on who ultimately paid any damages. To find out what in fact occurred, we paid special attention to indications in the decisions or settlement agreements that directors may have paid damages personally, and sought through news stories and other sources to discover whether directors had in fact made personal payments.

We were able with our research to update the effort by Black, Cheffins and Klausner to locate personal payments by outside directors. They report personal out of pocket payments by directors in three corporate law cases during our sample time period: Fuqua Industries, Lone Star Steakhouse, and a confidential case.[40] Searches undertaken for this project revealed three additional cases with personal payments by outside directors, Just for Feet; ICN Pharmaceuticals; and JTS Corp.[41]

[Discussion of Just for Feet and JTS to come. JTS is a self-dealing case; both are bankruptcy cases]

ICN involved the board approving $50 million in bonuses to insiders and outsiders under circumstances so raw that the award prompted a shareholder revolt; the shareholders installed a new board which then sued to recover the bonuses. The new board settled with the former outside directors for partial repayment, but pursued full repayment from the two principal executives.[42]

One lesson from these cases is that for outside directors to put money in their own pockets, apart from their regular compensation, can be a bad idea. Doing so creates the risk that you might have to pay it back. Lone Star Steakhouse, ICN Pharmaceuticals, and Just for Feet fit this pattern. A second lesson is that bankruptcy is an important risk factor. Two of the other three cases (Just for Feet and the confidential case) involved a bankrupt company; the third involved a bankrupt D&O insurer.

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[40] See Black, Cheffins & Klausner (2006), *supra* note xx, Table 2. Fuqua is technically not in our sample because the first reported decision precedes our sample period.

[41] There were also personal payments by insiders in ICN and in Health South. For Health South, see Tucker v. Scrushy, 2006 WL 2664197 (Ala. Cir. Ct. 2006), *aff'd*, 2006 WL 932013, (Ala. 2006), and Teachers' Retirement System of Louisiana v. Scrushy, 2004 WL 423122 (Del.Ch. 2004).

[42] **[details on sources and who paid how much to come]**.

3. United Kingdom

3.1 Sources of Litigation Risk

Under venerable case law authorities, UK directors owe several "core" duties to their companies. These include duties to act in the best interests of the company, to avoid conflicts of interest and duty and to act with care, skill and diligence. The Companies Act 2006 displaces the common law with a statutory statement of duties, with the key duties of directors being to act within their powers, to promote the success of the company, to exercise independent judgment, to exercise reasonable care, skill and diligence, to avoid conflicts of interest, to refrain from accepting benefits from third parties and to avoid unauthorised self-dealing.[43] The Act explicitly instructs courts to have regard to the corresponding common law rules and equitable principles in interpreting the general duties.[44]

UK companies legislation lacks a statutory provision equivalent to Delaware's § 102(b)(7) authorizing companies to exclude liability for breaches of the duties of care and skill. Instead, companies are prohibited from waiving or modifying the duties directors owe.[45] Directors, in addition to owing general duties to their companies, must comply with numerous regulatory and administrative obligations under companies legislation, but generally infringements of these obligations do not provide a legal foundation for civil suits.[46]

In most instances, directors of UK companies owe their duties solely to the company, which means the company, and the company alone, will be the only "proper plaintiff" in a potential suit alleging a breach of duty.[47] While it is in principle possible for directors to owe duties directly to shareholders the existence of any such duty depends on a demonstration that the directors have taken positive steps to create a legal obligation owed to shareholders.[48] This occurs rarely in publicly traded companies, meaning there is rarely a jurisprudential foundation for the "direct" breach of duty lawsuits that are so common in the US.

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[43] Companies Act 2006, §§ 172-77. Most of these provisions (except sections 175-177) came into force on 1 October 2007: see Companies Act 2006 (Commencement No 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007, reg. 2 (SI 2007/2194). Sections 175-177 are expected to come into force on 1 October 2008: see www.berr.gov.uk/files/file40844.doc (accessed 10 October 2007).

[44] Companies Act 2006, § 170(4).

[45] Companies Act 2006, § 232(1).

[46] 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.).

[47] On whom directors owe duties to, see Peskin v. Anderson, [2000] 2 B.C.L.C. 1, 14–15 (Ch.); Percival v. Wright, [1902] 2 Ch. 421, 423–25; Companies Act 2006, § 170(1). On the "proper plaintiff" principle, see Prudential Assurance Co. Ltd. v. Newman Indus. Ltd. (No. 2), [1982] 1 All E.R. 354, 357.

[48] These could include making direct approaches to, and entering into dealings with, shareholders in relation to a take-over bid, making material representations to shareholders, or supplying them with specific advice or information on which they have relied. See *Peskin v Anderson*, *supra* notexx, at 379.

Ordinarily the board of a UK publicly-traded company will control litigation decisions arising from a potential breach of directors' duties,[49] and directors will rarely sue one of their own. The English judiciary recognized early on that leaving the decision to sue purely in the hands of "the company" (i.e. the board of directors) could lead to serious wrongdoing remaining unaddressed and crafted exceptions where shareholders could sue for a breach of duty by directors through derivative litigation.[50] As sub-section 3.2 will discuss, English courts interpreted the exceptions narrowly. The Companies Act 2006 has displaced the relevant common law principles with a set of statutory standards that reconfigure the law substantially.[51] On balance it is unlikely reform will lead to an appreciable change in the litigation risk faced by directors (see sub-section 5.2).

When a company is being wound up, the company's liquidator becomes authorized to bring any action in the name of the company, including a breach of duty claim against directors.[52] In addition, UK insolvency legislation makes directors of companies liable for "wrongful trading", which occurs if directors fail to wind up a company when there was no reasonable prospect of avoiding insolvency.[53] Claims based on allegations of wrongful trading may only be enforced *ex post* by the liquidator.

When a shareholder in a UK 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.[54] While there is little scope for shareholders to allege directors owe duties directly to them, a shareholder who has been "unfairly prejudiced" by the conduct of a company's affairs has a statutory right to apply in a personal capacity for relief.[55] The proceedings are similar to a suit for oppression under US law, but whereas US courts do not entertain applications for relief based on oppressive conduct by a shareholder in a publicly-traded company, English courts will not dismiss such proceedings out-of-hand.[56] Since breaches of duty by a company's directors can be deemed unfairly prejudicial

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[49] This is an aspect of the board's right to manage the company, a right vested in the board by the company's constitution rather than by a legal rule.

[50] Atwool v. Merryweather (1867) L.R. 5 Eq. 464n; the principles were set down in their modern form in Edwards v. Halliwell [1950] 2 All E.R. 1064, 1066–67.

[51] Companies Act 2006, Part 11. For detailed analysis of the structure and operation of the new provisions, see DTI, *Companies Act 2006: Explanatory Notes* (2006), 73–77.

[52] Insolvency Act, 1986, c. 45, sched. 4, ¶ 4.

[53] Insolvency Act s 214. This criterion is, in practice, likely to be met only in extreme circumstances: where no out of court restructuring is possible, and the company lacks sufficient liquidity to pay current creditors. Directors will not be liable if they are engaged in a *bona fide* rescue attempt which has a reasonable prospect of success: *Re Continental Assurance Co of London* [2001] All ER (D) 229.

54. PALMER'S COMPANY LAW ¶ 8.809 (G.K. Morse ed., Sweet & Maxwell 2001).

[55] Companies Act 2006, s 994, formerly Companies Act, 1985, c. 6, § 459, which resulted in such proceedings often being referred to as a "section 459 petition".

[56] On public companies and the US oppression remedy, see D. COX, THOMAS LEE HAZEN & F. HODGE O'NEAL, CORPORATIONS § 14.12 (1997). On § 459 petitions being theoretically viable in UK public companies, see BRENDA HANNIGAN, COMPANY LAW 425-26 (2003). As to the English courts' (rather hostile) attitude to such claims, see Re Astec plc [1998] 2 B.C.L.C. 556.

and since the courts are given broad discretion to order a suitable remedy, an unfair prejudice petition can theoretically result in a damages award against a director.[57]

3.2 Literature Survey

There has only been scattered empirical research on corporate and securities litigation involving UK publicly-traded companies, but that which has been done suggests directors of British publicly traded companies are rarely sued under corporate law. In a 1996 study of institutional investment in the UK and Australia, Stapledon stated there had only been one reported case where a UK institutional investor had brought a derivative suit against directors of a portfolio company, this being a lawsuit in the early 1980s where the English Court of Appeal denied standing to insurance giant Prudential Assurance.[58] For the purposes of a 1996 consultation paper on shareholder remedies, the English Law Commission undertook a study of "unfair prejudice" petitions filed during 1994 and 1995 and found 156.[59] Only six involved "public limited companies" ("plcs"), which are eligible under UK company law to become publicly-traded, but typically are not.[60] A 2005 survey of wrongful trading cases found that none had involved claims brought against directors of publicly traded companies.[61]

For a 2006 study on outside director liability, Cheffins and Black carried out a number of searches on lawsuits involving directors using Westlaw's English case law database and annual indexes of Butterworths Company Law Cases, a law report series published since 1983 devoted solely to company law cases. They found, confirming Stapledon's claim, that the *Prudential Assurance* case was the most recent reported decision involving a derivative suit for damages against directors of a publicly-traded company.[62] In addition, they searched for cases where a liquidator exercised its right to bring an action on behalf of the company against a director for breach of duty and uncovered none involving a publicly traded company.[63]

Armour carried out additional electronic database searches for a 2007 working paper, examining case law databases compiled by Lawtel, Lexis Nexis and Westlaw.[64]

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[57] A. J. BOYLE, MINORITY SHAREHOLDERS' REMEDIES 100 (2002) (breach of duty constituting unfair prejudice); Companies Act, 1985, § 461; Companies Act 2006 § 996.

[58] G.P. STAPLEDON, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE 132 (1996) (citing Prudential Assurance Co. Ltd. v. Newman Industries Ltd. [1982] Ch. 204 as the one case).

[59] Law Commission, *Shareholder Remedies*, LCCP 142 (1996), 235-238.

[60] The Law Commission's study was anonymized, so it is impossible to tell for it whether any of the six public companies in question was publicly traded or not. As of 2002 there were 12,400 plcs on the register of companies but only 1600 companies listed on the London Stock Exchange: BRENDA HANNIGAN, COMPANY LAW 22 (2003).

[61] RIZWAAN JANEEL MOKAL, CORPORATE INSOLVENCY LAW: THEORY AND APPLICATION 289–92 (2005). Mokal 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 involved a publicly-quoted company.

[62] Cheffins and Black, *supra* note xx, 1407.

[63] Cheffins and Black, *ibid*., 1417.

[64] John Armour, 'Enforcement Strategies in UK Company Law: A Roadmap and Empirical Assessment', paper prepared for Harvard Law School conference on Enforcement in Corporate Law, March 2007.

He uncovered six unfair prejudice cases involving publicly traded companies brought between 1998 and 2006. Of these only three involved allegations of misfeasance by the company's directors and in none of these cases was the plaintiff (referred to as a "claimant" under English civil procedure rules) claiming damages or were they successful with their action.[65]

3.3 UK Corporate Cases: Methodology and Results

While with the US the fact that corporate law claims can theoretically be filed in 50 states means searches of judgments available on electronic databases is the only feasible way to carry out a nationwide search for lawsuits involving directors brought under corporate law, matters are potentially more straightforward in the UK. While in terms of court organization the UK is comprised of three jurisdictions (England and Wales, Scotland, and Northern Ireland) the English courts dominate corporate and securities litigation in a way not replicated by any state in the US. London, as a pre-eminent global financial center, thoroughly dominates the UK corporate and financial sectors. As a result, the UK is effectively a unitary jurisdiction for the purposes of corporate litigation involving publicly traded companies.[66] That means counting cases filed on a nationwide basis is at least a theoretical possibility.

Translating theory into practice is unfortunately not a straightforward task. Cases filed in English are not publicly available and are only available for inspection at the discretion of court officials. Hence, it is necessary to seek and obtain to carry out a search of cases filed, and the searching itself has to be done by hand because there is no electronic database.

Cases involving claims against directors of publicly-traded companies under company law are almost certain to be brought in the Chancery Division of the High Court of England and Wales, based in London. All court proceedings in England and Wales involving applications based on provisions in companies legislation must, for companies having a paid-up capital of more than £120,000, be started in the Companies Court, a specialist list within the Chancery Division.[67] All listed companies will almost certainly meet this financial criterion.[68] Of the sources of litigation risk described in section 3.1, the Companies Court will therefore be the

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[65] Amour, *ibid.* at 11-13. On the plaintiff/claimant nomenclature, see NEIL ANDREWS, ENGLISH CIVIL PROCEDURE: FUNDAMENTALS OF THE NEW CIVIL JUSTICE SYSTEM 1001 (2003). We will, for the sake of consistency, use the term "plaintiff" in the Part and other parts of the paper.

[66] As regards London, and consequently England, see "The Global Financial Centres Index" at p.13 (March 2007, available at http://www.cityoflondon.gov.uk/Corporation/business_city/research_statistics/research_publications.htm (last visited 18 August 2007). As regards the US, see Part 2 above.

[67] See Civil Procedure Rules, 1998, S.I. 1998/3132, Practice Direction 49B (Applications Under the Companies Act 1985 and Other Legislation Relating to Companies), paras 1(2), 2; Her Majesty's Court Service, The Chancery Guide 2005 (2005), Ch 20 (The Companies Court).

[68] "Paid-up capital" refers to the amount of funds which have been advanced to the company in return for new issues of shares. All companies listed on the main list of the London Stock Exchange will necessarily satisfy this criterion, as a company seeking IPO on the London Stock Exchange main market must have a market capitalisation of at least £700,000. There is no minimum market capitalisation requirement for AIM companies (London Stock Exchange, AIM Brochure (2007), 3). However, since only 6% of AIM-listed companies have a market capitalisation of less than £2m, it is unlikely any will have a paid-up capital of less than £120,000.

exclusive venue for cases involving "unfair prejudice" petitions and for lawsuits brought against directors by a liquidator under insolvency legislation.

We obtained permission from High Court officials to conduct a comprehensive review of all files in the Companies Court list for the years 2004, 2005, and 2006. This encompassed a total of 27,099 claims filed. We searched for files in which one of the parties was a public limited company -- that is, legally capable of being publicly-traded. These could readily be identified by the fact that such companies must have the suffix "plc" attached to their name.[69]

In each case involving a plc, we checked the file to see whether it concerned a claim against directors. This yielded 24 claims filed for all of 2004, 2005 and 2006. Table 4 gives a breakdown of these cases by year, and according to whether the claim was filed by a private party, or by public authorities. As plc status only means a company is legally capable of being publicly-traded, we then identified which of the companies involved was in fact publicly-traded.[70] We found there were only six claims involving publicly-traded companies where directors were named as defendants (Table 4).

Table 5

Claims filed in Companies Court, 2004-2006, in which defendants include directors of public limited company.

Year	All plcs				Publicly-traded companies			
	# claims	of which, plaintiff is...			# claims	of which, plaintiff is...		
		Public	Private	Private, seeking damages		Public	Private	Private, seeking damages
2004	9	7	2	2	2	1	1	1
2005	11	4	7	0	3	1	2	0
2006	6	4	2	1	1	1	0	0
Total	26	15	11	3	6	3	3	1
Mean	8.67	5	3.67	1	2	1	1	0.33

[69] Companies Act 2006 (U.K), § 58(1).

[70] Companies were classed as "publicly-traded" if they had been publicly traded at the point at which the action was commenced. Their status as publicly-traded was determined by consulting the register of public documents kept at Companies House, (www.companieshouse.gov.uk) which indicates whether a prospectus has been filed. The list of public documents filed for each company may be viewed online via a third party vendor, Creditgate:

https://secure.creditgate.com/search/search.aspx?businessname=magenta+mouldings&SearchType=CompanyReports.

Of the six claims where directors of publicly-traded companies were named defendants, three were proceedings brought to disqualify the defendants from serving as company directors. Disqualification cases are brought by a public agency, the Department of Business Enterprise and Regulatory Reform (DBERR, formerly known as the Department for Trade and Industry). The remedy sought is not financial compensation, but rather an order disqualifying the directors from being concerned in the management of a company.[71]

The other three claims where directors were named as defendants were launched by private parties. Of these three, only one involved a claim for damages.[72] This did not appear to be a genuine claim, since the plaintiff filed nothing more than a generally endorsed statement of claim, with no supporting details. The case was duly struck out by the court when the plaintiff failed to submit full particulars within the stipulated time. The conclusion from this exercise is that the annualised number of lawsuits seeking against directors of publicly-traded companies in the UK is effectively *zero* over our sample period.

To put our findings into context, there are approximately 2,600 domestic companies listed on the London Stock Exchange and on AIM (the Alternative Investment Market), an exchange operated by of the London Stock Exchange that allows smaller companies to carry out public offerings under a more flexible regulatory system than is applicable to the Exchange's Main Market.[73] Assuming we do not discount the one case filed against directors of publicly traded companies on the basis it was frivolous, this means per year the likelihood of directors of such a firm being named as defendants in a claim for damages under UK companies legislation was 1 out of 7,800, or 0.013%.

Though claims against directors of publicly traded companies under companies legislation will, as a practical matter, be brought in the Companies Court, not all cases potentially relevant for our purposes will be filed there. Historically the source of directors' duties under UK has been the common law, which means a company or a minority shareholder launching a lawsuit against directors alleging a breach of duty could opt to file in the mainstream Chancery Division of the High Court as well as the Companies Court.[74] As a result, as a check on our investigations in the Companies Court, we sought to carry out a search of cases filed in main Chancery Division.

Organizing the Chancery Division search proved more difficult than the search of the Companies Court. With the Companies Court, all filings are kept in one location, meaning that once we gained access to files we needed no further assistance from court officials. On the other hand, mainstream Chancery Division court filings are spread around throughout a basement store. This meant for us to look at cases

[71] For more background, see Part 6 of the paper.

[72] The other two were: (1) a claim requesting the court to call a shareholders' meeting to pass a resolution to remove and replace the board, which the incumbent board had sought to frustrate, and (2) a petition seeking an injunction regarding the way in which the defendants were managing the affairs of the company.

[73] London Stock Exchange, Market Statistics, available at http://www.londonstockexchange.com/en-gb/pricesnews/statistics/.

[74] Supreme Court Act 1981, Sch 1, para 1.

filed court officials had to collect the files together manually and bring them to us. Given the labor-intensive nature of the exercise, we could not carry out nearly as extensive a search. Chancery Division officials agreed they would track down for us two months' worth of filings, and we opted for the months of October and November 2006,[75] during which time a total of 629 cases were filed.

Of the 629 cases we examined, only one involved a claim arising under company law in relation to a plc. This was not a publicly-traded company, and the action arose out of the same set of facts as one of the claims we had found in the Companies Court during the same year. Given that our sample was only a two-month period, this would imply an annual rate of approximately six claims filed against plcs, but again no cases filed against directors of publicly quoted companies. Our findings imply that plaintiffs are not by-passing the Companies Court with any frequency to bring lawsuits against directors of such firms.

4. Putting Our Results Into Context: A Brief Look at Securities Litigation

When our research on the US and the UK is compared and considered in the context of existing studies, the disparity in lawsuits activity is striking, both with respect to cases filed and judgments reported. Thompson and Thomas found more than 460 complaints filed per year setting out fiduciary duty claims where a Delaware public company was involved, and nearly 150 per year once multiple complaints arising from similar facts were taken into account. For the UK, we found only three cases filed in Companies Court over a three year period where a director of a public company was named as a defendant and only one where a claim was brought for damages. Our two-month check of the main Chancery Division uncovered no lawsuits filed against directors of a publicly traded company.

As for reported judgments, we found 164 cases over a seven year period launched in state or federal courts involving a derivative or direct shareholder suit where damages were being sought against directors of publicly quoted companies. In the UK, one has to go back to 1983 to find a reported UK case where a director of a public company was a defendant in a derivative suit. We are also unaware of any judgments involving a case where a plaintiff brought a direct claim against directors of a publicly quoted company seeking damages, whether on grounds of unfair prejudice or otherwise.

These corporate law results can be put into context by considering the situation in the related field of securities law. In the US, as is the case with corporate law, lawsuits are commonly filed under securities law that create a theoretical liability risk for directors of publicly quoted companies. One of the authors of this study (Black) is undertaking research specifically on securities lawsuits where directors have been named as defendants, and he has found that between 1996 and 2003 there were 1,139 complaints filed under federal and state securities law where a damages claim was brought against directors, yielding 326 consolidated complaints over the same period. Black's data indicates Rule 10b-5 of the Securities Exchange Act of 1934 is the principal provision relied on in suits claiming misdisclosure which affects market trading once securities have been issued. Section 11 under the Securities Act

[75] We chose months outside the summer and the holiday season since these are the months when suits are most likely to be filed.

of 1933 is the principal provision relied upon in suits alleging misdisclosure in the context of a public offering.[76]

While numerous lawsuits are brought against directors of publicly traded companies under securities law in the US, the likelihood of them paying damages out of their own pocket is small. Black, Cheffins and Klausner found that there were nine instances between 1980 and 2006 where outside directors made out-of-pocket payments in securities law cases as a result of a settlement or judgment, including the well-known settlements involving outside directors of Enron and WorldCom.[77] Indemnification by the company and/or controlling shareholders, D&O insurance, and incentives parties have to settle rather than go to trial account largely for the disparity between claims brought and out-of-pocket payments. Black, as part of his continuing research on securities lawsuits brought against directors, is investigating the extent to which liability shields protect inside directors as well.

In the UK, shareholders in a publicly-traded company can potentially sue directors to recover losses caused by false or misleading disclosures in documents supporting a public offering of shares.[78] An investor can also sue at common law for compensation on the basis of a misleading prospectus but statutory liability is more extensive in a variety of respects.[79] There is no UK equivalent to Rule 10b-5 liability for secondary trading. Negligent misstatements in the annual accounts and other financial documentation disseminated by directors of a UK publicly-traded 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.[80] The Financial Services and Markets Act 2000 was recently amended to provide shareholders with the right to sue for compensation for misleading periodic disclosure documentation, but liability is not extended to directors.[81]

The available evidence suggests that, as is the case with corporate law, directors of UK public companies are rarely sued under UK securities law. Ferran, in a 2006 working paper, searched the Lexis-Nexis case law database going back to 1986 to investigate levels of private enforcement for misdisclosure under UK securities law. She found just one case brought under the provision in the Financial Services and Markets Act 2000 creating liability for misleading listing particulars and its statutory predecessor. She also uncovered a case arising from the same facts alleging a breach of the common law duty of care and two other prospectus cases

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[76] Further details are available upon request.

[77] Black, Cheffins and Klausner, *supra* note xx, 1070-71.

[78] Financial Services and Markets Act, 2000, c. 8, § 90 (creating liability for "persons responsible" for misleading disclosures; § 79(3); Financial Services and Markets Act 2000 (Official Listing of Securities) Regulations, 2001, S.I. 2001/2956, art. 6, ¶ (1)(b) (naming directors as a "person responsible").

[79] On the scope for applying under the common law, see Al-Nakib Investments, above note XXX and Possfund Custodian Tr. Ltd. v. Diamond, (1996) 2 All E.R. 774 (Ch.). On the scope of the common law action as compared with the statutory cause of action, see ENCYCLOPEDIA OF FINANCIAL SERVICES LAW ¶ 2A-190 (Eva Z. Lomnicka & John L. Powell eds., 1987–2001).

[80]See, eg, Al-Nakib Investments (Jersey) Ltd. v. Longcroft [1990] 3 All E.R. 321 and generally GORE-BROWNE ON COMPANIES ¶ 43.27 (Alistair Alcock ed., 50th ed. 2004).

[81] Companies Act 2006, § 1270, introducing Financial Services and Markets Act, 2000, § 90A; for background, see Paul Davies, Davies Review of Issuer Liability: Final Report 25 (2007).

alleging a breach of common law duties.[82] None of the cases proceeded to a trial on the merits. Ferran also found "a few cases" where directors of a company being acquired were sued by the bidder for negligent preparation of financial information relied on by the bidder but says there were none where the claim proceeded to a full trial.[83] She also reports there had been cases where investors succeeded in claiming compensation from a company and/or its directors on the basis of fraudulent or negligent misrepresentations made directly to the investors as they were deciding whether to purchase shares the company was issuing.[84] Neither of the cases she cites, however, involved a publicly quoted company.[85]

Armour, with the electronic searches he ran for the purposes of his 2007 working paper, found a second case brought under the provision in the statutory predecessor to the Financial Services and Markets Act 2000 creating liability for misleading listing particulars.[86] Nevertheless, his searches, as with Ferran's, confirm that at least as measured by reported judgments securities lawsuits are very rare in the UK. Hence, the available evidence indicates the pattern is the same as for corporate law, namely that lawsuits are brought much often against directors of US public companies than their counterparts in the UK.

5. Accounting for the Differences Between the UK and the US

5.1 "Culture"

Our results and related empirical research confirm the conventional wisdom that directors of publicly traded UK companies are much less likely to be sued than their US counterparts, even if US directors in fact rarely pay damages out of their own pocket. Some might be tempted to attribute our results to "culture", whereby the US is perceived to be a uniquely litigious society in which aggrieved parties have a special propensity to rush to the courthouse. The fact that litigation is considerably more common in other areas of the law – on an annual basis 3.3 tort suits are filed for each 1,000 US inhabitants as compared to only 1.2 per 1,000 in England, and on a per capita basis there are nearly eight times as many products liability suits in the US as in Britain[87] -- may be thought to imply that differences in national character could indeed be an explanatory variable.

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[82] Eilis Ferran, "Cross-border Offers of Securities in the EU: The *Standard Life* Flotation", 17-18 (2006) available at http://ssrn.com/abstract=955252, discussing *Axa Equity and Law Life Assurance Society plc v. National Westminster Bank plc* (1998) (Ch.D.); *Al-Nakib Investments (Jersey) Ltd. v. Longcroft* [1990] 3 All E.R. 321; *Possfund Custodian Trustee Ltd. v. Diamond* [1996] 2 All E.R. 774.

[83] Ferran, *ibid.*, 19-20.

[84] Ferran, *ibid.*, 18-19.

[85] Bottin (International) Investments Ltd. v. Venson Group plc [2006] All E.R. (D) 111 (the company, now in receivership, was a plc but not publicly quoted: http://www.alertdata.co.uk/company.php?companyid=593&bulletinid=8176 (last visited July 12, 2007); Man Nutzfahrzeuge AG v. Freightliner Ltd. [2005] EWHC 2347 (the company being acquired was a truck manufacturing subsidiary).

[86] Armour, *ibid*, at 14.

[87] Richard Posner, Explaining the Variance in the Number of Tort Suits Across US States and Between the US and England, 26 J. Legal Studies 477, 478 (1997) (tort law claims); Charles W. Branham, It Couldn't Happen Here: The English Rule but not in South Carolina, 49 SO. CAROLINA L. REV. 971, 974 (1998).

We doubt culture explains our results to any significant degree. Davies, in a 2007 a review of issuer liability commissioned by the UK government, pointed out that speculative litigation is not a unique American cultural phenomenon. Rather, such litigation also occurs in the UK when the structure of civil procedure rules permits it.[88] We find this logic persuasive, and prefer to attribute our findings to differences in aspects of corporate and securities law, civil procedure rules and attorney incentives.

Historical developments in Japan illustrate how legal rules and attorney incentives can trump "culture". The Japanese Commercial Code has included a derivative suit mechanism since 1950, but the mechanism remained largely unused until the 1990s.[89] The dearth of derivative suits was commonly attributed to Japanese values, exemplified by a desire to promote harmony and avoid conflict.[90] If culture in fact had been the primary deterrent to derivative suits, then changes to the law should have had little impact on litigation levels. Instead, after reforms in 1993 slashed filing fees for derivative litigation and permitted US-style recovery of attorneys' fees in successful cases,[91] the number of derivative suits soared from an average of one every two years to nearly 50 per year.[92] Applied to the British context, the lesson is that "culture" should operate as no more than a residual explanation for litigation patterns for directors.

5.2 Corporate and Securities Law Rules

Various differences in substantive corporate and securities law doctrine help to account for the different litigation pattern in the UK and the US. With securities law, we have already drawn attention to a key distinction, namely that that the UK lacks an analogue to S.E.C. Rule 10b-5, the far-reaching provision which provides a private right of action against companies and directors for material misstatements that affect secondary trading of securities. As for corporate law, sub-section 3.2 has already discussed one doctrinal feature that helps to explain the disparity in private enforcement in the UK and the US: directors rarely owe duties directly to shareholders, meaning that the "direct" shareholder suits that are so common in the US are generally impossible to bring under UK company law.

An additional aspect of UK corporate law, reinforced by the Listing Rules that govern companies listed on the London Stock Exchange, that discourages litigation against directors is that transactions otherwise afflicted by directors' conflicts of interest can be whitewashed reliably. UK company law permits disinterested directors to authorize transactions between a company and one or more of its

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[88] Davies, Davies Review, *supra* note xx, 12.

[89] 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).

[90] Mark D. West, The Pricing of Shareholder Derivative Actions in Japan and the United States, 88 NW. U. L. REV. 1436, 1439-41 (1994).

[91] Kawashima & Sakurai, *supra* note xx, at 20; Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 J. LEGAL STUD. 351, 355 (2002).

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

directors.[93] Similarly, disinterested directors can authorize directors to take corporate opportunities and benefits.[94] In some instances, certain rules of substantive corporate law[95] a company's constitution, or the Listing Rules require shareholders to "whitewash" transactions.[96] Though the process is not costless, generally convening the necessary meeting of shareholders in order to obtain the required consent can be done with minimal fuss.[97] Vitally, once the directors or shareholders have duly authorised a transaction where a director has a personal interest, the transaction can only subsequently be impugned on the basis of fraud or improper purposes.[98] Pleading and proving fraud under English law is difficult to do and establishing neutral directors were motivated by improper purposes is much more challenging than simply demonstrating a *prima facie* conflict of duty and interest.

In the US, "whitewashing" problematic transactions is more complex. If insiders obtain advance approval from the company's non-conflicted directors and the transaction was not with a controlling person (whether or not a director) the shareholder challenging the transaction bears the burden of showing a violation of the business judgment rule, and will almost surely lose unless they can show that the conflicted director failed to provide full information to the other directors. On the other hand if a controlling person was a party to the impugned transaction, then notwithstanding approval by non-conflicted directors, the shareholder can succeed by proving the transaction was substantively unfair. This leaves greater scope for credible lawsuits to be launched in the US. Many "freeze-out" transactions fall into this category, litigation is common with such transactions, and the lawsuits sometimes succeed.[99]

The law governing derivative suits also helps to explain why lawsuits against directors are much more common in the US than the UK. While English courts permitted shareholders at common law to seek to launch derivative litigation to rely on exceptions to the basic rule that a company, and more specifically its board, controls corporate litigation, the common law exceptions were narrow. The jurisprudence centred on an ill-defined concept referred to as "fraud on the minority" which came into operation not simply when the alleged breach harmed the company

[93] Companies Act 2006, §§177, 180(1). Prior to the Companies Act 2006, provisions to similar effect were very commonly included in a company's constitution: see, *e.g.*, Table A (1985), regs. 85-86, 94-98.

[94] Companies Act 2006, §175. Again, prior to the Companies Act 2006, see Table A (1985), regs 70, 94-98, though there was some doubt about the efficacy of consent by directors in these circumstances, as a consequence of *Regal (Hastings) Ltd v. Gulliver* [1942] 1 All E.R. 378, but no such doubt as a result of that case about the efficacy of shareholders' consent.

[95] See, e.g., Companies Act 2006, Part 10 Chapter 4 on substantial property transactions between a company and its directors, and loans by a company to its directors.

[96] See, *e.g.*, Listing Rules, LR 11, particularly LR 11.1.7.

[97] See now Companies Act 2006, Part 13.

[98] As well as the provisions cited in nn. XXX 97-98 above, see Companies Act 2006, §263(2)(c)(i). As regards the effect of due authorisation on an attempt to bring a derivative action, see *Burland v. Earle* [1902] A.C. 83, *Prudential Assurance Co. Ltd. v. Newman Industries Ltd.* (*No. 2*) [1982] Ch. 204 (C.A.) and *Smith v. Croft* (*No. 3*) [1987] 3 All E.R. 909.

[99] [citations, M&F and Emerging Communications examples]

but also required the wrongdoers to have benefited at the company's expense.[100] Thus, a breach of the duty of care was generally not actionable by derivative action.[101] Moreover, a derivative suit could only proceed if there was "wrongdoer control," which required that the defendants own enough shares and exercise sufficient influence to dictate voting outcomes.[102] Given that dispersed ownership is the norm in UK publicly-traded companies, this requirement could only rarely be fulfilled.[103]

In contrast, in the US the derivative action is a well-established procedural device that permits shareholders owning a small percentage of shares to launch proceedings against directors. While the US Supreme Court suggested in 1949 in *Cohen v. Beneficial Industrial Loan Corp.* that the derivative suit was "long the chief regulator of corporate management",[104] Thompson and Thomas' research shows this is no longer the case, with class actions being a considerably more common form of litigation under corporate law. The fact that plaintiffs in derivative lawsuits can easily become enmeshed in litigation seeking an exemption from the requirement that they make a demand on directors before the suit can proceed does much to explain the popularity of the class action, for which the demand requirement does not apply.[105] Nevertheless, with state corporate law lacking barriers to derivative litigation such as the narrowly construed "fraud on the minority" exception and the wrongdoer control requirement, the procedural terrain in the US has traditionally been considerably more hospitable to derivative litigation than the UK's.

Under the Companies Act 2006 the common law rules governing derivative litigation have been replaced with a statutory regime where a minority shareholder seeking to litigate on the company's behalf to enforce directors' duties must apply to a judge for leave, who in turn will follow statutory guidance on whether to grant leave.[106] 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).

Fears have been expressed that reform will open the door to litigation against directors.[107] At least a couple of "test cases" will be required to clarify the scope of the new provisions, and directors of the companies affected will feel very much on the

[100] See Hannigan, *supra* note xx, 458-61; PAUL L. DAVIES, GOWER AND DAVIES' PRINCIPLES OF MODERN COMPANY LAW 377–79 (7th ed. 2003) 458-61 (emphasizing, though, the ill-defined nature of the concept). Leading cases include Cook v. Deeks [1916] A.C. 554; Daniels v. Daniels [1978] Ch. 406, discussed by THE LAW COMMISSION FOR ENGLAND & WALES, SHAREHOLDER REMEDIES (CONSULTATION PAPER 142, 1996) at §§4.9-4.11.

[101] *Pavlides v Jensen* [1956] 2 All ER 518.

[102] Birch v. Sullivan, [1957] 1 W.L.R. 1247 (Ch.).

[103] Brian R. Cheffins, Company Law: Theory, Structure and Operation 465 (1997).

[104] 337 US 541, 548 (1949).

[105] Thompson and Thomas, "Public", *supra* note xx, 1780-81.

[106] Companies Act 2006, §§ 260-64. These provisions are supplemented by new procedural rules inserted into the Civil Procedure Rules (current draft of 30 May 2007 available at http://www.justice.gov.uk/civil/procrules_fin/consult.htm, last visited 18 August 2007).

[107] Nikki Tait & Bob Sherwood, *Directors on Guard Against Legal Action*, FIN. TIMES, Nov. 2, 2005, at 3; Robert Watts, *'This Bill Will Discourage People from Becoming a Director,'* TELEGRAPH, Jan. 29, 2006, at 6.

spot. However, English judges have generally been reluctant to intervene in disputes occurring within companies and if this bias continues to prevail under the new legislative regime then the scope for gaining leave will narrow accordingly.[108] The factors discussed in sub-sections 5.3 to 5.5 discuss should further discourage derivative lawsuits, thus ensuring they will not become as prevalent as they are in the US.

5.3 Takeover Regulation

Many of the instances of corporate law litigation against US directors arise out of circumstances surrounding mergers.[109] Takeovers of publicly traded companies are common occurrences in the UK, but these transactions almost never give rise to private litigation in the UK.[110] Consistent with these findings, there were no M&A-related lawsuits in our UK dataset.

The way in which takeovers are regulated in the UK does much to explain the disparity. In the UK, the actions of all participants in takeover situations relating to UK-registered companies are governed by a comprehensive code of conduct known at the City Code on Takeovers and Mergers ("the City Code"), which is promulgated and administered by the Panel on Takeovers and Mergers ("the Panel") under a regime recently shifted from a self-regulatory basis to a firm statutory foundation.[111] The Panel seeks to ensure compliance with, and to enforce, the City Code in "real time". To this end, parties are urged to consult with the Panel at the earliest possible opportunity, and guidance will be given promptly by the Panel's Executive, staffed by personnel on secondment from investment banks, law firms, and accountancy firms. Any disputes are resolved by reference to the Panel's Appeals Committee, and on appeal from there to the Takeover Appeals Board, with prompt resolution of contested matters remaining a high priority.

The City Code scheme effectively ousts private litigation as a dispute resolution mechanism.[112] The content of the City Code is often more onerous than are directors' ordinary duties under the general law, with the result that compliance with the former will necessarily imply compliance with the latter.[113] Moreover, the Panel will normally prohibit parties from engaging in any litigation (apart from a reference

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[108] Cheffins, Company Law, *supra* note xx, 342-43.

[109] See John Armour & David A. Skeel, Jr, Who Writes the Rules for Hostile Takeovers, and Why? The Peciliar Divergence of US and UK Takeover Regulation, 95 Geo L.J. 1727.

[110] Armour and Skeel (2006), *supra* note, at 1738 (reporting from Thomson Financial's SDC Platinum database of merger transactions that during the period 1990-2005 33.3% of US hostile takeovers were litigated and only 0.01% of such transactions in the UK were litigated).

[111] Companies Act 2006, ss. 942-59; CITY CODE ON TAKEOVERS AND MERGERS (8th ed., 2006 + updates), available at www.thetakeoverpanel.org.uk.

[112] See Lord Alexander of Weedon Q.C., *Takeovers: The Regulatory Scene*, J. BUS. L. 203, 213–14 (1990) (discussing a case in which the UK Court of Appeal expressly declared its hesitancy to intervene on a decision by the UK Takeover Panel); Geoffrey Morse, *Controlling Takeovers—The Self Regulation Option in the United Kingdom*, J. BUS. L. 58, 60–61 (1998) (noting that UK takeover law "is not devised by or for the benefit of lawyers"); Takis Tridimis, *Self-Regulation and Investor Protection in the United Kingdom: The Takeover Panel and the Market for Corporate Control*, 10 CIV. JUST. Q. 24, 25–27 (1991) (explaining that UK takeovers are self-regulated and that the Takeover Panel "avoids the formalities of legal proceedings").

[113] See Armour and Skeel (2006), *supra* note xxx, at 1780-84.

to the antitrust authorities) which might have the effect of frustrating an actual or potential takeover bid.[114] As a consequence, there is almost no litigation surrounding takeovers in the UK.

Market practice concerning takeovers also discourages litigation in the UK as compared with the US. In the UK, the almost universal practice with takeovers is for successful bidders to buy up all of the shares, meaning that there will be no minority shareholders to launch lawsuits. The way this is achieved is for bidders to make their bid conditional on those owning 90% or more of the shares accepting the bid, and then rely on a statutory provision that explicitly authorizes the cashing out of the remaining shareholders and offers little scope for a legal challenge by the hold outs.[115] In contrast, in the US it is reasonably common for takeovers to proceed with the successful bidder buying up enough shares to take control but leaving a continuing group of minority investors. The incumbents can then potentially launch a derivative suit or a direct class action alleging misdeeds by the directors orchestrating the transaction.

5.4 Rules Governing Mass Litigation

Many lawsuits brought against directors under US corporate and securities law are organized as class actions. This is in stark contrast with the UK, where multiparty litigation is only undertaken rarely on a general basis and, to this point, apparently never in the context of director litigation. Rules governing the launching of multiparty litigation help to explain the disparity.

In the US, under federal civil procedure rules, a judge must certify a class action before it can proceed. The rules say a judge should only do so if the class is so numerous it is otherwise impractical to join all members, if there are questions of law or fact common to the class, if the claims or defenses of the representative parties are typical of the claims or defenses affecting the class and if the representative parties will fairly and adequately protect the interests of the class.[116] A judge also must take into account whether separate actions would create a risk of varying outcomes that would establish incompatible standards of conduct for those not participating in the litigation and whether a class action would be a superior method of adjudicating the

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[114] See CITY CODE ON TAKEOVERS AND MERGERS (8th ed., 2006 + updates), Rule 21.1; TAKEOVER PANEL, PANEL STATEMENT 1989/7 (CONSOLIDATED GOLD FIELDS PLC) (available at http://www.thetakeoverpanel.org.uk/new/statements/DATA/1989/1989-07.pdf); WILLIAM UNDERHILL (ED.), WEINBERG AND BLANK ON TAKE-OVERS AND MERGERS (5th ed., 1989, supp. 2006), ¶¶ 4-7114 to 4-7130B. In deference to the overriding public importance perceived to attach to antitrust concerns, a more lenient approach is taken as regards references to competition authorities by the target. An initial reference, at least, would be unlikely to be considered to breach the Code (*see* TAKEOVER PANEL, PANEL STATEMENT 1989/20 (B.A.T. INDUSTRIES PLC), available at http://www.thetakeoverpanel.org.uk/new/statements/DATA/1989/1989-20.pdf, at 11). Bidders have responded to the risk that his poses to offers by seeking clearance, where antitrust concerns are material, in advance of making a firm offer. If clearance is given, then a tactical appeal by the target against the competition authority's decision would be likely to be viewed as "frustrating action" by the Panel (*see* GARY EABORN (ED.), TAKEOVERS: LAW AND PRACTICE (2005) at 679-80).

[115] Companies Act 2006, s. 979. A dissident shareholder must show that the terms were "unfair", a difficult hurdle to clear when those owning 90% of the shares have accepted the offer (see Companies Act 2006, s. 984).

[116] Fed. R. Civ. P. 23(a).

dispute quickly.[117] Despite these various requirements, and despite additional rules introduced by the Private Securities Litigation Reform Act of 1995 (PSLRA) to rein in securities law strike suits, plaintiffs are routinely granted certifications to bring class actions against directors under corporate and securities law.

Organizing multiparty litigation is much more problematic in the UK. Traditionally, the closest English equivalent to the US 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 proceedings.[118] Reforms carried out in 2000 sought to facilitate multiparty litigation by letting those launching proceedings bring their cases under the control of a single court at a very early stage through a "group litigation order."[119] These reforms led to speculation that a wave of securities fraud litigation would follow.[120] As the discussion in section 4 indicates, this has not happened.

The legal expenses associated multiparty lawsuits helps to explain why introduction of the group litigation order procedure has not had a substantial impact. Class action lawsuits launched by shareholders against directors have the potential to be highly complicated affairs, generating large legal bills. Off-loading the risk on to lawyers is theoretically possible since plaintiffs in the UK can enter into conditional fee agreements under which a lawyer can agree to a "no win, no fee" arrangement.[121] However, for lawyers the maximum "upside" under such an agreement is a success fee amounting to 100% of hourly fees.[122] This is a very conservative figure compared with contingency fees American lawyers charge, meaning UK lawyers do not have the same incentive as their US counterparts to take on high-risk (in the sense of a relatively low probability of winning), high-value litigation.[123] Since this is just the sort of claim that characterises the work of US shareholder attorneys, the development of a US-style shareholder plaintiffs' bar in Britain has suffered accordingly.[124]

The rules governing group litigation orders also constitute an obstacle to multiparty litigation. Class actions in the US operate on an "opt out" basis, in the sense that all members of a class become entitled to recover unless they choose to take themselves out of the class action at an early stage. In contrast, with group

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[117] Fed. R. Civ. P. 23(b).

[118] Neil Andrews, Principles of Civil Procedure 135–43 (1994).

[119] ANDREWS (1994), *supra* note xx, at 977–83 (discussing Civil Procedure Rules, 1998, S.I. 1998/3132, art. 19.11).

[120] Kate Burgess & Jean Eaglesham, *Litigious Rush May be Equal to Courting Worse Disaster*, FIN. TIMES, May 4, 2002, at 2; Florian Gimbel, *UK Gets Ready to Adopt a US Class Act*, FIN. TIMES, Nov. 25, 2002, at 3.

[121] Hans C. Hirt, The Enforcement of Directors' Duties in Britain and Germany: A Comparative Study with Particular Reference to Large Companies 132-34 (2004); A.J. Boyle, Minority shareholders' Remedies 37, 59 (2002).

[122] US-style contingency fees, where a lawyer receives a percentage of any judgment or settlement, remain unlawful in the UK. *See* Neil Andrews, *Common Law Invalidity of Conditional Fee Agreements for Litigation: "U-Turn" in the Court of Appeal*, 59 CAMB. L.J. 265, 266 (2000).

[123] Winand Emons, Playing it Safe with Low Conditional Fees versus Being Insured by High Contingency Fees, 8 Am. L. & Ec. Rev. 20, 29-30 (2006).

[124] Richard Matthews, *Why America Is in a Class of Its Own*, TIMES (UK), Jan. 25, 2005, at 10.

litigation orders a court's judgment only benefits those who are on the "group register" when the judgment is handed down or, if the court so directs, those who bring claims in the future.[125] With this "opt in" system, the legal team organizing a lawsuit must take the time and trouble to identify the full range of class claimants and seek the permission of individuals within that class to have their claims entered on the register. As a result, it is more difficult for those organizing multiparty litigation in the UK to maximize the size of the overall recovery for eligible claimants than it is for their American counterparts.

5.5 "Loser Pays"

Procedural rules governing the allocation of legal expenses in the wake of litigation promote the launching of corporate and securities lawsuits in the US and discourage the same in Britain. Litigants in the US generally pay their own legal expenses, regardless of whether they win or lose in court. The PSLRA 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.[126] Judges rarely invoke this provision.[127]

England, in contrast, has a "loser pays" regime.[128] Rulings on costs in civil lawsuits are within the court's discretion but fees are typically assessed against the loser on a "standard basis" that covers litigation expenses "proportionately and reasonably incurred" and "proportionate and reasonable in amount."[129] "Standard basis" costs orders typically indemnify between two-thirds and four-fifths of actual legal bills.[130]

From an economic perspective, a prospective plaintiff is only going to launch a lawsuit if he estimates the size of the likely judgment, discounted by the possibility of losing the case, exceeds his anticipated legal costs.[131] To state the matter more formally, under the assumption that each party pays their own legal costs, if d represents the expected damages, c_{p} represents the plaintiff's costs and p (where $0 < p < 1$) represents the plaintiff's estimated probability of success, then a plaintiff will launch a suit if:

$$pd > c_{\mathrm{p}} \qquad (1)$$

Assume now the UK "loser pays" rule applies. A plaintiff will litigate if he estimates that the size of the likely judgment, multiplied by the probability of winning, is greater than the sum of both sides' recoverable litigation costs multiplied by the

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125 Davies, "Liability", *supra* note xx, 46-47 on the effect of Civil Procedure Rules, 1998, S.I. 1998/3132, para 19.12.

126 *See* Securities Exchange Act of 1934 § 21D(c), 15 U.S.C. § 78u-4(c) (2006).

127 Cheffins and Black, *supra* note xx, 1393, n. 19.

128 Civil Procedure Rules, 1998, S.I. 1998/3132, para 44.3, esp. para 44.3(2)(a).

129 Civil Procedure Rules, 1998, S.I. 1998/3132. para. 44.5, ¶ 1; Lownds v. The Home Office, [2002] 1 W.L.R. 2450, 2453.

130 ANDREWS (2003), *supra* note xx, at 830–31.

131 If the defendant's perceptions differ and/or he has private information that leaves him optimistic he would win at trial, a trial then becomes likely: THOMAS J. MICELI, ECONOMICS OF THE LAW: TORTS, CONTRACTS, PROPERTY, LITIGATION 157, 165-66 (1997).

probability of losing. If c_d represents the defendant's recoverable costs, then the plaintiff will now bring suit when the following condition is met:

$$pd > (1 - p)(c_p + c_d) \qquad (2)$$

A key point that emerges from a comparison of inequalities (1) and (2) is that the UK rule makes the defendant's likely legal costs relevant to the plaintiff's decision whether to sue.[132] This will tend to deter (compared to the US rule) litigation in cases where the defendant's legal fees are likely to be large, since the plaintiff runs the risk of paying most of these costs in the event of losing.[133] This deterrent to sue will be even greater if – as seems plausible – those who spend more on legal services are more likely win in court. So long as prospective plaintiffs lack the financial wherewithal to match the defendants' legal firepower, their chances of losing, and having to pay the defendants' legal expenses, will increase as the defendants outspend them. They will therefore tend to avoid suing in the first place.[134]

Litigation involving directors of a publicly quoted company under corporate and securities law fits the pattern. Assuming the company is a defendant and is not bankrupt, there will be large amounts of money available to spend on the case. Directors and officers' insurance, which invariably provides coverage for legal expenses properly incurred, will usually constitute a supplemental fund directors can draw upon to defend claims against them. The legal bills are thus liable to mount quickly, fostering concern among plaintiffs in the UK that they will be outspent and will face a large adverse costs order as and when they lose in court.

Concerns about the other side's spiralling legal expenses will be compounded where a plaintiff intends to target multiple defendants. If the defendants are independently advised, aggregate legal expenses will likely increase, meaning a larger "loser pays" bill in the event of losing in court. Multiple defendants will be the typical scenario in a corporate or securities case, since plaintiffs will typically want to join as defendants the company, various directors and officers and perhaps the company's auditors and financial advisers. The English "loser pays" rule will discourage the launching of lawsuits of this character, absent the unlikely possibility that a plaintiff is so confident of winning that they are unconcerned about being on the hook for legal expenses.

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[132] Another potentially important implication is that the expected probability of success enters into both sides of the inequality under the UK rule. The increased significance of this variable, relative to the others, will influence a prospective plaintiff's decision whether or not to litigate. However, the implications for overall litigation activity are uncertain. A plaintiff confident of success in court is thus more likely to litigate under the UK than the US costs rule. On the other hand, the UK rule punishes more severely a litigant who is over-optimistic about the probability of prevailing, with punishment being to pay not only his own legal expenses but also the bulk of those incurred by the successful party. The UK rule thereby discourages "speculative" litigation, where the expected probability of success is low. It is unclear whether, in aggregate, the higher number of "sure winner" lawsuits that may be expected to be launched under the UK costs rule will outnumber the "speculative" lawsuits discouraged, so the implications for aggregate litigation activity of this point of difference are unclear.

[133] Snyder and Hughes, *supra* note xx, 349. See also James W. Hughes & Edward A. Snyder, *Litigation and Settlement Under the English and American Rules: Theory and Evidence*, 38 J. Law & Econ. 225, 227-8 (1995).

[134] Michael R. Baye, Dan Kovenock and Casper G. de Vries, *Comparative Analysis of Litigation Systems: An Auction-Theoretic Approach*, 115 ECON. J. 583, 585, 595-98 (2005).

A "loser pays" rule also serves to deter litigation by hampering risk shifting through fee arrangements made with lawyers. In situations where plaintiffs enter into a contingent fee arrangement with their lawyers, under the US costs rules a plaintiff who loses in court will not have to pay his own legal expenses or those of the other party. For such a plaintiff, c_p in inequality (1) is effectively zero. Under the UK loser pays rule, on the other hand, unsuccessful plaintiffs will potentially have to pay the defendant's costs even if they do not have to pay their own lawyers.

The deterrent effect of the UK's "loser pays" costs rule is particularly potent with derivative litigation. In a derivative action, any damages are paid to the company, rather than the shareholder plaintiff, so the shareholder's expected recovery is in effect only a fraction of the damages commensurate with the proportion of shares he holds. The effective size of d will therefore be quite small. Despite this, the *prima facie* rule that the loser pays the winner's costs still applies, meaning c_p is unchanged. This dilemma is resolved in the US by the use of contingency fees, which again have the effect of setting c_p to zero. In the UK, by contrast, it follows from inequality (2) that a reduction in d will reduce the likelihood of litigation.

The English judiciary responded to this problem by developing in 1975 a doctrine whereby the court can order a company to indemnify a shareholder who properly brings a derivative action on its behalf.[135] However, in a subsequent case it was held that, a minority shareholder seeking this sort of relief needed to show a *prima facie* facts existed substantiating the derivative action claim and establishing the company was controlled by the wrongdoers.[136] Since these hurdles had to be surmounted in a separate application to court *before* a costs indemnity could be granted,[137] a plaintiff faced a significant risk of incurring costs liability when simply seeking financial backing for the lawsuit. In effect, therefore, the problem was unresolved.

5.6 The Entrepreneurial Attorney

With corporate and securities litigation involving publicly-traded companies, a major potential stumbling block for litigation is that the plaintiff can potentially end up investing time, effort and money supporting litigation that primarily benefits other shareholders. With derivative litigation, if the lawsuit is successful, the company will be the winning party and the recovery will be by the company.[138] Thus, a shareholder

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[135] *Wallersteiner v Moir (No 2)* [1975] QB 373, 403; *Jaybird Group Ltd v Greenwood* [1986] BCLC 319, 321. The doctrinal theory upon which this innovation was based—a payment being made out of a fund to a party who has assisted in the protection or recovery of the fund—is very similar to that used by US courts to justify the payment of contingency fees to plaintiff attorneys: see *infra*, text to notes xx-xx. Under the new regime for derivative actions created by Companies Act 2006 §§260-64, the principle of *Wallersteiner* will be continued by the civil procedure rules: see draft rule 19.9E(1) (current draft of 30 May 2007 available at http://www.justice.gov.uk/civil/procrules_fin/consult.htm, last visited 18 August 2007).

[136] Or as the matter was recently put, the minority shareholder will be prevented from bringing the claim if it is, in all the circumstances, one which no reasonable independent board of directors would authorise commencing: *Airey v Cordell* [2006] EWHC 2728 (Ch) at [66]-[76]. This language is effectively mirrored, for the future, in Companies Act 2006, §263(2)(a).

[137] Wallersteiner v. Moir (No. 2) [1975] Q.B. 373; Smith v. Croft (No.1) [1986] 1 W.L.R. 580.

[138] In the English context, see Spokes v. The Grosvenor & W. End Ry. Terminus Hotel Co. Ltd., (1897) 2 Q.B. 124, 128.

who launches such litigation faces the prospect of investing time, effort and money to secure relief that will benefit all shareholders pro rata. Similarly, with a class action the plaintiff who takes the initiative potentially bears all of the downside risk but might well be entitled to recover only a tiny proportion of any amount paid as damages or in a settlement.

In the US the legal system addresses these obstacles by treating plaintiffs' attorneys as entrepreneurs who seek out legal violations and suitable clients rather than waiting passively for litigants to come to them.[139] Attorneys in the US have long had substantial discretion in civil litigation to arrange for their fees to take the form of a contingency fee arrangement that entitles them to a prescribed percentage of whatever is recovered.[140] If recovery in this context was limited to the sum to which an individual shareholder plaintiff was entitled, the amounts involved would typically be too small to justify proceeding. The US legal system addresses this problem in the corporate and securities context with a "common fund" doctrine that entitles a plaintiff who creates a fund that benefits others to recover attorney fees out of the fund based on principle of unjust enrichment.[141] Hence, if a class action securities suit is successful at trial or (much more likely) settled out of court, the presiding judge will generally sanction the awarding of legal fees out of the proceeds, usually as a percentage of the class recovery.[142] Likewise, when a derivative suit is settled, the 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.[143] Judges must approve settlements, but they rarely object to the parties' agreement on fees.[144]

Circumstances are very different in Britain. English civil procedure rules make no allowance for the possibility of a judge awarding a portion of an award of damages to lawyers as part of a judgment. Instead, legal fees are in principle a matter to be negotiated purely between the client and the lawyer. This means that if a lawyer agrees to a "conditional fee" arrangement with a shareholder litigant, the upside for the lawyer will be limited to the typically tiny recovery available to the client, meaning in turn there is no incentive to be entrepreneurial in the US manner.

6. What Substitutes for Private Litigation in the UK?

Again, share ownership is dispersed in both US and UK publicly-traded companies, meaning a similar agency cost problem—that of keeping managers

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[139] On this characterization, see 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, 678-79 (1986).

[140] Janet E. Findlater, *The Proposed Revisions of DR 5-103(B): Champerty and Class Actions*, 36 BUS. LAW. 1667, 1669 (1981) (noting, though, that the manner in which legal expenses are allocated in class and derivative often conflicts with the relevant provision in the Code of Professional Responsibility).

[141] Coffee, "Understanding", *supra* note xx, 670, n. 2.

[142] Courts, when approving a fee award, will have regard for the fee arrangements negotiated by the lawyer and the client but will also often consider the time the plaintiffs' lawyers have devoted to a case: Goldberger v. Integrated Res., 209 F.3d 43, 50 (2d Cir. 2000).

[143] Robert W. Hamilton, The Law of Corporations 540–41 (5th ed. 2000).

[144] For an exception, see Cox Communications Inc. Shareholders Litigation 879 A. 2d 604 (2006).

accountable to shareholders—arises. If the UK does not rely on private enforcement by way of litigation, how—if at all—are managers kept in check in Britain? There were no British Enrons, WorldComs, or even Parmalats;[145] indeed the last time the UK faced a series of corporate governance scandals was in the early 1990s. How can this be accounted for, given the dearth of private enforcement?

One possibility is that public enforcement acts as a substitute. A recent study concludes that public enforcement of securities laws, measured via a proxy based on the budget and resources available to regulators, is at least as strongly correlated with stock market development around the world as is private enforcement, measured by reference to an index based on the formal ease of bringing a private lawsuit.[146] These findings imply that even if lawsuits brought by private plaintiffs are uncommon, enforcement by securities regulators can fill the gap. However, staff and budget levels at the Financial Services Authority, Britain's securities regulator are slightly below US levels, having made due allowance for differences in the size of the domestic population and GDP.[147] Moreover, with respect to the number of public enforcement actions brought and the size of the penalties imposed (normalized by reference to market size) the UK trails the US to a degree comparable to the disparity we report as regards private litigation.[148] Enforcement by securities regulators is thus an implausible substitute for the lack of private enforcement in UK.

Director disqualification constitutes another means by which public regulators in Britain can seek to reduce managerial agency costs. If a company goes into bankruptcy (known as "insolvency proceedings" in the UK), the DBERR's Insolvency Service can apply to court to disqualify the directors from serving in that capacity for a specified period if their conduct in the period leading up to the insolvency demonstrates unfitness to be concerned in the management of a company.[149] A disqualification "plea bargain" with directors is also possible.[150]

The numbers of directors disqualified is quite substantial, averaging around 1500 per annum.[151] However, the disqualification regime does not appear to operate as an important substitute for private litigation in addressing agency costs in publicly traded companies. Very few listed companies go into insolvency proceedings—an average of 10 per year over the period 1996-2003[152] -- so there cannot be many consequential disqualifications of directors of listed companies. Our empirical

[145] The closest call in the UK was Marconi plc's rapid fall from grace in autumn 2001. However, this was revealed to have been no more than too-aggressive acquisition-lead growth during the 1990s; no fraud was involved.

[146] Howell E. Jackson and Mark J. Roe, Public Enforcement of Securities Laws: Preliminary Evidence, working paper, Harvard Law School (2007).

[147] The UK's securities regulator, the FSA, has 14.32 staff per million of population, and a budget of $65,507 per billion of GDP, as compared with figures of 23.29 and $76,459, respectively, for the US securities regulator, the SEC: Jackson and Roe, *supra* note 146, 41 (Table 1).

[148] John C. Coffee, Law and the Market: The Impact of Enforcement, working paper, Columbia Law School (2007), 38-41.

[149] Company Directors Disqualification Act 1986, s 6.

[150] Company Directors Disqualification Act 1986 ss 1A, 6, 7.

[151] See Armour, *supra* note xx, at 22.

[152] See Maria Carapeto and Lukas Stuflesser, The Information Content of Administration and Administrative Receivership Filings in the UK, working paper, Cass Business School, 20 (2006).

findings illustrate the point. Court proceedings for the disqualification of a director of a company with a paid-up share capital in excess of £120,000 need to be commenced in the Companies Court.[153] As detailed in section 3.3 above, our search of Companies Court filings for 2004, 2005 and 2006 uncovered only three cases where disqualification proceedings were brought against directors of publicly traded companies.

The takeover regulation scheme in place in Britain stands out as a more promising method by which public regulators substitute for private enforcement. As we have seen, while takeovers generate a large part of the shareholder litigation that occurs in the US in the UK the oversight of takeovers is handled by a public body, the Takeover Panel, which administers the City Code that governs the conduct of take-over bids for companies listed in the UK. There is data on the number of cases upon which the Panel is called upon to offer guidance that indicates the Panel often functions as a substitute for private litigation.[154] Figure 2 shows annual data on the number of Panel engagements since 1969 (black line) and the number of actual bids made (dashed line). Since Panel engagements exceed actual bids by nearly 50%, the Panel is clearly not only making rulings on bids that proceed but also in numerous situations is giving rulings where a bid does not actually materialise. The Takeover Panel therefore appears to be performing a major prophylactic function.

Figure 2: Engagements by the Takeover Panel, 1969-2006

Source: Takeover Panel, Annual Reports, 1969-2006[155]

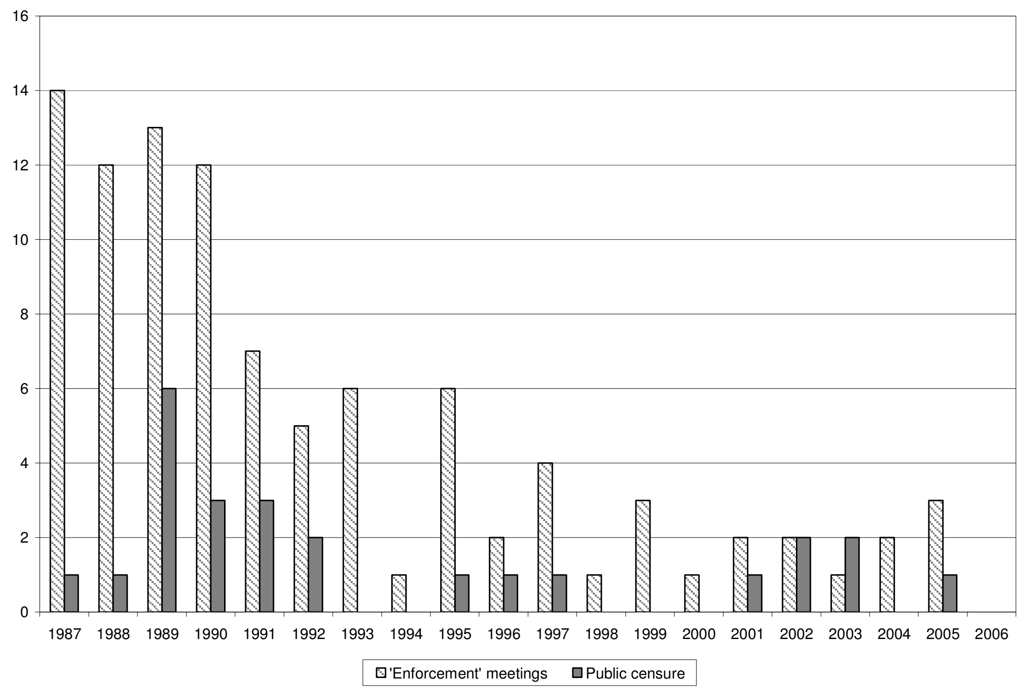
[153] See Company Directors Disqualification Act 1986, s 6(3); Practice Direction: Directors Disqualification Proceedings, para 4.1; Her Majesty's Court Service, The Chancery Guide 2005 (2005), para 20.1.

[154] In the vast majority of cases, the Panel's response to a reference will be given in private. However, in a small minority of cases, the Panel will make a public ruling concerning the conduct of a particular bid situation.

[155] Data on total cases for 2005 and 2006 are estimates.

Another metric for Panel activity concerns sanctions for non-compliance. For minor breaches, a quiet reprimand in private is likely to be delivered. For more significant matters, a remedial order can be issued, either to stop the non-compliant activity or to compensate stockholders who missed out on an opportunity to sell out on terms as advantageous as other stockholders. Remedial orders are sometimes coupled with a statement of public censure, usually aimed at "naming and shaming" financial advisers rather than directors. Figure 3 reports annual data on the number of times the Panel has met with a view to exercising an enforcement function, and the number of statements of public censure issued. Here the evidence matches more closely the pattern with director disqualification, as sanctions are relatively uncommon. Thus while the Panel's activities do help to substitute for private enforcement in the UK, the frequency with which sanctions are imposed remains modest.

Figure 3. Takeover Panel Enforcement Activity, 1987-2006



Source: Takeover Panel, *Annual Reports* 1987-2006; *Panel Statements*, 1987-2006

While public enforcement is at best a partial substitute for private enforcement in the UK, other mechanisms come into play. One is the exercise of collective shareholder power. In various ways shareholders in the UK are better positioned to exercise influence over managers on a joint basis than their counterparts in the US. For instance, it is easier for UK shareholders to call a general meeting to deal with contentious issues.[156] Also, unlike in the US, it is impossible for UK boards to entrench themselves effectively against a resolution for their removal.[157] Moreover, while public offerings of shares in the US are rarely structured so as to give existing shareholders pre-emption rights, this is standard practice in the UK. As a result, UK

[156] Companies Act 1985, §368; Companies Act 2006, §§303-305.

[157] Companies Act 1985, §§303-304; Companies Act 2006, §§168-169.

managers typically cannot issue new shares without approaching existing shareholders first, thus giving the shareholders considerable leverage when capital-raising occurs.[158]

If the UK was a retail-dominated share market as the US has traditionally been, the presence of greater collective shareholder rights would be largely irrelevant in practice as investors would be unable to coordinate themselves sufficiently to exercise influence over management. However, the UK has been for a number of decades a share market dominated by institutions, which, together with their fund managers, are based in close proximity in London's financial district.[159] Institutional shareholders have thus been well positioned to coordinate their activities and make use the collective shareholder rights company law provides, which in turn likely does constitute a meaningful substitute for corporate and securities litigation.

What can be labelled as "informal" enforcement also likely matters. While the US lacks any form of authoritative "code" of corporate governance, Britain has a Combined Code of Corporate Governance as an appendix to the London Stock Exchange's listing rules. The Combined Code is structured as a series of "provisions" offering specific guidance on key aspects of corporate governance, set within a framework of over-arching "principles".[160] Key provisions include the separation of the CEO and chairman of the board, the inclusion of a minimum number of independent ("non-executive") directors, and the establishment of separate audit, remuneration and nomination committees, which must be populated by a majority of independent directors.

The Code is not formally "binding" on listed companies. Instead, it operates on a "comply or explain" basis, meaning that companies do not have to comply with the Code's provisions as such but failures to do so must be disclosed and explained in the annual reports circulated to shareholders.[161] In theory, a failure by a company to state whether it complies with the Combined Code or to give reasons for non-compliance can be sanctioned by a fine or even de-listing, but there are no reported instances of any such enforcement actions.[162] Regardless, listed companies usually comply with key substantive provisions of the Combined Code and usually disclose failures to comply (Table 6). The likely explanation is that investors price at a discount the shares of companies which fail to adhere to the Combined Code, thus creating a feedback loop in favour of adherence.[163] This process of "informal

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[158] Companies Act 1985, §§80-96; Companies Act 2006, §§560-577.

[159] Armour and Skeel, *supra* note xx, 1769-71.

[160] The Combined Code 2003 is available at http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf. A revised version has been promulgated by the Financial Reporting Council, which the FSA intends, after the closure of public consultation, to make applicable to UK listed firms. This is expected to occur in mid-2007. The revised Code ("Combined Code 2006") is available at: http://www.frc.org.uk/documents/pagemanager/frc/Combined%20Code%20June%202006.pdf.

[161] LR 9.8.6(4).

[162] Ian MacNeil and Xiao Li, '"Comply or Explain": Market Discipline and Non-Compliance with the Combined Code' 14 *Corporate Governance: An International Review* 486, ___ (2006). See also Financial Services Authority, *Annual Report 2004-5*, 140 (2005); Financial Services Authority, *Annual Report, 2005-6*, 141 (2006) (annual breakdowns of enforcement activity).

[163] Carol Padgett and Amama Shabbir, "The UK Code of Corporate Governance: Link Between Compliance and Firm Performance" (2005), working paper; Sridhar R. Arcot and Valentina Giulia Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK', working paper,

enforcement" likely operates as at least a partial substitute for private enforcement by way of litigation.

Table 6: Compliance with the Combined Code

Provision	% stating compliant		% non-compliance explained
	PIRC (2004) 2003-4	Arcot & Bruno (2006a) 1998-2004	
Key Provisions			
Separate CEO/Chairman	92	90	86
Proportion/# NEDs	97	95	74
Majority of NEDs independent	94	92	72
Service contracts	N/a	57	86
Nomination committee	85	88	91
Remuneration committee	87	87	69
Audit Committee	88	92	91
Mean	90.5	85.9	81.2
All provisions	47	33	83

Sources: PIRC (2004), Arcot and Bruno (2006a).[164]

7. Conclusion

Concerns exist that corporate and securities law in the US "over-regulates" due to robust private enforcement, in the form of lawsuits launched by shareholders. Our results show that a country – Britain -- can have robust securities markets without numerous lawsuits being filed against directors of publicly traded companies. This, in turn, implies that there is scope in the US for reducing the costs and hassle associated with corporate and securities litigation without compromising the vibrancy of securities markets. We hesitate to draw this conclusion, for at least a couple of reasons.

First, substitutes need to be taken into account. In the UK, the work done by the Takeover Panel displaces the corrective role that litigation potentially plays in the M&A context. If steps were taken to deter private lawsuits in the takeover context in the US without the introduction of a similar regime, the costs of reform, in the form of takeover practices adversely affecting investors, could well exceed the benefits. It is unlikely that the SEC and the states, which determine the corporate laws that govern takeovers, would be able or willing to coordinate matters so as to set up an equivalent to the Takeover Panel. As a result, radical changes to the status quo could well be ill-advised.

London School of Economics (2006) (noting, though, investors do not appear to react adversely so long as a non-complying company is delivering good financial results, which they characterize as a "comply or perform" system).

[164] PIRC cite;

Second, it is important to remember that the large volume of corporate and securities lawsuits in the US does not translate into substantial financial risk for directors of publicly traded companies. Consider the position of outside directors of a US public company. Unless their company is bankrupt or they put money in their own pockets, they face very little personal liability risk from shareholder litigation. Our searches found only about 20 corporate cases a year where damages are sought, outside directors are named as defendants, and the case met the threshold seriousness standard of producing a written judicial decision. Many of these cases, moreover, are dismissed, and most of the others settle. So long as the company is solvent, the company or a D&O insurer will typically pay all damages, and the risk of personal liability approaches zero. The risk of out-of-pocket payments thus seems highly unlikely to produce counterproductive incentives for outside directors. Thus, in this context at least, the benefits arising from the deterrence of lawsuits by shareholders seems marginal.

Other important questions we simply have to leave open. We do not purport to say on the basis of our results what degree of formal private enforcement is optimal. Nor do we offer a definitive view on how the optimal level of formal private enforcement might vary depending on levels of public enforcement and informal enforcement. Nevertheless, we have provided an empirical departure point for debate on these key questions by providing empirical evidence showing how markedly levels of private enforcement differ the US and the UK, by explaining why these differences exist and by drawing attention to potential substitutes for shareholder lawsuits.