OUTSIDE DIRECTOR LIABILITY

Bernard Black,* Brian Cheffins,** and Michael Klausner***

This Article analyzes the degree to which outside directors of public companies are exposed to out-of-pocket liability risk—the risk of paying legal expenses or damages pursuant to a judgment or settlement agreement that are not fully paid by the company or another source, or covered by directors' and officers' (D&O) liability insurance. Recent settlements in securities class actions involving WorldCom and Enron, in which lead plaintiffs succeeded in extracting out-of-pocket payments from outside directors, have led to predictions that such payments will become common. We analyze the out-of-pocket liability risk facing outside directors empirically, legally, and conceptually and show that this risk is very low, far lower than many commentators and board members believe, notwithstanding the WorldCom *and* Enron *settlements. Our extensive search for instances in which outside directors of public companies have made out-of-pocket payments turned up thirteen cases in the last twenty-five years. Most involve fact patterns that should not recur today for a company with a state-of-the-art D&O insurance policy.*

We offer a detailed assessment of the liability risk outside directors face in trials under corporate and securities law, including settlement dynamics. We

* Hayden W. Head Regents Chair for Faculty Excellence and Professor of Law, University of Texas Law School; Professor of Finance, McCombs School of Business, University of Texas, Austin.

** S.J. Berwin Professor of Corporate Law, Cambridge University, United Kingdom.

*** Nancy and Charles Munger Professor of Business and Professor of Law, Stanford Law School.

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argue that, going forward, if a company has a D&O policy with appropriate coverage and sensible limits, outside directors will be potentially vulnerable to out-of-pocket liability only when (1) the company is insolvent and the expected damage award exceeds those limits, (2) the case includes a substantial claim under section 11 of the Securities Act or an unusually strong section 10(b) claim, and (3) there is an alignment between outside directors' or other defendants' culpability and their wealth. Absent facts that fit or approach this "perfect-storm" scenario, directors with state-of-the-art insurance policies face little out-of-pocket liability risk, and even in a perfect storm they may not face out-of-pocket liability. The principal threats to outside directors who perform poorly are the time, aggravation, and potential harm to reputation that a lawsuit can entail, not direct financial loss.

INTRODUCTION

This Article analyzes outside director liability risk empirically, legally, and conceptually. Concern over liability for outside directors has arisen periodically since the 1970s, typically in response to specific events that appear to expose outside directors to heightened risk.[1] Outside director liability is again causing much concern, with the current trigger being the 2005 securities class action settlements involving WorldCom and Enron. In these settlements, outside directors agreed to make substantial payments out of their own pockets to settle securities class action lawsuits even though there was no evidence in either case that the outside directors knowingly participated in fraudulent activity.

The *WorldCom* securities class action arose out of the largest bankruptcy in U.S. history.[2] The company's twelve outside directors personally paid $24.75 million as part of a settlement with a plaintiff class led by the New York State Common Retirement Fund (NYSCRF). The *Enron* securities class action arose out of the second-largest bankruptcy in U.S. history; in this case, ten outside directors paid $13 million out of their own pockets to settle claims against them. In addition, the Enron outside directors paid $1.5 million to settle a suit by the U.S. Department of Labor (DoL) under the Employment Retirement Income Security Act (ERISA). In both settlements, the lead plaintiff insisted on personal payments by the outside directors. In announcing the *WorldCom* settlement, Alan Hevesi, the Comptroller of the State of New York and Trustee of the NYSCRF, stated that the payments were intended to send "a strong message to the directors of every publicly traded company that they must be

1. *See, e.g.*, Richard J. Farrell & Robert W. Murphy, *Comments on the Theme: "Why Should Anyone Want To Be a Director?,"* 27 BUS. LAW. 7 (1972) (special issue); Larry D. Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U. L. REV. 1341, 1341-42, 1362-63 (1977); *Companies Expected To Have Trouble Getting Outside Directors*, N.Y. TIMES, May 9, 1974, at 67. Lax boardroom practices allegedly contributed to the much-publicized 1970 collapse of railway giant Penn Central and generated discussion of the role outside directors should play in public companies. *See, e.g.*, Daniel J. Schwartz, *Penn Central: A Case Study of Outside Director Responsibility Under the Federal Securities Laws*, 45 UMKC L. REV. 394, 395-99 (1977); Peter Vanderwicken, *Change Invades the Boardroom*, FORTUNE, May 1972, at 156. In the 1980s, the famous case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), also led to widespread concern over outside director liability risk. *See, e.g.*, Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 7 (1989); Fran Hawthorne, *Outside Directors Feel the Heat*, INSTITUTIONAL INVESTOR, Apr. 1989, at 59. Even earlier there was a concern over the potential liability of inside and outside directors generally. *See, e.g.*, Joseph Bishop, *Current Status of Corporate Directors' Right to Indemnification*, 69 HARV. L. REV. 1057 (1956); Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968) [hereinafter Bishop, *Sitting Ducks*]. In each era, these concerns turned out to be unwarranted.

2. A ranking of U.S. bankruptcies by prefiling assets in millions of dollars can be calculated from the Bankruptcy Research Database compiled by Professor Lynn LoPucki, which is available at http://lopucki.law.ucla.edu/ (last visited Feb. 1, 2006). For instance, WorldCom's prefiling asset value is listed as $114.9 billion.

vigilant guardians for the shareholders they represent. . . . We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud."[3]

Press reports of the *WorldCom* and *Enron* settlements emphasized that they represented disturbing precedents for outside directors. For example, Richard Breeden, former chairman of the Securities and Exchange Commission (SEC), opined that the *WorldCom* deal "will send a shudder through boardrooms across America and has the potential to change the rules of the game."[4] Law firm client memos supported this view.[5] Many believe that lead plaintiffs in securities suits will follow the *WorldCom* and *Enron* script by seeking personal payments from outside directors as a condition of settlement and will succeed in extracting such payments.

Outside directors' anxiety about legal liability was high prior to the *WorldCom* and *Enron* settlements. The conventional wisdom was that being an outside director of a public company was risky. Fear of liability has for some time been a leading reason why potential candidates turn down board positions.[6] The *WorldCom* and *Enron* settlements have heightened these fears.[7] Outside directors are not worried about liability for self-dealing, insider trading, or other dishonest behavior. These actions indeed entail significant liability risk, but a director can avoid that risk by refraining from engaging in suspect actions. Outside directors are concerned instead that, as in *WorldCom* and *Enron*, they will be sued for oversight failures when, unbeknownst to them, management has behaved badly; that neither indemnification by the company

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

4. Brooke A. Masters & Kathleen Day, *10 Ex-WorldCom Directors Agree to Settlement*, WASH. POST, Jan. 6, 2005, at E1; *see also* John C. Coffee, Jr., *Hidden Issues in "*WorldCom,*"* NAT'L L.J., Mar. 21, 2005, at 13 ("[The] explicit agenda of requiring a personal contribution has traumatized outside directors . . . ."); Michael W. Early, *Protecting the Innocent Outside Director After* Enron *and* WorldCom, 2 INT'L J. DISCLOSURE & GOVERNANCE 177, 179 (2005) (collecting press quotations).

5. *See, e.g.*, Memorandum, Bailey Cavalieri LLC, D&O Liability: Now It's Personal (undated) (on file with authors); Memorandum, Shirli Fabbri Weiss & David A. Priebe, Partners, DLA Piper Rudnick Gray Cary, Potential for Personal Liability from Recent Securities Settlements Heightens Importance of Corporate Governance to Directors (Jan. 13, 2005), http://www.dlapiper.com/global/publications/detail.aspx?pub=397; Memorandum, Skadden, Arps, Slate, Meagher & Flom, *WorldCom*/*Enron* Settlements—Implications for Directors (Jan. 2005), http://www.skadden.com/Index.cfm? contentID=51&itemID=998; Memorandum, Sullivan & Cromwell LLP, *WorldCom* and *Enron*—Personal Liability of Outside Directors, 2-3 (Jan. 10, 2005) (on file with authors).

6. *See, e.g.*, Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 1-2 (1989).

7. *See, e.g.*, Michael T. Burr, *Securing the Boardroom*, CORP. LEGAL TIMES, June 5, 2005, at 53; Anne Fisher, *Board Seats Are Going Begging*, FORTUNE, May 16, 2005, at 204; Suzanne McGee, *The Great American Corporate Director Hunt*, INSTITUTIONAL INVESTOR, Apr. 1, 2005, at 32.

nor D&O liability insurance will fully protect them; and that they will therefore bear "out-of-pocket" liability.[8]

We address in a separate article the normative question of the degree to which outside directors should bear out-of-pocket liability risk for oversight failures.[9] Regardless of one's position on the issue, however, all would agree that, beyond some level of liability risk, qualified people may decide not to serve as directors and that those who do serve may become excessively cautious. Too much fear of liability, therefore, may reduce rather than enhance the quality of board decisions. But before one can assess the proper scope of outside directors' out-of-pocket liability risk or the need for reform, one needs to understand the actual extent of that risk under the current legal regime.

This Article addresses the following questions: How often have outside directors paid damages, or even legal expenses, out of their own pockets—either pursuant to a judgment or a settlement? Under what circumstances are outside directors likely to face out-of-pocket liability when a lawsuit launched by shareholders or creditors under corporate or securities law goes to trial? What conditions need to be in place for an outside director to make an out-of-pocket payment when a shareholder suit settles? How often will lead plaintiffs such as NYSCRF try to extract out-of-pocket payments from outside directors? If they try, how likely are they to succeed? Do the *WorldCom* and *Enron* settlements reflect a major change in the underlying dynamics of shareholder suits that increase the risk of out-of-pocket payments by outside directors in cases involving oversight failures? Do other sources of risk, such as enforcement by the SEC or suits brought under ERISA, alter matters by creating substantial out-of-pocket liability risk?

We begin with the results of an extensive empirical investigation of outside director liability. We find that out-of-pocket payments by outside directors are rare. Companies and their directors are frequently sued under the securities laws and state corporate law, and settlements are common. But the actual payments are nearly always made by the companies involved—either directly

8. For the purposes of this Article, we define "out-of-pocket liability" to include any situation in which liability for damages or litigation expenses comes out of the outside directors' personal assets—potential costs that are unindemnified and uninsured. We do not include instances where outside directors representing a major shareholder were found liable at trial or agreed to pay damages in a settlement, and the major shareholder paid on the director's behalf.

9. For partial installments on this project, see Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability: A Policy Analysis*, 162 J. INSTITUTIONAL & THEORETICAL ECON. (forthcoming 2006) [hereinafter Black, Cheffins & Klausner, *Policy Analysis*], and Parts III-IV of Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability (Before* Enron *and* WorldCom*)* (Working Paper 2004), *available at* http://ssrn.com/abstract=382422. For an argument in favor of legal liability for directors, see Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393 (2005).

or pursuant to directors' rights to indemnification[10]—or by a D&O insurer, a major shareholder, or another third party. Since 1980, outside directors have only once made personal payments after a trial. That was in the famous *Van Gorkom* case in 1985.[11] We found an additional twelve cases in which outside directors made out-of-pocket settlement payments or payments for their own legal expenses. Ten of those cases involved claims of oversight failure; two involved duty of loyalty claims; and one involved an allegedly ultra vires transaction involving the directors' compensation. (We count two payments by the Enron outside directors, in a securities case and an ERISA case, as one instance.) Most of the oversight cases involved fact patterns that should not recur today for a company with a state-of-the-art[12] D&O insurance policy.

We then explain the rarity of out-of-pocket payments in shareholder suits by analyzing the complex interaction of multiple factors: (1) substantive liability rules; (2) procedural hurdles that plaintiffs must overcome to win a damage judgment against outside directors; (3) indemnification and D&O insurance, which prevent "nominal liability"[13] for settlement payments, damage awards, or legal expenses from turning into out-of-pocket liability; and (4) settlement incentives. Our analysis reveals a narrow set of circumstances in which outside directors face a risk of a judgment against them that could result in out-of-pocket liability. Setting aside self-dealing and other dishonest behavior, the window of exposure was narrow prior to *WorldCom* and *Enron*, and it remains narrow today.[14]

We next analyze settlement incentives that arise in the shadow of the outside directors' exposure to an actual finding of liability following a trial. Settlement incentives sharply narrow the already limited level of out-of-pocket liability risk. Once settlement incentives are considered, outside directors face significant risk primarily in two situations. One situation, which we call a "perfect storm," requires the confluence of the following elements: (1) the company is insolvent and the expected damage award exceeds the amount the company can pay plus the limit on the company's insurance policy; (2) the case includes either a large claim under section 11 of the Securities Act of 1933 (Securities Act) or a large and unusually strong claim against the outside directors under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act); and (3) there is an alignment between individual culpability

10. In most settlements, the issue of whether a payment is made on behalf of outside directors or by the company directly is avoided. The company and the D&O insurer fund a settlement, and the parties agree that the defendants do not acknowledge a violation.

11. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

12. *See infra* note 121 and accompanying text.

13. We define "nominal liability" to include situations in which a court has held outside directors liable for damages or an outside director agrees to a settlement, but where the actual payments for damages and legal expenses are made by the company, the D&O insurer, a major shareholder, or another third party.

14. We analyze corporate and securities law cases in detail and address ERISA and other laws in less detail. We do not include liability for insider trading in our analysis.

and personal wealth among the officers, directors, or both. Even if these conditions are met, however, an outside director may still be protected from out-of-pocket liability if his company provides its directors with supplemental insurance coverage that is separate from that covering the company and the inside managers. Perfect storms have happened and they can happen again, but they are rare.

The second out-of-pocket liability scenario, which we call "can't afford to win," occurs when the company is insolvent, and, due to a lack of D&O insurance or insufficient coverage, an outside director must pay his own litigation expenses to defend a suit. Under these conditions, even a director facing a meritless lawsuit may incur legal expenses, make an out-of-pocket payment to settle, or do both, rather than defend a case further. This risk should not be a substantial concern today for a well-counseled board. Virtually all companies now carry D&O insurance at levels that will cover litigation expenses. Furthermore, companies can now purchase separate Side A Only policies or traditional policies with severability clauses in order to preserve outside directors' coverage irrespective of inside managers' conduct.[15]

Commentators have suggested that *WorldCom* and *Enron* will encourage other lead plaintiffs to attempt to extract out-of-pocket payments from outside directors.[16] Even if this is true (a point that remains unsubstantiated), there are substantial constraints on a lead plaintiff's ability to translate a desire for personal payments into actual payments. Absent a perfect storm, a lead plaintiff in a securities class action can pursue personal payments from outside directors only by sacrificing the interest of the class in maximizing the net present value of the eventual recovery, thus likely violating a duty owed to the class and potentially posing a similar risk for the class counsel. Even if a lead plaintiff and class counsel are willing to go after outside directors' personal assets under those circumstances, the effort to extract personal payments is likely to fail unless the lead plaintiff can credibly threaten to litigate a case to a judgment that will require the outside directors to make out-of-pocket payments. To make this threat credible, the company must be insolvent, and the other perfect-storm elements must be present to a substantial degree—we call this a near-perfect storm—which is still a rare convergence of factors. *WorldCom* and *Enron* fit the perfect or near-perfect-storm pattern.

15. *See* Early, *supra* note 4, at 184-86.

16. *See, e.g.*, Coffee, *supra* note 4 (noting that the NYSCRF agenda to require personal contributions is "being copied by other public pension funds"); John R. Engen & Charlie Deitch, "*Chilling" (What Directors Think of the* Enron/WorldCom *Settlements)*, CORP. BOARD MEMBER, Mar./Apr. 2005, *available at* http://www.boardmember.com/issues/archive.pl?articleid=12143&V=1; Fisher, *supra* note 7; Charles Hansen, *A Seismic Shift in Director Liability Exposure: The* WorldCom *and* Enron *Settlements*, CORPORATION, July 15, 2005; Joann Lublin, Theo Francis & Jonathan Weil, *Directors Are Getting the Jitters; Recent Settlements Tapping Executives' Personal Assets Put Boardrooms on Edge*, WALL ST. J., Jan. 13, 2005, at B1; McGee, *supra* note 7; Peter Wallison, *The* WorldCom *and* Enron *Settlements: Politics Rears Its Ugly Head*, FIN. SERVS. OUTLOOK, Mar. 2005.

Enforcement actions by the SEC and the DoL pose some additional risk to outside directors. Our search, however, uncovered only one instance in which an SEC enforcement proceeding yielded an out-of-pocket payment by an outside director, and this situation involved self-dealing rather than a failure to exercise sufficient oversight. There has also been only one DoL enforcement action under ERISA that has resulted in a personal payment by outside directors: the action against the Enron board. The bottom line is that, despite the litigious environment in which public companies function, outside director liability is, and will in all likelihood remain, a rare occurrence, particularly for companies with state-of-the-art D&O insurance.

I. AN EMPIRICAL INVESTIGATION OF OUTSIDE DIRECTOR LIABILITY

Because the *WorldCom* and *Enron* settlements are recent, large, and highly visible, they weigh heavily in the perceptions of outside directors, lawyers, and commentators. But how common has out-of-pocket liability been for outside directors of public companies?[17] Many lawsuits are filed seeking damages, but how many lead to trials, and how many lawsuits end with out-of-pocket payments by outside directors, either in a settlement or after a trial? No data have been collected to address this question. Moreover, collecting complete data from public records is impossible because the vast majority of shareholder suits settle without a trial, information about trials and settlements is difficult to track through court records (despite being technically public), and settlement documentation often leaves unclear the sources of payments (sometimes deliberately so). Even for trials, there is no public record of who actually paid damage awards—officers or directors, their company, the D&O insurer, a major shareholder, or another third party.

Lacking a comprehensive source of information about either trials or out-of-pocket payments following trials or settlements, we adopted a multi-prong approach to investigating both. We read widely in the D&O literature and searched for news stories in the legal and business press and in practitioner-oriented journals dealing with director liability and D&O insurance. We conducted Westlaw searches for corporate law cases that had gone to trial in

17. For the purposes of this study, we defined outside director broadly to encompass any director of a public company not serving in a managerial capacity. If an individual served as an executive during the period of alleged wrongdoing and subsequently became an outside director by giving up his managerial duties, we treated him as an inside manager. For instance, a securities lawsuit involving Symbol Technologies settled in 2004 with company founder Jerome Swartz paying $4 million. He was CEO during part of the period when the alleged securities fraud occurred (2000 to 2002) and a director during the entire period. We treated him as an inside manager. For background, see Complaint, *Gold v. Razmilovic*, 2003 WL 23712371 (Del. Ch. Dec. 18, 2003); Press Release, Bernstein Litowitz Berger & Grossmann LLP, Louisiana and Miami Pension Fund Lead Plaintiffs Announce $139 Million Partial Settlement of Securities Litigation Against Symbol Technologies Inc. (June 3, 2004), http://www.blbglaw.com/notices/symbolsettpressrel6.3.04.pdf.

which outside directors had been sued for damages, and we searched SEC litigation releases for payments resulting from SEC enforcement.[18] Our search covered the period from 1980 through the end of 2005.

In addition, we conducted an extensive telephone survey of (1) law firms with large securities litigation practices, on both the defense and plaintiff sides; (2) leading Delaware firms specializing in corporate litigation; (3) lawyers that represent insurers as monitoring counsel; (4) lawyers specializing in D&O insurance; (5) in-house legal counsel at major public pension funds that often act as lead plaintiffs; (6) major D&O insurance brokers; (7) major D&O insurers; and (8) current and former SEC officials. We followed up on leads as to possible trials or instances of out-of-pocket liability. Sometimes we had to speak to or investigate several sources about a single case to be sure we had a full picture. Not infrequently, when one source thought outside directors had paid personally, other sources revealed that the payment was covered by insurance or indemnification or that the director in question was an inside manager. Our interviews included one or more senior partners at each of twenty-four plaintiffs' law firms and sixty-seven law firms that primarily represent either defendants or insurers or both, and one or more senior executives at eight major D&O insurance companies and seven D&O insurance brokers. Appendix A provides details on our survey methodology and a list of the firms we interviewed. In the end, we may have missed some trials and out-of-pocket payments, especially earlier ones as to which memories may have faded, but it is unlikely that we missed many.

Our empirical investigation did not cover insider trading. We did, however, cover SEC enforcement proceedings involving other forms of self-dealing or failures of oversight. In addition, we sought to find trials and out-of-pocket settlements arising under ERISA, under which directors who exercise authority over employee retirement plans that hold company shares can be held liable as fiduciaries for plan losses.[19]

We find that while lawsuits are common—securities class actions alone come to roughly 200 cases per year—but trials are uncommon. When cases settle, as the vast majority do, plaintiffs often recover cash, but the cash nearly always comes from the company, a D&O insurer, a major shareholder, or another third party. Outside directors make personal payments in a tiny percentage of cases. From 1980 onwards—as far back as we looked—we found

18. Details on the searches are provided at various points in this Part, Part III, and Appendices A and B. Most corporate law cases are tried in Delaware before a chancery court judge, who writes an opinion. Thus, a search that covers decided cases should capture most corporate trials. Securities class actions, in contrast, are almost invariably tried to juries, so an online search for judicial opinions would not capture them.

19. *See In re* Schering-Plough Corp. ERISA Litig., 420 F.3d 231, 231-32 (3d Cir. 2005) (giving plaintiffs who invest in company shares under a 401(k) plan standing to sue on behalf of the plan and recover damages for losses due to a fiduciary-duty breach). Among ERISA cases, we examined only those in which employees claimed damages for losses on company shares.

a total of thirteen cases in which outside directors made out-of-pocket payments. This includes payments pursuant to judgment, payments to settle cases, and payments simply to cover legal expenses until a case was resolved. Ten of these cases involved oversight failure, two involved self-dealing or duty of loyalty claims, and one involved a claim that a transaction involving directors' own compensation was ultra vires.

Most cases in which outside directors made out-of-pocket payments have involved small companies and little or no publicity. Of the thirteen cases we found, four are well known (*WorldCom*, *Enron*, *Tyco*, and *Van Gorkom*). One is little known but could in principle be found through a careful search of news stories (*Independent Energy Holdings*). The remaining cases are either entirely hidden or the existence of out-of-pocket payments can be inferred only by piecing together multiple sources of information.[20]

A. *Trials: Frequency and Outcomes*

The volume of shareholder litigation is considerable. According to the securities litigation database maintained by the National Economic Research Associates (NERA), 3239 federal securities cases were filed against public companies between 1991 (when NERA began to collect this data) and 2004.[21] That does not include state fiduciary duty cases or state securities law cases.

Very few cases, however, go to trial. We looked back to 1980, and as Table 1 indicates, we uncovered only thirty-seven securities law cases seeking damages that were tried to judgment against public companies, their officers and directors, or both. Thirty-three cases were brought in federal court under the federal securities laws. Thirty-one of those were class actions and two were individual actions.[22] We also found five state securities law cases that were

20. Our findings are consistent with historical patterns. According to a 1944 judgment of the New York Supreme Court, "it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." Bayer v. Beran, 49 N.Y.S.2d 2, 6 (1944). Professor Joseph Bishop found in 1968 "that cases in which directors of business corporations are held liable, at the suit of stockholders, for mere negligence [without self-dealing] are few and far between." Bishop, *Sitting Ducks*, *supra* note 1, at 1095. With respect to derivative suits, Bishop famously reported: "The search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." *Id.* at 1099.

21. On filed cases, see ELAINE BUCKBERG ET AL., NERA ECONOMIC CONSULTING, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEAR MARKET CASES BRING BIG SETTLEMENTS (2005). Multiple complaints involving similar facts are counted as a single case. Similar but somewhat smaller numbers are reported in PRICEWATERHOUSECOOPERS LLP, 2004 SECURITIES LITIGATION STUDY (2005), and in CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2005: A YEAR IN REVIEW 3 (2005), which relies on the Stanford Securities Class Action Clearinghouse, *available at* http://securities.stanford.edu/.

22. Our count of securities trials includes one trial that ended in a hung jury, which was settled prior to retrial.

tried to judgment. One case included both federal and state claims and is included in our count of state and federal cases (but only as one case in the thirty-seven total cases).[23] Appendix B provides details on completed trials as well as eleven additional cases against companies, officers, or directors that settled during trial. It also lists a number of securities law trials against third-party defendants, including accounting firms, investment banks, and others.

Table 1. Securities and Corporate Law Trials Against Public Companies and Their Directors for Damages, 1980-2005

Area of Law (State or Federal Court)	Total Cases Tried to Judgment	Trial Includes Outside Directors	Plaintiff Win Against Outside Directors	Damages Paid by Outside Directors
Securities—Federal Court	33	7	0	0
Securities—State Court	5	3	1	0
Corporate (Fiduciary Duty)—Derivative	Data Not Available	5	2	0
Corporate (Fiduciary Duty)—Direct	Data Not Available	12	4	1
ERISA (Fiduciary Duty; Losses on Company Shares)	0	0	0	0

In only eight[24] completed securities trials were outside directors named as defendants when the trial began. In one of those cases, the outside directors settled during trial within D&O insurance policy limits. In six others, the suit against the outside directors failed. In each of these cases the outside directors involved faced little out-of-pocket risk even if they had lost at trial because the

23. Since 1998, shareholder class actions under state securities laws have been largely preempted by federal law. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 15 U.S.C. § 77p (2006); Exchange Act § 28(f), 15 U.S.C. § 78bb(f) (2006); ROBERT W. HAMILTON, THE LAW OF CORPORATIONS 572-73 (5th ed. 2000). Class actions were common for a brief period in the mid-1990s, when plaintiffs were seeking to escape restrictive rules introduced under the Private Securities Litigation Act of 1995. One study of securities cases filed in state court between 1996 and 1998 found forty-nine such cases. *See* PRICEWATERHOUSECOOPERS LLP, 2002 SECURITIES LITIGATION STUDY 1 (2002). Individual actions (with fewer than forty-nine shareholder plaintiffs) under state law remain viable and are sometimes brought. *See, e.g.*, Amended Consolidated Complaint, Peregrine Litig. Trust v. Moores, Consol. Case No. GIC 788659 (Cal. Super. Ct. 2004).

24. The one case that was tried in both federal and state court included outside directors among the defendants. Thus, the total number of securities trials in Table 1 is ten rather than nine.

defendant companies were solvent and thus could have indemnified them.[25]

The only case since 1980 in which plaintiffs have won a damage award against an outside director in a securities case involved computer disk drive maker MiniScribe. After MiniScribe got into financial trouble, an investment bank invested in MiniScribe and sent a "company doctor" to run the business.[26] The investment bank's founder joined MiniScribe's board and audit committee as an outside director. A financial fraud ensued, followed by both federal and Texas state securities litigation. In the state case, the jury awarded $530 million in punitive damages and $20 million in actual damages to the plaintiffs, including a large award against the founder of the investment bank.[27] In a post-trial settlement, the investment bank paid on behalf of its founder. Other than MiniScribe, one has to go back to before 1980 to find securities cases where outside directors were found liable in court.[28]

Table 1 also summarizes the trials we found involving state corporate law fiduciary duty claims for damages against outside directors.[29] There is no comprehensive count of fiduciary duty damage actions filed. Randall Thomas and Robert Thompson reported that in 1999 and 2000, a total of 294 cases were filed against public companies in Delaware Chancery Court.[30] This figure, however, includes cases seeking damages and those seeking injunctions. Thomas and Thompson also do not identify cases in which outside directors were defendants. Our search for trials of damages actions against outside directors of public companies uncovered five derivative suits since 1980. Some of those cases include direct claims along with derivative claims. In only two cases, *ASG Industries* and *In re MAXXAM, Inc./Federated Development Shareholders Litigation*, did the plaintiff win. *ASG* was a freeze-out case, which apparently settled after trial with modified terms and no payment by directors. In *MAXXAM*, the trial judge did not rule on damages, and the case settled with D&O insurers paying $7.5 million on behalf of the directors.[31]

25. We discuss indemnification in Part II, *infra*.

26. For details, see Kevin Moran, *Disk Maker Faces Fraud Judgment/Accountants Also Cited in Verdict*, HOUS. CHRON., Feb. 5, 1992; Kathleen Pender, *Hambrecht & Quist Reels from Lawsuits in MiniScribe Fiasco*, S.F. CHRON., Apr. 27, 1992, at B1.

27. The lawsuits filed in federal court settled prior to trial. *See* Gottlieb v. Wiles, 150 F.R.D. 174, 178 (Colo. 1993). On who paid what, see Pender, *supra* note 26, at B1.

28. *See* Gould v. Am.-Hawaiian S.S. Co., 535 F.2d 761, 776-78 (3d Cir. 1976) (granting summary judgment on liability against outside director in 1971 in a § 14(a) case, but with an overlay of self-dealing because the director was employed by and represented a major shareholder who received favorable treatment in a merger); Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 688-89 (S.D.N.Y. 1968) (finding two outside directors liable, one of whom was the company's outside legal counsel).

29. For details on the electronic searches we ran, see Appendix B, *infra*.

30. Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 169 (2004).

31. *See In re* MAXXAM, Inc./Federated Dev. S'holders Litig., No. CIV.A. 12111, CIV.A. 12353, 1997 WL 187317, at *30-31 (Del. Ch. Apr. 4, 1997); David Ivanovich, *6 Year Legal Battle Between 2 Texas Investors Ends in Delaware Court*, HOUS. CHRON., Dec.

We also found twelve *direct* shareholder suits tried to judgment where plaintiffs sought damages and outside directors were defendants. The plaintiffs were successful in four of these cases, but only in *Van Gorkom* were there out-of-pocket payments by outside directors. In that case, the directors of a takeover target, Trans Union, were sued for breach of the duty of care in selling their company without adequately informing themselves. The trial court found in favor of the directors, but the Delaware Supreme Court reversed.[32] The case was remanded and ultimately settled before damages were awarded. The settlement was for $23.5 million, which exceeded Trans Union's $10 million in D&O coverage. The public story is that the acquirer, controlled by the Pritzker family, voluntarily paid the damage award against the directors, and the Pritzkers asked only that each director make a charitable contribution equal to ten percent of the damages exceeding the D&O coverage ($135,000 per person).[33]

The full story is more complex. Because the lawsuit was direct rather than derivative, indemnification was permissible under Delaware law, as long as the directors acted in good faith. Trans Union, like almost all public companies, had committed to indemnify its directors to the full extent permitted by law. It is unclear from public accounts why the outside directors were not simply indemnified by Trans Union (an obligation the acquirer would assume in the merger). One might infer that the acquirer disputed Trans Union's obligation to indemnify the directors and that the directors' payments to charity reflected a compromise of that dispute.[34]

For ERISA fiduciary duty cases involving losses on employee-held company shares, we relied on a 2005 study by Cornerstone Research and on our own survey to find cases that have gone to trial.[35] The number of ERISA suits is growing quickly—Cornerstone found seventy-five ERISA class action suits filed between 1997 and mid-2005—and there have been some large settlements.[36] Cornerstone, however, found no trials involving ERISA claims,

9, 1997.

32. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

33. *See Roundtable Discussion: Corporate Governance*, 77 CHI.-KENT L. REV. 235, 237-38 (2001) (quoting Robert Pritzker as saying that the Pritzkers paid ninety percent and the outside directors paid ten percent—a total of $1.35 million—to charity). The Trans Union CEO, Mr. Van Gorkom, made the contributions on behalf of several directors for whom this would have been a financial strain. *Id.*

34. For the outside directors, the basis for the acquirer to dispute indemnification is not clear. Case law on indemnification was sparse at the time, but current Delaware case law is strongly pro-indemnification, so a similar dispute would be unlikely to arise today.

35. *See* CORNERSTONE RESEARCH, ERISA COMPANY STOCK CASES (2005).

36. On the fact that the number of ERISA fiduciary duty suits by employees claiming losses on company shares is growing, see Leigh Jones, *A "Perfect Storm" for Pension Suits?*, NAT'L L.J., Dec. 13, 2004, at 1. Large ERISA settlements include lawsuits involving Enron (discussed in Part IV, *infra*), Global Crossing Ltd. (settlement for $79 million), and Lucent Technologies ($69 million). *See* Stephen J. Weiss & Shannon A.G. Knotts, *Look into Fiduciary Liability Insurance: This Policy Fills in a Big Gap Left by D&O Insurance,*

nor did we.

B. *Out-of-Pocket Payments by Outside Directors in Settlements*

While trials are uncommon, a great many securities, corporate, and ERISA suits settle.[37] For instance, according to NERA's securities litigation database, of the 3239 federal securities cases filed against public companies between 1991 and 2004, 1754 had settled by the end of 2004.[38] Of those suits filed that do not settle, many either do not survive a motion to dismiss or a motion for summary judgment, or they simply disappear quietly, meaning that the plaintiffs do not pursue the case and the defendants let sleeping lawsuits lie.[39]

Since settlements are so common, we investigated whether outside directors have made out-of-pocket payments pursuant to settlement agreements. The only generally known instances in which outside directors made out-of-pocket payments to settle securities, corporate, or ERISA claims involved WorldCom, Enron, and proceedings brought by the SEC against an outside director of Tyco.[40] Our empirical investigation unearthed nine additional settlements since 1980 in which outside directors made out-of-pocket payments.[41] These cases, at least as a practical matter, are not publicly known.

DIRECTORS & BOARDS, June 22, 2005, at 12.

37. *See* CORNERSTONE RESEARCH, *supra* note 35 (finding that of seventy-five ERISA class actions brought since 1997, twenty-five had settled); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 57-60 (1991) (arguing that incentives to settle are especially high in corporate law cases and finding that out of 128 lawsuits brought against a sample of 535 public companies, 64.8% of the cases settled out of court); *see also* Thomas M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits*, 60 B.U. L. REV. 542, 545 (1980) (finding that settlements were common in corporate cases in the 1970s); *cf.* Thompson & Thomas, *supra* note 30, at 178 (finding that among corporate lawsuits filed in the Delaware Chancery Court in 1999 and 2000, only 28.1% of those involving public companies settled).

38. BUCKBERG ET AL., *supra* note 21. Other than the cases identified above as having gone to trial, the remainder were either dismissed or are still pending. Some cases that are technically still pending have likely been abandoned by the plaintiffs. NERA tracks dismissals but does not try to identify cases that become indefinitely inactive.

39. Many suits under corporate law settle without any monetary payments by defendants. *See* Thompson & Thomas, *supra* note 30, 179-81 (finding in a study of Delaware corporate litigation that approximately half of settlements fail to provide monetary recovery); Romano, *supra* note 37, at 61 (finding that nearly half of the settlements in her study failed to provide for a monetary recovery)

40. Technically, *Van Gorkom* was a settlement as well. As discussed above, the parties settled after a trial, appeal, and remand. We discuss it in the previous Part in the discussion of trials.

41. Although we did not systematically search for out-of-pocket payments prior to 1980, our research uncovered several cases dating from 1968 to 1979 in which out-of-pocket payments possibly occurred, though none are confirmed. During this time period, securities litigation was in its infancy and D&O insurance coverage was far from universal. If a company without D&O insurance went bankrupt and a securities lawsuit followed, directors faced substantial out-of-pocket risk.

The payments involved include settlement payments and payments outside directors made simply to cover their own legal expenses pending resolution of a case—even if no settlement payment was ever made.[42] Table 2 provides a summary, dividing cases into three categories: oversight failures, self-dealing and other loyalty breaches, and one case of an ultra vires transaction.

The most significant of the nonpublic settlements, in terms of dollars paid, was a securities class action settlement described to us on a no-names basis by two separate sources and labeled in Table 2 as Confidential Case #1.[43] This case was resolved in the early 2000s and involved a serious oversight failure in the context of an alleged accounting fraud that ended in the company's insolvency. Several directors each paid a mid-six-figure amount to settle the case. D&O coverage was low in relation to damages claimed and was contested by the insurer on the basis of application fraud.[44] The maximum amount the insurer was willing to pay, taking into account its potential defense to paying at all, could have been exhausted if the case had gone to trial.

The other nonpublic oversight cases also involved insolvent companies with serious D&O coverage problems. Ramtek and Baldwin-United had not purchased D&O insurance at all. Ramtek was a Silicon Valley pioneer in computer graphics. During the 1980s it apparently was reasonably common for publicly held Silicon Valley companies to go without D&O coverage. The hope was that companies without insurance would be less likely to be sued. However, as plaintiffs' counsel familiar with the era explained to us, there was

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One possible case is the classic first decision finding liability under Securities Act § 11, *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Two outside directors were found liable: Auslander, who admitted doing no diligence whatsoever before signing the prospectus for Barchris Construction's debenture offering; and Grant, who was also the company's outside counsel and was held to a higher diligence standard. The accountants, investment bankers, and insiders were also found liable. The case then settled, apparently for $780,000. An op-ed article, written several years later, asserts that the directors paid some of this amount, but we could not confirm this. *See* Michael C. Jensen, *Corporate Boards Rise to Challenge: Directors Find Passive Role Leads to Lawsuits*, N.Y. TIMES, Dec. 28, 1975; *see also* Mooney v. Vitolo, 301 F. Supp. 198, 199 (S.D.N.Y. 1969) (mentioning the settlement, dismissing a related claim against the directors for fraud and waste under New York corporate law). If Barchris lacked D&O coverage, which was not standard at the time, the directors likely also paid their own legal fees.

One source also reported to us two Oregon cases in the early 1970s involving small, intrastate offerings. The companies involved, Cryo-Freeze and SDS, went bankrupt and lacked D&O insurance. Our source indicated that when securities suits brought against the companies settled, their directors made out-of-pocket payments. It is unclear whether any directors who paid were outside directors.

42. We did not seek to identify instances in which an outside director paid to settle a case but was indemnified by a major shareholder he represented, such as a venture capitalist, a private equity fund, or other institutional investor. We are aware of one such case (the details of which are confidential); it is possible that there are others.

43. The details of the sources of payment in the settlement agreement were confidential.

44. The nature of application fraud is described in Part II, *infra*.

no way for them to know whether a company had D&O insurance before a suit was filed. In *Ramtek*, two outside directors who were members of the audit committee paid a combined $300,000 in the settlement, plus legal fees.[45] Baldwin-United was an insurance company that sold these policies, but it had not purchased D&O insurance itself. The result was that its directors paid legal expenses to defend against a securities suit.[46] It appears, however, that they did not make a settlement payment.[47]

Table 2. Out-of-Pocket Payments by Outside Directors, 1980-2005

<table>
<tr><th>Company</th><th>Type of Case</th><th>Year</th><th>Company Solvent</th><th>D&O Insurance</th><th>Number of Directors Sued</th><th>Nature of Payment</th><th>Total Payment by Outside Directors</th></tr>
<tr><td colspan="8">Oversight Failures (Ranked by Size of Payment)</td></tr>
<tr><td>WorldCom</td><td>Securities § 11</td><td>2005</td><td>No</td><td>Contested</td><td>12</td><td>Settlement</td><td>$24.75 Million</td></tr>
<tr><td rowspan="2">Enron</td><td>Securities § 11</td><td>2005</td><td rowspan="2">No</td><td>Yes</td><td>10</td><td>Settlement</td><td>$13 Million</td></tr>
<tr><td>ERISA / DoL</td><td>2004</td><td>Yes (ERISA Cover-age)</td><td>11</td><td>Settlement</td><td>$1.5 Million</td></tr>
<tr><td>Independent Energy Holdings</td><td>Securities § 11</td><td>2003</td><td>No</td><td>Low, Contested</td><td>4</td><td>Settlement</td><td>Portion of $2 Million Paid by Directors & Officers</td></tr>
<tr><td>Confidential Case #1</td><td>Securities § 11</td><td>~2000</td><td>No</td><td>Low, Contested</td><td>Several, Exact Number Not Disclosed</td><td>Settlement</td><td>Low $ Millions</td></tr>
</table>

45. *See In re* Ramtek Sec. Litig., No. C 88-20195 RPA, 1991 WL 56067 (N.D. Cal. Feb. 4, 1991). Our information is based on interviews with plaintiff's counsel, underwriters' counsel, and defense counsel.

46. *See Directors Quit at Baldwin*, N.Y. TIMES, Jan. 25, 1985, at D13 (explaining that seven outside directors resigned and that bankruptcy examiner recommended lawsuits against them and Baldwin's executive chairman); *see also In re* Baldwin-United Corp., 43 B.R. 443 (S.D. Ohio 1984) (reversing bankruptcy judge's order allowing advancement of legal expenses to former directors who were defendants in the securities class action, but allowing advancement of expenses for then-current directors); *Judge To Rule on Baldwin Settlement*, ASSOCIATED PRESS, Dec. 24, 1986 (describing the $10.6 million settlement of securities class action with holders of Baldwin shares and debentures, law firm, accounting firm underwriter, and "former Baldwin-United Corp. officials" that are among those contributing; plaintiffs' counsel comments that they needed to "try to find the deep pockets"; and Baldwin-United's directors and officers did not have liability coverage).

47. One source reported that the directors did make a settlement payment, perhaps in another suit on behalf of annuity holders, but we could not confirm this.

Company	Type of Case	Year	Company Solvent	D&O Insurance	Number of Directors Sued	Nature of Payment	Total Payment by Outside Directors
Van Gorkom	Duty of Care	1985	Yes	Yes	10	Settlement	$1.35 Million
Ramtek	Securities §§ 10(b), 11	1992	No	No	2	Settlement & Legal Fees	$300,000 Plus Legal Fees
Baldwin-United	Securities § 10(b)	1985	No	No	Several	Legal Fees	Unknown
Confidential Case #2	Securities § 10(b)	~2000	No	Low, Contested	Several, Exact Number Not Disclosed	Legal Fees	~$50,000
Confidential Case #3	Creditor Suit, Duty of Care	Mid-2000s	No	Low, Contested	Several, Exact Number Not Disclosed	Settlement	$300,000-400,000
Peregrine	Securities § 11	2000s	No	Low, Contested	Several	Legal Fees	Unknown, Case Ongoing
Self-Dealing and Duty of Loyalty Cases							
Tyco (Frank Walsh)	SEC and Criminal Enforcement	2002	Yes	Yes	1	Disgorgement; Criminal Fine	$22.5 Million
Fuqua	Duty of Loyalty	2005	Yes	Insurer Bankrupt	1	Settlement	Portion of $7 Million Paid by Directors & Officers
Ultra Vires Transaction							
Lone Star Steakhouse	Ultra Vires	2005	Yes	Yes	4	Settlement	$54,400 + Option Repricing

Fuqua Industries' directors had the misfortune of being insured by Reliance Insurance, which went bankrupt. The case involved an alleged breach of the duty of loyalty by Fuqua directors in approving a transaction between Fuqua and a related company, Triton. The claim was derivative, so Fuqua could not indemnify its directors for damages. Triton had gone bankrupt, so it too was not available to pay damages. The inside manager who profited directly, J.B. Fuqua, was apparently unable to pay the whole amount. The result was that some of Fuqua's outside directors made undisclosed settlement payments. *Fuqua* serves as a reminder that a board's approval of self-dealing transaction by inside managers carries personal risk, even if the outside directors do not profit directly. In similar cases discussed in Appendix B, outside directors were found liable for such actions, but D&O insurance or the inside managers who profited directly paid damages on the outside directors' behalf. The Fuqua directors were less lucky—they paid because neither of those sources was available.[48]

Independent Energy was a U.K. company that issued shares in the United States and soon after went bankrupt due to fraud. Insurance was low and contested. Four individual defendants contributed $2 million to settle a section 11 case. Most of this amount was paid by the former CEO, who was the nonexecutive chairman during the class period, but our sources advised us that two outside directors also contributed to the payment. The insurer and third-party defendants made payments into the settlement as well.[49]

Confidential Case #2 involved a coverage dispute between the company's insurers and the directors. Two insurers each sought to disclaim coverage on different grounds. The directors were able to obtain early dismissal of the lawsuit and then pursued a claim against the insurers to recover legal expenses. They ultimately settled with the insurers for partial reimbursement.[50]

Confidential Case #3 involved creditor claims for breach of the duty of care against the directors of a bankrupt non-Delaware company. Insurance was low, in part because the insurer providing one layer of coverage had gone bankrupt. In addition, the remaining insurers contested coverage under the

48. *See In re* Fuqua Indus., Inc. Sec. Litig., Civ. No. 11974, 2005 Del. Ch. LEXIS 60 (May 6, 2005); Stipulation and Agreement of Compromise, Settlement and Release of Claims, *In re* Fuqua Indus., Inc. Sec. Litig., Civ. No. 11974, 2005 Del. Ch. LEXIS 60 (Dec. 30, 2005); In re Fuqua Indus., Inc. Shareholders Litig., *Defax Case No. D62090 (Del. Ch. May 6, 2005)*, DEL. L. WKLY., July 13, 2005, at D7. Fuqua advanced the defendants' legal expenses and agreed as part of the settlement not to seek reimbursement from the directors. We were told that the outside directors' payments were small relative to those of inside managers.

49. *See In re* Indep. Energy Holdings PLC Sec. Litig., No. 00 Civ. 6689, 2003 U.S. Dist. LEXIS 17090 (S.D.N.Y. Sept. 29, 2003) (describing personal payments of $2 million, most of which was paid by former CEO Burt H. Keenan); Ben Wright, *CSFB To Pay Millions in US Legal Settlement*, FIN. NEWS ONLINE, Sept. 22, 2003, http://www.efinancialnews.com/index.cfm?page=archive_search&storyref=1850000000003 9421. Keenan had left the CEO post and was an outside director during the class period, but was still CEO for part of the period during which the fraud occurred, so we treat him as an insider. However, there were payments by two clear outside directors as well. Telephone Interview with Plaintiffs' Lawyer (Dec. 16, 2005).

50. This case was described to us on a no-names basis. The terms of the settlement agreement regarding sources of payment.

insured-versus-insured exclusion[51] but ultimately paid a portion of the settlement. The directors were not protected by the equivalent of a Delaware General Corporate Law section 102(b)(7) shield against duty of care liability. Several outside directors paid a total of $300,000 to $400,000 and may also have paid some of their own legal fees.[52]

Peregrine Systems, still pending, is an oversight case that could result in an out-of-pocket payment by outside directors. Company executives cooked the books, the company went bankrupt in 2002, and it emerged from bankruptcy in 2005. A federal securities class action under section 11 and several state securities suits are ongoing against a number of outside directors, including founder John Moores, who has substantial personal wealth and was the nonexecutive chairman at the time of the fraud. The D&O insurers have sought to deny coverage, claiming application fraud. If the insurers' defense succeeds, the outside directors would likely face personal liability for both legal expenses and damages. Meanwhile, the directors have been paying at least some legal expenses out of their own pockets. We list *Peregrine* in Table 2 because the policy is small enough, and the litigation extensive enough, so that full recovery of these fees seems unlikely, even apart from the potential for a damage payment.[53]

We found two cases in which outside directors profited from transactions with the company. One involved SEC and criminal enforcement against Frank Walsh at Tyco based on an undisclosed $20 million finders' fee for a Tyco acquisition.[54] We discuss this transaction in Part III. The second, *Lone Star Steakhouse*, was much smaller and involved a board decision to reduce the exercise price on options the directors held. In a preliminary motion, the court ruled that the board's decision was ultra vires. In settling the case, the directors

51. *See infra* Part II.A.1.c.

52. This case was described to us on a no-names basis. It involved a claim by creditors against the directors of a bankrupt non-Delaware company. The company apparently lacked a shield protecting directors from damages claims arising out of breaches of the duty of care akin to that authorized by section 102(b)(7) of the Delaware General Corporation Law. Insurance was low and contested under the insured-versus-insured exclusion to coverage; in addition, the insurer for one tier of coverage was bankrupt. The remaining insurer(s) contributed to the settlement and may have paid some of the legal expenses.

53. *See In re* Peregrine Systems, Inc. Sec. Litig., Civ. No. 02cv870-J (Cal. Super. Ct. Nov. 21, 2003). Claims against Moores and other outside directors brought under § 10(b) of the Exchange Act of 1934 were dismissed in 2005, but claims under § 11 of the Securities Act remain. *See* Bruce V. Bigelow, *Fraud Claims v. Peregrine Ex-Directors Tossed Out*, S.D. UNION-TRIB., Apr. 2, 2005, at C1. Peregrine agreed to reimburse Moores for some of his legal expenses as part of its bankruptcy reorganization. *See* Bruce V. Bigelow, *Moores, Peregrine Settle for $1 Million; Ex-Chairman Asked More for Legal Fees*, S.D. UNION-TRIB., June 14, 2005, at C1. Bernard Black has been retained as an expert witness by counsel to Mr. Moores.

54. *See* SEC v. Walsh, SEC Litig. Release No. 17896, 2002 SEC Lexis 3193, at *1 (Dec. 17, 2002) (ordering disgorgement of concealed $20 million finder's fee); Ben White, *Ex-Director of Tyco Arrested; Improperly Reported $20 Million Fee Will Be Returned*, WASH. POST, Dec. 18, 2002, at E1.

agreed to reset the options back to their original exercise price. One director who had already exercised his options paid back his gains from the repricing.[55]

An additional pending case that merits mention is *Friedman's Jewelers*.[56] This case illustrates the difficulties an insurance coverage dispute can pose for outside directors. The directors were sued under both section 11 of the Securities Act and section 10(b) of the Exchange Act. They won dismissal of the section 10(b) claims, but remained exposed under section 11. As in Confidential Case #2, the D&O insurer has refused to advance defense costs to the outside directors, and the outside directors are paying their own legal expenses. At the time of this writing, a settlement appears likely in which the outside directors will be covered for both legal expenses and damages. Even if this occurs, however, the directors will still have lost the time value of money for their legal expense payments and will have borne the risk that they would not recover fully from the insurer.

C. *The Bottom Line*

In all, we found ten cases of out-of-pocket payments by outside directors attributable to oversight failures—including the three well-known ones (*WorldCom*, *Enron*, and *Van Gorkom*). We also found out-of-pocket payments in two cases involving breach of the duty of loyalty and one involving an ultra vires transaction. Several common themes emerge.

Among the cases of oversight failure, only *Van Gorkom* involved a solvent company, and the basis of liability in that case was effectively overruled by the Delaware legislature. The remaining cases involved insolvent companies. As we explain in Part II, insolvency is essentially a prerequisite to outside director liability for oversight failure. The duty of loyalty and ultra vires cases involved solvent companies. Insolvency is not a factor with respect to out-of-pocket liability risk in those contexts.

In addition, nearly all the cases in which the outside directors made settlement payments involved either self-dealing or an oversight violation subject to a negligence standard. The DoL case against Enron involved ERISA's negligence standard, but all others involved the negligence standard provided for under section 11 of the Securities Act. As discussed in Part II, it is easier for plaintiffs to prove claims under section 11 than under section 10(b) of the Exchange Act or under state fiduciary duty law—and therefore easier to

55. *See* Notice of Pendency of Class and Derivative Action, Proposed Settlement of Class and Derivative Action, and Settlement Hearing, Cal. Public Employees' Retirement Sys. v. Lone Star Steakhouse & Saloon, Inc., C.A. No. 19191 (Del. Ch. June 1, 2005); *see also* Cal. Pub. Employees' Ret. Sys. v. Coulter, 2002 WL 31888343 (Del. Ch. Dec. 18).

56. *See In re* Friedman's, Inc. Sec. Litig., 385 F. Supp. 2d 1345 (N.D. Ga. 2005); Fed. Ins. Co. v. Friedman's, Inc., CIV No. 2004-CV-90701 (Ga. Super. Ct. 2004) (concerning insurer's claim for policy rescission); Interview with J. Marbury Rainer, Partner, Parker, Hudson, Rainer & Dobbs LLP (Dec. 13, 2005).

obtain personal payments in settlements.

These two factors—insolvency and section 11's negligence standard—are elements of a scenario we describe in Part II as a "perfect storm."[57] *Enron*, *WorldCom*, *Independent Energy Holdings*, and Confidential Case #1 all fit or came close to fitting this scenario.

The other securities cases involved companies with no D&O insurance or D&O policy limits that were too low to cover the litigation expenses that would be incurred by going to trial. In the latter set of cases, the insurer also apparently had a strong basis for denying coverage altogether. With D&O insurance low or absent, directors would pay, or risked paying, legal expenses out of pocket even if they went to trial *and won*—a scenario we refer to below as "can't afford to win."[58] In some of these cases (*Baldwin-United* and Confidential Case #2), the directors did not make payments to settle with plaintiffs, but they did pay legal fees personally. In *Ramtek*, a case involving a settlement payment, settling for less than the legal fees they would incur by going to trial understandably looked attractive to the directors. Confidential Case #3, a creditors' fiduciary duty case, was similar. The company was bankrupt, so the directors' litigation expenses would not be indemnified, and the company's D&O insurance coverage was low and contested.

Fuqua involved a loyalty claim and a bankrupt insurer. The company was solvent, however, and therefore able to indemnify the directors' legal expenses. If, however, the case went to trial and the outside directors lost, their damage payments would not be indemnified.[59] Not surprisingly, the directors in that case chose to settle for a small fraction of potential damages rather than risk a much larger loss at trial. As discussed in Part II, this is a scenario in which outside directors faced with a derivative suit could be pressured to make settlement payments.

Our search may have missed some instances of out-of-pocket liability, but the fact that such an extensive search has found only a small number of cases is strong evidence that the actual incidence is very low, and substantially lower if directors are covered by D&O policies with reasonable limits and terms that appropriately constrain the insurer's ability to deny coverage.[60] One might reasonably ask whether future liability risk will differ from past experience. A principal source of concern is whether the "send a message" settlements in *WorldCom* and *Enron* herald a new era of heightened risk. Our answer is that past experience remains highly relevant. As we explain in Part II, the infrequency of out-of-pocket liability reflects a complex interaction among legal rules governing nominal liability, legal rules governing indemnification, the terms of D&O insurance policies, and the incentives of parties to settle suits

57. *See infra* Part II.B.1.e.i.
58. *See infra* Part II.B.1.e.ii.
59. *See infra* Part II.A.2.d.
60. *See infra* note 121.

on terms that leave directors' personal assets intact. The key elements of that interaction remain largely unchanged—notwithstanding the send-a-message motive that emerged in *WorldCom* and *Enron*. Consequently, especially if outside directors are covered by state-of-the-art D&O policies, out-of-pocket liability risk for oversight failure by outside directors will remain very low.[61]

II. WHY IS OUT-OF-POCKET LIABILITY SO RARE? A LEGAL ANALYSIS OF SECURITIES AND CORPORATE SUITS

Among securities and corporate lawsuits that are not dismissed, why are nearly all settled rather than tried, and why are they settled with no out-of-pocket payments by outside directors? In any legal dispute, there is an inherent bias in favor of settlement since both the plaintiff and defendant can save litigation costs by avoiding a trial.[62] But there are forces specific to shareholder suits that favor settlement even more strongly. These forces not only lead parties to settle, but they also lead them to settle on terms that leave the outside directors' personal assets intact. This Part analyzes why this situation has been true in the past and assesses whether the legal environment has changed in a way that is likely to increase the incidence of out-of-pocket liability for outside directors in the future.

There are two scenarios in which outside directors potentially bear out-of-pocket liability as a result of a shareholder suit. First, the plaintiffs may pursue a case through trial to judgment and obtain a damage award against the outside directors. For the damage payment to come out of the outside directors' pockets, however, certain conditions must be present which prevent the directors from being indemnified by their company or another source[63] or covered by D&O insurance. The second scenario is one in which the plaintiffs settle with the outside directors for a payment that is neither indemnified nor covered by insurance. For the outside directors to agree to such a settlement, the plaintiffs must be able to credibly threaten to go to trial, under circumstances in which the trial might lead to out-of-pocket liability.

Part II.A analyzes the scope of out-of-pocket liability if a case is pursued through to judgment. The legal rules that determine whether a judge will hold a director liable are summarized. The legal rules governing indemnification, and the terms of D&O insurance policies, are then analyzed in order to identify the scenarios in which this nominal liability will translate into out-of-pocket liability for an outside director. Against this background, Part II.B analyzes settlement dynamics that occur in the shadow of out-of-pocket liability risk and identifies the scenarios in which outside directors may make out-of-pocket

61. On what constitutes a state-of-the-art D&O policy, see *infra* note 121.

62. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 401-03 (2004).

63. Other potential sources of indemnification include controlling shareholders, venture capital funds, or other organizations with which the outside director is affiliated.

payments to settle a case. Part II.C analyzes the *WorldCom* and *Enron* settlements in the light of the analysis in Parts II.A and II.B.

A. *The Scope of Out-of-Pocket Liability Risk if a Case Is Pursued to Judgment*

Most shareholder suits brought against outside directors of public companies take the form of class actions brought under the securities laws. The others are suits for breach of fiduciary duty brought under state corporate law. In some instances, the same transaction may prompt both types of suit. For each of these sources of potential liability, this Part identifies the circumstances under which an outside director can be held liable at trial for damages and then describes the additional factors that must be present for indemnification and insurance to fail to provide full protection against out-of-pocket liability. We show that, so long as an outside director has not engaged in self-dealing, the scope of potential out-of-pocket liability is very narrow.

1. *Securities lawsuits*

A typical securities class action seeks damages on the grounds that the company has misled investors either by saying something material that is untrue or misleading or by failing to say something material. The defendants typically include the company itself, the CEO, and other specified company executives, often including the chief financial officer (CFO). Outside directors are named in some cases,[64] as are the company's auditor and investment banker.

There are two basic causes of action. One is a claim under section 11 of the Securities Act of 1933, which provides that those responsible for a registration statement issued in connection with a public offering may be liable if there is a material misstatement or omission in the registration statement or related documentation.[65] The other is a claim under section 10(b) of the Exchange Act, under which those responsible for material misstatements or omissions on which investors have relied in secondary trading can incur liability.[66] Damage

64. Preliminary data that Bernard Black, Elaine Buckberg, Michael Klausner, and Ron Miller have collected for a separate article indicates that, from 2000 to 2003, outside directors were named as defendants in nineteen percent of securities class actions. Among section 11 cases, which comprise fifteen percent of cases during this period, outside directors are named fifty percent of the time. Among section 10(b) cases, they are named thirteen percent of the time.

65. Securities Act of 1933 (Securities Act) § 11, 15 U.S.C. § 77k (2006).

66. Claims under section 11 are often accompanied by claims that the directors should be liable as control persons under section 15 of the Securities Act. *See* Securities Act § 15, 15 U.S.C. § 77o (2006). Claims under section 10(b) can similarly be accompanied by claims that the directors should be liable as control persons under the Exchange Act section 20(a). *See* Securities Exchange Act of 1934 (Exchange Act) § 20(a), 15 U.S.C. § 78t(a) (2006).

We do not address control person liability in this Article, but the addition of a control actions are also possible under section 14(a) of the Exchange Act for misdisclosure in a proxy statement and under section 9(a) of the Exchange Act for manipulating securities prices, but these claims are far less common, and we do not address them here.

a. *Risk of nominal liability under the securities laws*

If a registration statement contains a material misstatement or omission, section 11 of the Securities Act provides that an outside director is liable to those who purchased securities unless the director succeeds in proving a due diligence defense. To succeed in this defense, a director must prove (1) that he engaged in reasonable investigation; (2) that with respect to those portions of the registration statement based on the authority of an expert, the director had no reasonable ground to believe, and he did not in fact believe, that any information was untrue; and (3) that with respect to other portions of the registration statement, he had reasonable grounds for believing that the registration statement was true.[67] "Reasonable investigation" and "reasonable grounds" are judged under a negligence standard. Thus, in effect, outside directors are subject to a negligence standard under section 11—a standard that is substantially more favorable toward plaintiffs than the liability standard applicable under section 10(b) or the liability standard applicable in fiduciary duty cases under state corporate law.

Under section 10(b), plaintiffs must prove that a defendant responsible for a material misstatement had scienter. Verbal formulas for scienter vary among circuit courts, but scienter is generally understood to require, at a minimum, a high degree of recklessness with regard to the truth, approaching conscious

person claim to a section 11 or section 10(b) claim probably does not increase an outside director's out-of-pocket liability risk. One reason is that each control person claim requires proof of a mental state that is similar to the mental state required under section 11 and section 10(b) respectively. *See, e.g.*, *In re* Enron Corp. Sec., Derivative & ERISA Litig., 258 F. Supp. 2d 576, 597-98 (S.D. Tex. 2003); *In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 351-52, 392-98 (S.D.N.Y. 2003); *see also* 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD § 7:353 (2005) (describing the cases discussing the good faith defense as "highly fact specific," making it "difficult to extract guiding legal principles"). *See generally* Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263 (1997).

The proportionate liability rules that serve to protect outside directors under section 11 and section 10(b) seem to apply to control person liability as well. The point is addressed explicitly in section 20(a) of the Exchange Act. The issue has never arisen specifically under section 15 of the Securities Act, but if proportionate damages do not apply under section 15, Congress's intent in creating proportionate liability under section 11 would be undermined. One would therefore expect the same damage rule to apply. For these reasons we do not address control person liability.

67. *See* Securities Act § 11(a)(2), (b)(3), 15 U.S.C. § 77k(a)(2), (b)(3) (2006); JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION: CASES AND MATERIALS 875-915 (9th ed. 2003) (discussing the due diligence defense).

disregard of truthfulness or conscious knowledge of untruthfulness.[68] A defendant's motion to dismiss a suit brought under section 10(b) will be granted unless the plaintiff pleads "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[69]

The strong inference requirement at the pleading stage for a section 10(b) action poses a substantial hurdle for a plaintiff seeking to bring a case against outside directors. Without the benefit of discovery, the plaintiff must allege specific facts that support its claim that the directors had the scienter required under section 10(b).[70] Because outside directors are ordinarily not involved in the day-to-day operation of the company, plaintiffs often have no basis for establishing a strong inference against the outside directors when a material misstatement or omission has occurred.[71] Such an inference is possible in some circumstances, such as when the outside directors fail to investigate reports of problems in their company[72] or sell a suspiciously large number of shares shortly before bad news is released.[73] Commonly, however, evidence supporting the required inference will be unavailable, and plaintiffs will either not include outside directors as defendants in section 10(b) cases, or the outside directors will succeed in having the claims against them dismissed at a preliminary stage.[74]

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68. *See* Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2006); Exchange Act Rule 10b-5, 17 C.F.R. 240.10b-5 (2006); COFFEE & SELIGMAN, *supra* note 67, at 1117-30 (discussing the culpability standard under Rule 10b-5). For forward-looking statements the culpability standard is actual knowledge under both the Securities Act and the Exchange Act. *See* Securities Act § 27A(c)(1)(B), 15 U.S.C. § 77z-1(c)(1)(B) (2006); Exchange Act § 21E(c)(1)(B), 15 U.S.C. § 78u-5(c)(1)(B) (2006).

69. Exchange Act § 21D(b)(2)-(3), 15 U.S.C. § 78u-4(b)(2)-(3) (2006).

70. *See, e.g.*, Part III.B.3, *infra* (discussing the *WorldCom* and *Enron* cases, in both of which 10(b) claims against the outside directors were dismissed); *In re* Reliance Sec. Litig., 135 F. Supp. 2d 480, 506-08 (D. Del. 2001) (dismissing defendant outside directors' motion for summary judgment because a reasonable juror could find that outside directors had requisite scienter). It is not enough to show that the director signed an inaccurate disclosure document. *See In re* Sensormatic Elecs. Corp. Sec. Litig., No. 018346CIVHURLEY, 2002 WL 1352427, at *5 (S.D. Fla. June 10, 2002) (granting outside director's motion to dismiss on grounds that an allegation that the director was an audit committee member and signed the company's annual Form 10-K does not satisfy the section 10(b) pleading standard).

71. *See* JAMES HAMILTON ET AL., RESPONSIBILITIES OF CORPORATE OFFICERS AND DIRECTORS UNDER FEDERAL SECURITIES LAWS ¶ 308 (1997).

72. *See, e.g.*, *In re* Lernout & Hauspie Sec. Litig., 286 B.R. 33, 37-38 (D. Mass. 2002) (finding that directors ignoring auditors' warnings about lack of internal controls was sufficient to state a claim under the Securities Exchange Act).

73. Plaintiffs allege insider trading in more than half of shareholder class action complaints. *See* Jordan Eth & Christopher A. Patz, *Securities Litigation and the Outside Director*, REV. SEC. & COMMODITIES REG., May 9, 2000, at 95, 101. Outside directors can protect themselves from a claim of suspiciously timed stock sales by refraining from selling shares while on the board or, if they do need to sell stock, by taking advantage of securities regulation "safe harbor" by selling on a preestablished schedule. *See* Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2006).

74. Eth & Patz, *supra* note 73, at 101, 104.

The differences in standards of liability between section 10(b) and section 11 claims have led some commentators to argue that outside directors face considerably greater risk under section 11.[75] The danger of section 11 liability, however, is not as great as it appears since under this provision, as well as under section 10(b), the plaintiffs have a claim against the company itself in addition to claims against individual officers and directors. Especially in a section 11 case, the company is the most attractive defendant because the company is strictly liable under section 11; unlike individual defendants, the company has no due diligence defense.[76] In a section 10(b) case, there must be proof of scienter for the company to be liable, but proof of scienter on the part of any officer or (less likely) director is sufficient to constitute proof. Moreover, under both section 11 and section 10(b), if the company is found liable it likely will be responsible for all damages.[77] Thus, under either provision, so long as the company is solvent or has sufficient entity coverage under its D&O policy to pay foreseeable damages, litigating against individual defendants will generally not augment the plaintiffs' recovery.[78]

Despite the foregoing, plaintiffs may have reason to name outside directors as defendants in securities suits against solvent companies. Doing so may facilitate the extraction of useful testimony, or it may increase pressure on companies to settle by putting the outside directors directly in the line of fire.[79] Consequently, it is not uncommon for outside directors to be named as defendants in these suits. Nonetheless, litigating against outside directors

75. *See* John C. Coffee, Jr., *Why the* WorldCom *Settlement Collapsed*, N.Y.L.J., Mar. 17, 2005, at 5; Hansen, *supra* note 16.

76. *See* Securities Act § 11(b), 15 U.S.C. § 77k(b) (2006) (outlining the due diligence standards for individual defendants).

77. Under the Securities Act, the company is explicitly subject to strict liability for all damages. Securities Act § 11(a)(1), (b), 15 U.S.C. § 77k(a)(1), (b) (2006). The damage rule applicable to the company under the Exchange Act is different from that of the Securities Act, but the conclusion is the same. Under section 21D of the Exchange Act, any defendant is jointly and severally liable if that defendant "knowingly committed a violation of the securities laws." Exchange Act § 21D(f)(2)(A), 15 U.S.C. § 78u-4(f)(2)(A) (2006). The knowledge of any officer or director of the company would be attributed to the company and the company would consequently be jointly and severally liable. If no officer or director commits a knowing violation, meaning the violation was entirely the result of recklessness, then all individuals' reckless conduct would be attributed to the company and the company would be vicariously liable for each individual's proportionate liability, the total of which would be one hundred percent.

78. Approximately ninety-three percent of public companies have D&O policies that include entity coverage as well as coverage for individual directors and officers. *See* TILLINGHAST-TOWERS PERRIN, UNDERSTANDING THE UNEXPECTED: 2004 DIRECTORS AND OFFICERS SURVEY REPORT 42 (2004).

79. For a discussion of reasons outside directors are added as defendants in securities class actions, see Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 530 (1991); Eth & Patz, *supra* note 73, at 95-97. Both works note that directors were often named as defendants to trigger D&O policies covering directors and officers only, and not the corporate entity. With entity coverage now being the norm, this is no longer necessary.

through trial will rarely augment the plaintiffs' recovery. Moreover, trying a case with numerous individual defendants can distract and confuse a jury and thus jeopardize the plaintiffs' entire case.[80] Accordingly, so long as a company is solvent, lead plaintiffs may name outside directors as defendants initially for strategic reasons, but they will often not pursue them all the way to trial.

If a company is insolvent or insufficiently solvent to cover the maximum damages likely to be awarded at trial, and it lacks entity coverage sufficient to cover such damages, the plaintiffs may be able to augment their recovery by pursuing individual defendants. Under both section 10(b) and section 11, however, inside managers still tend to be a more promising source of recovery for plaintiffs than outside directors. In a section 11 case, while a disclosure failure can occur even in circumstances where outside directors have carried out a reasonable investigation, inside managers' involvement in day-to-day management makes a due diligence defense difficult for them to sustain. Similarly, under section 10(b), because inside managers are responsible for preparing all disclosure statements, it is easier to show scienter than to make the same showing for outside directors.

Damage-allocation rules under section 10(b) further enhance the relative attractiveness of inside managers over outside directors as targets of a section 10(b) suit when the company is insolvent. Under section 10(b) all parties' liability is based on their "percentage of responsibility" unless a party has committed a "knowing violation," in which case he is jointly and severally liable.[81] "Percentage of responsibility" is defined as a "percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff."[82] Factors relevant to the determination of responsibility are the "nature" of an outside director's conduct and the "nature and extent of the causal relationship between the conduct . . . and the damages."[83] Although this damage rule applies to both inside managers and outside directors, inside managers' direct responsibility for accounting and other disclosure decisions makes them more vulnerable than outside directors to claims that they have committed a knowing violation. Even if inside managers are found to have been merely reckless, their proportionate liability is still likely to be higher than that of outside directors.[84] Inside mangers are thus more attractive defendants

80. Alexander, *supra* note 79, at 530.

81. Exchange Act § 21D(f)(2), 15 U.S.C. § 78u-4(f)(2) (2006). A knowing violation encompasses actual knowledge that a misrepresentation is false or misleading. Consequently, outside directors will be subject to the proportionality rule unless they essentially participate in a fraud.

82. Securities Act § 11(f)(2)(A)-(B), 15 U.S.C. § 77k(f)(2)(A)-(B) (2006); Exchange Act § 21D(f), 15 U.S.C. § 78u-4(f) (2006).

83. Securities Act § 11(f)(2)(A), 15 U.S.C. § 77k(f)(2)(A) (2006); Exchange Act § 21D(f)(3)(C)(i), (ii), 15 U.S.C. § 78u-4(f)(3)(C)(i), (ii) (2006).

84. Even if other defendants cannot pay their proportionate share of damages, the statutory damage rule in effect caps an outside director's liability at 150% of her proportionate share. *See* Exchange Act §21D(f)(4), 15 U.S.C. § 78u-4(f)(4) (2006).

than outside directors. Nonetheless, if the company is insolvent, there are cases in which a lead plaintiff can augment the class's recovery by pursuing outside directors. We return to this possibility in Part B.1.e below.

The damage rules under section 11 have an ambiguous impact on the attractiveness of outside directors as defendants when the company is insolvent. Under section 11, inside managers and third-party defendants such as investment banks and accounting firms are jointly and severally liable for the full amount of damages awarded,[85] while outside directors are subject to the proportionate damage rule applicable to section 10(b) violations. Thus, a lead plaintiff would ordinarily get a much larger damage award against inside managers and third-party defendants than against outside directors.

There is an apparently inadvertent twist in the section 11 damage rule, however, that puts outside directors in a potentially vulnerable position when the company is insolvent. If a lead plaintiff is unable to settle a section 11 case with inside managers or third parties, and the case goes to trial, the damage rules reduce the defendants' joint and several liability differently depending on whether the outside directors have settled or remain in the case through trial.

If the outside directors remain in the case through trial, inside managers and third parties are jointly and severally liable for full damages minus any amount the outside directors actually pay pursuant to judgment.[86] So, for example, if outside directors are judgment proof and pay nothing, the inside directors and third parties would be liable for all damages. But if the outside directors have settled prior to judgment, the court will reduce the nonsettling parties' damages by an amount corresponding to the outside directors' percentage of responsibility, *even if* the outside directors in fact pay a smaller amount in their settlement.[87] As a result of this damage-reduction rule, if a lead plaintiff goes to trial against inside managers or third parties, it may want to keep the outside directors in the case through trial, rather than settling with them separately, in order to maximize its recovery from these other parties. Although this rule delayed the outside directors' settlement in *WorldCom* for several months until other defendants settled, it did not have an impact on the outside directors' ultimate out-of-pocket liability.[88] Nor did this rule apparently

85. Securities Act § 11(f)(1), 15 U.S.C. § 77k(f)(1) (2006).

86. Exchange Act § 21D(f)(4), 15 U.S.C. § 78u-4(f)(4) (2006) (setting out relief available to plaintiffs for an "uncollectible share").

87. Exchange Act § 21D(f)(7), 15 U.S.C. § 78u-4(f)(7) (2006).

88. In *WorldCom*, the lead plaintiffs initially settled separately with the outside directors, subject to persuading the court *not* to apply the damage-reduction rule according to its literal terms as we have described it. The court instead applied the damage-reduction rule literally, despite concluding that the rule is inconsistent with Congress's intent to protect outside directors in the PSLRA. The plaintiffs then put the settlement with the outside directors on hold for another several months until all the investment banks settled, at which point the settlement was reinstated on essentially the same terms. If the investment banks had gone to trial, the outside directors would presumably have gone to trial as well, with plausible damages far larger than the amounts for which they settled. On the other hand, the

affect any of the trials listed in Part I and Appendix B. It does, however, constitute a source of risk for outside directors—a source that Congress did not intend to introduce in the Private Securities Litigation Reform Act of 1995 (PSLRA),[89] and one that it may want to revisit.[90]

b. *Indemnification*

In the unlikely event that an outside director is sued, goes to trial, and is found liable under securities law, indemnification by the company potentially provides protection against out-of-pocket liability. Under Delaware corporate law, a corporation may indemnify a director for damages, amounts paid in settlement, and legal expenses so long as the director acted "in good faith and in a manner [the director] reasonably believed to be in or not opposed to the best interests of the corporation."[91] Delaware law also permits a corporation to reimburse a director on an ongoing basis for legal expenses she incurs in a securities suit.[92] Almost all public companies have indemnification agreements with outside directors or bylaws that convert this permission into an obligation to directors by providing that the corporation shall advance legal expenses and indemnify legal fees, damages, and amounts paid in settlement to the fullest extent permitted by law.[93] This analysis assumes that a company has such an agreement with its outside directors.

There are three scenarios in which indemnification might not protect

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lead plaintiff in *Enron*, in similar circumstances, settled with the outside directors while continuing to pursue claims against the inside managers, investment banks, and other third-party defendants.

89. Pub. L. No. 104-67, 109 Stat. 737 (codified at 15 U.S.C. §§ 77z-78u (2006)).

90. *See* Coffee, *supra* note 4, at 13 (explaining the effect of this rule).

91. DEL. GEN. CORP. LAW. § 145(a), DEL. CODE ANN. tit. 8, § 145(a) (2005). Under the Model Business Corporation Act, a company's charter may permit or require indemnification and advancement of expenses for all actions except "(A) receipt of a financial benefit to which [the director] is not entitled, (B) an intentional infliction of harm on the corporation or its shareholders, (C) [an improper dividend or share repurchase], or (D) an intentional violation of criminal law." MODEL BUS. CORP. ACT § 2.02(b)(5) (2004); *see also id.* §§ 8.51(a), 8.53, 8.58(a).

92. Section 145(e) of the Delaware General Corporation Law allows a corporation to pay a director's legal expenses "in advance of the final disposition of [an] action, suit or proceeding [if the director agrees] to repay such amount if it shall ultimately be determined that [the director] is not entitled to be indemnified by the corporation . . . ." DEL. CODE ANN. tit. 8, § 145(e) (2005).

93. Indemnification agreements and bylaws that require companies to indemnify directors are expressly permitted by section 145(f) of the Delaware General Corporate Law. DEL. CODE ANN. tit. 8, § 145(f) (2005); *see also* MODEL BUS. CORP. ACT § 8.58(a) (2004). Bylaws of this sort are broader than, and therefore supersede, legal rules that make indemnification mandatory in some cases. *See* DEL. CODE ANN. tit. 8, § 145(c) (2005); MODEL BUS. CORP. ACT § 8.52 (2004). For a discussion of indemnification agreements, see Paul Shim & Lillian Rice, *Re-Assessing the Availability of D&O Insurance and Indemnification*, M&A REP., Dec. 2005, at 5, http://www.cgsh.com/files/tbl_s47Details/FileUpload265/535/CGSH_ Cleary_Gottlieb_MA_Report_-_December_2005.pdf.

outside directors who lose a securities law trial. First, the corporation may be insolvent or insufficiently solvent to cover the outside directors' damages. Second, a director's conduct may fall outside the statutory qualification for indemnification quoted above. As the Delaware Chancery Court has defined the term in the recent *Disney* case, an absence of "good faith" comprises acts of self-dealing or an "intentional dereliction of duty, a conscious disregard for one's responsibilities."[94]

Third, in a section 11 case, SEC policy may preclude indemnification. The SEC has taken the position that any indemnification obligation to directors for damages paid in section 11 claims is "against public policy as expressed in the [Securities] Act and is therefore unenforceable."[95] The SEC enforces this policy by requiring a company seeking acceleration of the effective date of a registration statement to agree in advance that if a director seeks indemnification for damages, the company "will . . . submit to a court of appropriate jurisdiction the question whether such indemnification by [the company] is against public policy as expressed in the Act."[96] A company is under no such obligation, however, if the expenses were incurred in the course of a "successful defense."[97]

As seen in Part I, securities suits are almost always settled, and settlements do not trigger these undertakings with the SEC since settlement agreements routinely recite the defendants' position that no wrongdoing occurred. During the time period we studied, no securities case resulted in outside directors being tried and held liable for damages. If an outside director were tried and held liable, a court might be called upon to rule on the validity of the SEC's policy and the extent to which indemnification in that particular case violated public policy. However, the company and the directors might be able to avoid the issue by having the company pay damages directly. If a company were to bring the question of indemnification to court, it is unclear what the outcome would be, especially in a case involving nothing worse than negligence.[98]

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94. *In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113, at *174-75 (Aug. 9, 2005). This case is currently on appeal.

95. Reg. S-K, 17 C.F.R. § 229.510 (2006).

96. Reg. S-K, 17 C.F.R. § 229.512(h)(3) (2006). In practice, all companies that register securities seek to accelerate the effective date of the registration.

97. *Id.*

98. In the well-known case of *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), in which the company and three directors were held liable under section 11, the SEC treated the company's proposal to pay the entire judgment as a declaration of intent to indemnify the directors and challenged the proposal. The parties subsequently agreed that the three directors pay the company $5000 each. The SEC did not challenge this arrangement, but the *Leasco* court found that the agreement did not violate public policy. *See* Joseph W. Bishop, Jr., *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153, 1161-64 (stating reasons why a court could find no inconsistency with public policy).

c. *D&O insurance*

If indemnification turns out to be unavailable to outside directors, D&O insurance provides an additional layer of protection. Virtually all public companies purchase D&O insurance for their officers and directors.[99] D&O insurance covers directors' legal expenses, damages paid pursuant to judgment, and amounts paid in settlement. In contrast to indemnification, neither corporate law[100] nor securities law[101] places limitations on the permissible scope of D&O coverage.[102] Furthermore, D&O coverage is available if the company is insolvent or contests its obligation to indemnify its directors (for example, when a corporate meltdown has led to the appointment of a new

99. *See* TILLINGHAST-TOWERS PERRIN, *supra* note 78, at 25 (reporting that one hundred percent of publicly held U.S. firms responding to survey had D&O insurance). Insurers sell and companies routinely buy policies without copayments or meaningful deductibles for covered individuals. When policies have copayments or deductibles, the company's indemnification obligation covers those payments. *See id.* at 46 (reporting that ninety-eight percent of surveyed firms purchase insurance with no deductible for personal coverage); JOHN F. OLSON & JOSIAH O. HATCH, III, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 12.20 (2003) (noting that most companies have no copayments and that the exceptions are almost exclusively New York corporations, which must comply with a state insurance rule that requires a minimum deductible ranging from $100 to $5000).

100. Section 145(g) of the Delaware General Corporation Law gives a corporation the

> power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation . . . against any liability asserted against such person . . . in any such capacity . . . whether or not the corporation would have the power to indemnify such person against such liability . . . .

DEL. CODE ANN. tit. 8, § 145(g) (2005); *see also* MODEL BUS. CORP. ACT § 8.57 (2004).

101. The SEC does not oppose insurance coverage for outside directors. *See* Securities Act Rule 461(c), 17 C.F.R. § 230.461(c) (2006). On the potentially anomalous nature of the SEC's distinction between indemnification and insurance, see Bishop, *supra* note 98, at 1165 (stating reasons why a court could find no inconsistency with public policy).

102. Under common law, courts will not permit recovery under insurance policies when the result would contravene public policy. For instance, in *Level 3 Communications Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), and *Conseco Inc. v. National Union Fire Insurance Co.*, No. 49D130202CP000348, 2002 WL 31961447 (Ind. Cir. Ct. Dec. 31, 2002), the courts held that it was contrary to public policy for an insurer to reimburse a company for settlement payments attributable to a section 11 breach. The rationale for the rulings was that it is inappropriate for a company to obtain via insurance restitution of the ill-gotten gains it received from a fraudulent securities offering. The decisions have led to some speculation that directors may not be able to rely on D&O insurance for coverage of section 11 claims. The public policy rationale does not go so far, however, except perhaps where the outside directors have enriched themselves in a fraudulent offering, in which case the policy exclusions would apply to the extent a damage payment constitutes restitution of amounts the outside directors gained as a result of the fraudulent offering. *See* Joseph P. Monteleone, *Directors' and Officers' Liability and Insurance: The Emerging Hot Issues in 2003*, THE RISK REPORT (Int'l Risk Mgmt. Inst., Inc., ed., 2003), *available at* http://www.eagle-law.com/papers/ newyork2003_en-04.pdf (last visited Jan. 14, 2006). For a somewhat broader reading of the restrictions imposed by public policy, see James Denison, *Anticipated Coverage Issues Arising from Securities Actions Seeking Return of Ill-Gotten Gains*, 33 SEC. REG. L.J. 162, 167-68 (2005).

board that is hostile to the former directors).[103]

There are, however, scenarios in which D&O insurance will not cover an outside director's liability. One possibility is that damages awarded in a suit will exceed the amount of insurance available under a policy. The policy limit may have been insufficient from the start, or the policy may have become depleted by litigation expenses in the suit itself or in related cases.

D&O policies also contain exclusions from coverage. The most important of these are conduct exclusions, which bar claims for suits based on "criminal or deliberately fraudulent misconduct" and suits based on transactions resulting in an individual receiving "any personal profit or advantage to which he is not legally entitled."[104] If an outside director's conduct falls within either of these exclusions, the policy will not cover his losses. Under many policies, the "deliberate fraud" exclusion applies only if there is a "final adjudication" of the issue in the underlying securities suit, which means the insurer cannot contest coverage on the basis of this exclusion if the case is settled. The "illegal profit" exclusion is often structured similarly, but it sometimes allows the insurer to contest coverage in a separate action.[105] Taken together, the deliberate fraud and personal profit exclusions are considerably narrower than the good faith limitation on indemnification since the exclusions contemplate some form of actual dishonesty, whereas the good faith standard will be breached if there has been a "conscious disregard for one's responsibilities."[106]

An outside director can also find himself without insurance coverage for reasons unrelated to his own conduct. First, unless a policy provides for full severability of the conduct exclusions, the conduct of an inside manager (e.g., deliberate fraud or the gaining of illegal profits by the CFO) could allow the insurer to deny coverage to all insureds, including outside directors.[107] Second,

103. On D&O insurance being a response to this problem, see Priya Cherian Huskins, *Why Are You Buying Side-A D&O Insurance?*, 2 INT'L J. DISCLOSURE & GOVERNANCE 196, 200 (2005).

104. These exclusions are commonly referred to as the deliberate fraud and illegal profits exclusions. *See* 2 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 25.03 (7th ed. 2005); JOHN R. MATHIAS, JR. ET AL., DIRECTORS AND OFFICERS LIABILITY: PREVENTION, INSURANCE AND INDEMNIFICATION §§ 8.04, 8.14 (2003); OLSON & HATCH, *supra* note 99, § 12.12.

105. 2 KNEPPER & BAILEY, *supra* note 104, § 25.03; MATHIAS ET AL., *supra* note 104, § 8.04; OLSON & HATCH, *supra* note 99, § 12.12; *see also* MODEL BUS. CORP. ACT § 8.57 cmt. (2002) (noting that D&O policies "typically do not cover . . . dishonesty, self-dealing, bad faith, knowing violations of [law], or other willful misconduct").

106. *In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113, at *168 (Aug. 9, 2005). We will use "conscious disregard" as shorthand for the level of culpability needed to show lack of good faith, a matter on which Chancellor Chander's *Disney* opinion uses different formulations in different places.

107. Fed. Ins. Co. v. Homestore, 144 Fed. App'x 641 (9th Cir. 2005); Cutter & Buck v. Genesis Ins. Co., 144 Fed. App'x 600 (9th Cir. 2005); 2 KNEPPER & BAILEY, *supra* note 104, § 23.02; MATHIAS ET AL., *supra* note 104, §§ 6.02[2], 8.21; OLSON & HATCH, *supra* note 99, § 12.35.

if inside management has misstated or omitted information in the company's application for insurance, the concept of fraud in the application allows the insurer to rescind the policy entirely unless the policy provides for full severability as to the outside directors with respect to its right to rescind. Third, there may be temporal gaps in coverage because the company failed to ensure that there was a policy in place at all relevant times. Fourth, an "insured versus insured" exclusion may prevent coverage for suits by one insured party against another. One important context in which this exclusion adversely affected outside directors in the past was when creditors brought suits against the board of a bankrupt company. Insurers took the position that these suits were brought on behalf of the corporation and were therefore covered by the insured-versus-insured exclusion.[108] Fifth, courts have held that under certain circumstances, when a company is bankrupt, the insurance policy proceeds are the property of the estate.[109]

Market pressures have driven insurers to offer policies that eliminate these and other coverage risks for outside directors. To avoid the problem of continuity of coverage, companies can now either negotiate for an early inception date for new policies or purchase "tail coverage" on old policies.[110] Insurers now sell policies that protect the outside directors (and other individual insureds) in the event of bankruptcy. These policies provide that the insured-versus-insured exclusion does not apply to creditors' suits against directors of a bankrupt corporate debtor,[111] and they contain priority-of-payment provisions that give the individual insureds priority over the corporation and thereby eliminate the basis for a claim that the proceeds belong to the estate.[112] In addition, policies are now widely available that provide for full severability with respect to both conduct exclusions and the insurer's right to rescind the policy. These severability provisions protect innocent outside directors' coverage from the misconduct of inside managers.[113]

Moreover, to address the possibility of a company's primary policy being rescinded or exhausted, companies can buy separate "Side A" coverage that pays judgments, settlements, and legal expenses on behalf of directors and

108. 2 KNEPPER & BAILEY, *supra* note 104, § 25.09; MATHIAS ET AL., *supra* note 104, § 8.02; OLSON & HATCH, *supra* note 99, §12.14. For an overview of current coverage issues, see CORP. BD. MEMBER, INC., DIRECTORS & OFFICERS LIABILITY INSURANCE: STRIKING OUT RISK (2003) (special supplement to *Corporate Board Member Magazine*).

109. MATHIAS ET AL., *supra* note 104, § 10.07[2].

110. Foley & Lardner LLP, *Directors' and Officers' Liability Insurance—A Changing Landscape*, LEGALNEWS, Feb. 5, 2003, http://martindale.com/matter/asr-3774.pdf.

111. 2 KNEPPER & BAILEY, *supra* note 104, § 23.08; MATHIAS ET AL., *supra* note 104, § 8.02; OLSON & HATCH, *supra* note 99, § 12.14.

112. MATHIAS ET AL., *supra* note 104, § 10.07[2].

113. 2 KNEPPER & BAILEY, *supra* note 104, § 26.03[3]; MATHIAS ET AL., *supra* note 104, § 8.21; OLSON & HATCH, *supra* note 99, § 12.35. The fact that full severability is available, however, does not mean that it is actually included in all policies. Companies must negotiate for it—not only in their primary policy but in their excess policies as well.

officers independently of the company's traditional policy when the company is insolvent.[114] Buyers of separate Side A coverage have thus far primarily been larger companies.[115] Finally, policies are now available to cover only outside directors. These policies, sometimes referred to as "independent director liability" (IDL) policies, have dedicated policy limits that cannot be depleted by claims against the company or the inside managers.[116] Policies covering only outside directors have reportedly not sold well in the past, but growing fears of outside director liability may well cause this to change.[117]

A final insurance-related risk for outside directors is that the insurer will become insolvent, as Reliance Group Holdings Inc., a major underwriter of D&O insurance, did in 2001.[118] Under such circumstances, outside directors and other insured parties could be vulnerable. Often, however, this exposure is limited by virtue of the fact that the company's D&O insurance is provided in tiers by several insurers.[119] In that situation, if the company has an excess Side A policy, that policy may drop down to provide the coverage of the insolvent insurer.[120]

In sum, coverage risks exist, but most can be addressed by a state-of-the-art policy.[121] Outside directors' coverage risks arise largely as a result of their company's policy having coverage holes that might have been negotiated away, perhaps at a price. Inevitably, however, new coverage gaps will arise that, for a time at least, could expose outside directors.

114. The label "Side A" is derived from the fact a company's D&O policy usually has three sides: Side A, Side B indemnity coverage to reimburse the corporation for judgments and settlements for which the corporation indemnifies directors and officers, and Side C entity coverage. *See* Gary S. Mogel, *A-Side D&O Is "Sleep" Cover*, NAT'L UNDERWRITER PROPERTY & CASUALTY-RISK & BENEFITS MGMT., Dec. 2003, at 14. For a discussion of the extent to which the protections of Side A coverage can be incorporated into a traditional policy, see Huskins, *supra* note 103, at 200.

115. Mogel, *supra* note 114, at 14.

116. Stephen J. Weiss & Shannon A.G. Knotts, *Do Independent Directors Need IDL Coverage?*, DIRECTORS & BOARDS, Mar. 22, 2005, at 12.

117. *Id.*

118. *See* Geraldine Fabrikant, *Private Concern, Public Consequences*, N.Y. TIMES, June 15, 2003 (reporting that Reliance provided $20 million out of a total of $50 million in D&O insurance for the Trace directors); *Penn. Battles for Reliance Cash*, INS. CHRON., Aug. 13, 2001. The *Fuqua* out-of-pocket payment we discuss in Part I would likely not have occurred but for Reliance's bankruptcy. When an insurer fails, the failure is often not total. Its remaining assets will be divided among the claimants; state insurance funds may provide additional recovery sources.

119. Christopher Oster, *When the Boss Caused the Loss, Who Pays?*, WALL ST. J., June 13, 2002, at C1 (discussing the possibility that Reliance's bankruptcy could leave directors exposed but acknowledging that plaintiffs rarely sought damages from them).

120. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §§ 13.05, 13.12 (12th ed. 1998); Douglas R. Richmond, *Issues and Problems in "Other Insurance," Multiple Insurance, and Self-Insurance*, 22 PEPP. L. REV. 1373, 1403-09 (1995).

121. We will use the term "state-of-the-art" to describe a D&O policy that closes the gaps described here.

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So what is an outside director's exposure to liability in a securities suit that is tried to judgment? The primary exposure is to section 11 liability. *Escott v. Barchris Construction Corp.*, the first case finding liability under section 11 in 1968, provides an example.[122] Our search produced no cases since 1980 in which outside directors were held liable after trial under either section 11 or section 10(b). However, all securities settlements that we found in which directors paid out-of-pocket damages (as opposed to just legal expenses) were brought under section 11. The SEC's policy against indemnification in section 11 cases raises uncertainty regarding the ability of an outside director to be indemnified if he is held nominally liable. Moreover, indemnification will not be available if the company is insolvent, as was the case with all of the out-of-pocket damage payments described in Part I. A state-of-the-art D&O policy, however, would cover an outside director's section 11 damage payment, up to the policy limit, so long as the outside director's conduct was not so extreme as to fall within the policy's exclusion for illegal profits or deliberate fraud.

2. *Corporate lawsuits—breach of fiduciary duty*

Suits against outside directors for breach of fiduciary duty are often assumed to take the form of derivative suits. In fact, many fiduciary duty cases are brought as direct class actions by shareholders,[123] often by minority shareholders challenging a freeze-out by a controlling shareholder. The standards of liability and procedural rules, as well as the availability of indemnification and insurance, provide considerable protection for outside directors against these suits. As a result, a trial of a fiduciary duty claim will normally not result in out-of-pocket liability unless an outside director has engaged in self-dealing or has consciously neglected his oversight duties—and in the latter case, only if his D&O coverage is insufficient to cover damages and litigation expenses.

a. *Nominal liability in direct and derivative suits*

A director's fiduciary duty includes the duty of loyalty and the duty of care.[124] Cases brought against outside directors alleging self-dealing,

122. 283 F. Supp. 643 (S.D.N.Y. 1968); *see also supra* note 28 (explaining that Barchris Construction's outside directors likely lacked D&O insurance and may have made out-of-pocket payments to settle the case after trial).

123. *See* Thompson & Thomas, *supra* note 30, at 133. Consistent with their data, our search for trials against outside directors found eleven direct suits but only three derivative suits. *See supra* Table 1 and *infra* Appendix B.

124. The care/loyalty dichotomy is overly simplistic as a depiction of directors' obligations. Directors have two other identifiable fiduciary duties—a duty of disclosure and

preferential treatment of a controlling shareholder, or other conflicts of interest are litigated as breaches of the duty of loyalty. Courts apply a strict standard of conduct in these cases. If an outside director is shown to have improperly enriched herself, she will be found liable and, as explained below, may well pay damages out of pocket.

Our data on trials indicate that the primary area in which outside directors of public companies face duty of loyalty claims is not where they have enriched themselves, but rather where they have favored a controlling shareholder—or sometimes the CEO or other inside manager—over minority shareholders.[125] The law provides no direct protection for an outside director who breaches her duty of loyalty in this way, even if the director does not enrich herself. However, as a practical matter, the controlling shareholder will also be liable and is likely to be a more attractive defendant, both to sue and eventually from whom to collect. Moreover, if the outside director represents a controlling shareholder, the director will often be entitled to indemnification by the controlling shareholder.[126] Thus, while the risk of nominal liability exists, an outside director's out-of-pocket liability risk is likely limited to situations in which the person who benefited directly cannot or will not pay all of the damages. The *Fuqua* case discussed in Part I illustrates this point. J.B. Fuqua, who profited personally from the transaction that gave rise to claims based on a breach of loyalty, contributed only modestly to the settlement, presumably because he could not afford to pay more.

In suits based on a failure of oversight, the duty of care provides the legal rubric to measure outside directors' conduct. Establishing even nominal liability against an outside director for a duty of care breach is exceedingly difficult. A plaintiff confronts the first hurdle at the outset of a case. Virtually every public company incorporated in Delaware has in its charter an exculpatory provision, authorized by section 102(b)(7) of the Delaware General Corporation Law, that in effect requires a court to dismiss a suit seeking damages from outside directors based on breach of the duty of care unless the plaintiff alleges facts showing that the defendant engaged in intentional

a duty of special care when one's company is a takeover target. *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. Absent a conflict of interest, however, an outside director's failure to ensure proper disclosure is treated as a duty of care violation—so too for an outside director's decision to accept or oppose a takeover offer. Hence, for the purposes of assessing outside director liability, the care/loyalty dichotomy is sufficient.

125. Our findings are consistent with empirical studies by Robert Thompson and Randall Thomas. *See* Thompson & Thomas, *supra* note 30, at 133; Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747 (2004) [hereinafter Thompson & Thomas, *Public and Private Faces*].

126. DEL. GEN. CORP. LAW. § 145(a), DEL. CODE ANN. tit. 8, § 145(a) (2005). The *Emerging Communications* and *Tad's Enterprises* cases, discussed in Appendix B, *infra*, are examples in which outside directors approved a transaction favorable to inside managers. The *MiniScribe* case described in Part I is an example of a case in which an outside director represented a major shareholder, who indemnified him.

misconduct or failed to act in good faith.[127] Companies incorporated elsewhere usually have similar provisions, under similar and sometimes broader statutory authorization.[128] As explained in Part II.A.1.b, the Delaware Chancery Court in the recent *Disney* case held that a failure of oversight meets the bad faith standard if a director's conduct reflects a conscious disregard of duty.[129] A plaintiff must plead with particularity facts that meet this standard.[130]

Even if the allegations in a complaint withstand a motion to dismiss, the plaintiff seeking damages still must prove its case at trial. A plaintiff will have to overcome the presumption under the business-judgment rule that the board acted honestly and on an informed basis and thus is entitled to the rule's protection.[131] Even if the plaintiff does so, the board still can invoke the protection of the company's exculpatory charter provision by proving that it acted in good faith. The failure of the plaintiff's claim in *Disney*, despite surviving preliminary challenges, illustrates the difficulty a plaintiff faces.[132]

b. *Additional protection against nominal liability in derivative suits*

The rules governing derivative suits establish additional protection against nominal liability. At the outset of a derivative suit, in addition to the pleading

127. *In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113, at *168 (Aug. 9, 2005) ("The vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by § 102(b)(7)."); DEL. GEN. CORP. L. § 102(b)(7), DEL. CODE ANN. tit. 8, § 102(b)(7) (2005). This provision allows a company charter to include a

> provision eliminating or limiting the liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director [other than] (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 [for declaring an improper dividend]; or (iv) for any transaction from which the director derived an improper personal benefit.

Id. Despite the complex and overlapping wording of the exclusions, the import is clear enough. A company's charter can limit or eliminate liability for good faith conduct (which would be judged under the duty of care, not the duty of loyalty).

128. *See* MODEL BUS. CORP. ACT ANN. § 2.02 (2002) (outlining the "Provision Limiting or Eliminating Personal Liability of Director"). Twenty-eight states have enacted provisions based on Delaware's section 102(b)(7). Fourteen states have adopted the Model Business Corporation Act's (MBCA) provision, which allows a company charter to eliminate a director's liability "except liability for (A) the amount of a financial benefit received by a director to which he is not entitled; (B) an intentional infliction of harm on the corporation; (C) [an improper dividend or share repurchase]; or (D) an intentional violation of criminal law." MODEL BUS. CORP. ACT ANN. § 2.02(b)(4) (2004). Thus, the MBCA contains neither the good faith exception of section 102(b)(7), nor an exception for duty of loyalty violations from which the director does not personally profit. Five states have enacted provisions that do not closely resemble Delaware's Act or the Model Act.

129. *In re Walt Disney*, 2005 Del. Ch. LEXIS 113, at *175.

130. Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000) ("[I]n a due care case . . . the complaint must allege particularized facts (not conclusions) . . . .").

131. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

132. *See generally In re Walt Disney*, 2005 Del. Ch. LEXIS 113.

hurdle that the exculpatory charter provision creates, a plaintiff must either make a demand on the company's board that the company pursue the suit against its own directors or persuade the court that making such a demand would be futile. The latter approach is the one that plaintiffs routinely follow, but it is not an easy argument to win. To succeed in showing futility, the plaintiff must allege specific facts that "create a reason to doubt that: '(1) the directors are disinterested or independent' or '(2) the challenged transaction was otherwise the product of a valid exercise of business judgment.'"[133] These failures refer to the board as a whole, which means that a majority of the board or relevant committee must have been compromised in one of these respects or must have been dominated by a powerful director who was so compromised.[134]

Even if a plaintiff succeeds at the demand stage, the company may, at any point in the case, establish a special litigation committee comprised of independent directors to consider whether the company should move to dismiss the case. Grounds for moving to dismiss include a determination by the committee that the case is not meritorious or, even if it is meritorious, that "ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal" factors support dismissal.[135] There is no guarantee that a special litigation committee will conclude that the case should be dismissed, especially if there has been a turnover on the board as often occurs in the wake of a serious fraud. If, however, a special litigation committee does recommend dismissal, so long as the court finds that the committee was independent and that it followed a sensible deliberative process in reaching its conclusion, a court will subject the committee's determination to only a moderate level of scrutiny.[136]

c. *Fiduciary duty suits brought by creditors in bankruptcy*

Insolvency adds a distinctive dynamic to litigation based on an allegation of a breach of duty by directors: the potential for a suit to be brought by bankruptcy trustees, creditors' committees, and liquidation trustees. These are suits based on a breach of fiduciary duty to the corporation and are brought in the name of the corporation.[137] The recovery, if any, goes to the corporate estate for the ultimate benefit of creditors. After some confusion in various

133. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 285 (Del. Ch. 2003) (quoting *Aronson*, 473 A.2d at 814).

134. *See Aronson*, 473 A.2d at 815 (requiring a showing that "through personal or other relationships the directors are beholden to the controlling person").

135. Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981) (quoting Maldonado v. Flynn, 485 F. Supp. 274, 285 (S.D.N.Y. 1980)).

136. The degree of deference differs across states. *See, e.g.*, *Zapata*, 430 A.2d 779 (requiring heightened scrutiny of business judgment); Auerbach v. Bennett, 47 N.Y.2d 619 (1979) (requiring deferential scrutiny).

137. Prod. Res. Group, LLC v. NCT Group, Inc., 863 A.2d 772, 792 (Del. Ch. 2004).

courts, the Delaware Chancery Court has ruled that in these cases outside directors have the protection of exculpatory charter provisions, authorized by section 102(b)(7) and the business-judgment rule, just as they do in shareholder derivative suits.[138] Consequently, fiduciary duty suits initiated by creditors on behalf of the bankrupt estate should not differ greatly from derivative suits brought by shareholders,[139] meaning outside directors sued on the basis of a breach of loyalty face a risk of paying out of their own pockets, but those being sued for a failure to exercise sufficient oversight face very little risk.

Procedurally, outside directors have less protection in these suits than they do in shareholder suits. There is no demand requirement and no special litigation committee in creditor suits. Thus, if the merits of a case against the outside directors are strong, creditor-initiated breach-of-duty cases pose a greater threat of at least nominal liability than do shareholder suits where the company is solvent. Nonetheless, our search turned up only one case in which an outside director has made an out-of-pocket payment in litigation of this sort.

d. *Indemnification and D&O insurance*

As explained above, essentially all corporations bind themselves to provide indemnification to outside directors to the fullest extent permitted by law.[140] In regulating the availability of indemnification, the law distinguishes between direct and derivative suits. In a direct suit, but not a derivative suit, the corporation can indemnify directors for damages paid pursuant to a judgment or amounts paid in settlement.[141] In derivative litigation a corporation is limited to indemnifying directors for legal expenses and advancing funds necessary to pay legal costs on an interim basis.

The absence of indemnification for amounts an outside director pays in damages or in settlement in a derivative suit does not expose directors to out-

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138. *Id.* For cases illustrating the division of opinion in the courts prior to *Production Resources,* see *Continuing Creditors' Committee of Star Telecommc'ns v. Edgecomb*, 385 F. Supp. 2d 449 (D. Del. 2004); *Pereira v. Cogan*, No. 00-CIV.-619(RWS), 2001 WL 243537 (S.D.N.Y. Mar. 8, 2001) (applying Delaware law); *In re Ben Franklin Retail Stores, Inc.*, No. 97C7934, 2000 WL 28266 (N.D. Ill. Jan. 12, 2000) (applying Delaware law).

139. Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005).

140. *See supra* text accompanying note 93; *see also* Scharf v. Edgecomb Corp., No. Civ.A.15224-NC, 2004 WL 718923 (Del. Ch. Mar. 24, 2004) (citing company's bylaw provision for indemnification "to the fullest extent permitted by law"), *rev'd*, 864 A.2d 909 (Del. 2004).

141. DEL. GEN. CORP. LAW. § 145(b), (e), DEL. CODE ANN. tit. 8, § 145(b), (e) (2005). Subsection (b), which applies to derivative suits, further provides that

> no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity.

Id. § 145(b).

of-pocket liability, however, because the same good faith standard that a director would have to meet to be indemnified applies when the director seeks to invoke the exculpatory charter provision in the underlying action. Consequently, if the director can show he acted in good faith, he will not be held nominally liable in the first place, and indemnification for damages will be irrelevant. Indemnification in fiduciary duty suits is therefore important in two respects. First, it covers litigation expenses in both derivative and direct suits. Second, it covers payments made in settlement of direct suits. Since defendants do not acknowledge wrongdoing in settlement agreements, the good faith requirement does not bar indemnification.

If outside directors have failed to such an extent that their conduct constitutes a lack of good faith—self-dealing or conscious disregard of their oversight duties[142]—they will lose both indemnification for expenses and the protection of the exculpatory charter provision. Nonetheless, even outside directors whose oversight failure is so extreme as to fail to meet the good faith standard may still be covered by D&O insurance to the extent of the policy limit. As explained above, D&O policies exclude from coverage conduct that constitutes deliberate fraud or the taking of illegal profits.[143] These exclusions are narrower than the conscious disregard of duty conception of good faith. Accordingly, a director who fails the good faith test for purposes of nominal liability and indemnification of expenses may nonetheless have his damages and expenses covered by D&O insurance. Furthermore, D&O insurance protects directors when the company is insolvent and cannot indemnify expenses for that reason.

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The bottom line? Where failure is one of oversight as opposed to one of loyalty, a plaintiff alleging a breach of duty under corporate law is highly unlikely to win the case on the merits against an outside director. This is consistent with our finding in Part I that there has been only one such case—the famous case of *Smith v. Van Gorkom*. The Delaware legislation authorizing adoption of exculpatory charter provisions was enacted after *Van Gorkom*—indeed, in response to *Van Gorkom*—so the burden of pleading and proof for oversight failures is now substantially higher than it was at the time of that case. Directors do face some risk of nominal liability in a derivative suit that involves conduct that is ambiguous with respect to whether a lack of care or loyalty was involved. This fact pattern was plausibly the situation for the outside directors in the *Fuqua* settlement discussed in Part I. Unless an outside director's conduct was so extreme as to fall within the deliberate fraud or illegal profit exclusions to D&O coverage, however, the outside directors will

142. *See supra* text accompanying notes 94, 129.
143. *See supra* text accompanying notes 107-08.

be protected by the D&O policy up to its limit. If, on the other hand, an outside director breaches his duty of loyalty, he faces the risk of being tried, held liable, and paying damages out of pocket.

3. *The resulting windows of out-of-pocket liability exposure*

Having now analyzed the scope of outside directors' nominal liability under securities and corporate law, the scope of indemnification, and insurance coverage, what exposure to out-of-pocket liability do outside directors face when a case goes to trial? That is, under what circumstances could an outside director lose a shareholder suit on the merits *and* find himself with less-than-complete indemnification or insurance coverage? We address this question in terms of facts that ultimately would have to be proven for outside directors to pay personally. Settlement negotiations occur against a backdrop of going to trial. We therefore defer the analysis of settlements to Part II.B.

We distill our findings in Table 3 (securities law) and Table 4 (corporate law). These tables are structured to reflect the two key determinants of outside directors' exposure to out-of-pocket liability at trial: solvency of the company and sufficiency of its D&O coverage relative to the damages awarded.

a. *Securities lawsuits*

If a company is sufficiently solvent to pay the maximum amount of damages foreseeable for its outside directors, the exposure of the outside directors to out-of-pocket liability in securities class actions is very narrow. There is, as we have seen, little economic reason for a lead plaintiff to pursue outside directors of a solvent company. Even if a lead plaintiff were to pursue them, however, and the outside directors were tried and held liable under section 10(b) of the Exchange Act, the company would be directly liable as well, and the directors would be indemnified so long as they did not engage in self-dealing or consciously neglect their duty.[144] If an outside director is held liable under section 11 of the Securities Act, the SEC's policy regarding indemnification makes its availability uncertain. But misconduct under either section 10(b) or section 11 that is ineligible for indemnification will be covered by a state-of-the-art D&O insurance policy, up to its limits, so long as the director did not engage in deliberate fraud or the taking of illegal profits. The two left-hand cells of Table 3 (Corporation Sufficiently Solvent) reflect these scenarios.[145]

144. The scienter standard applicable under section 10(b) differs from the good faith standard for indemnification. The extent to which the two standards differ, however, is unclear. We assume the outside directors have indemnification agreements providing protection to the full extent permitted by law.

145. To the extent insurance is available in addition to indemnification, the outside directors may be protected even if the company alone is not sufficiently solvent to cover the

If a company is insolvent or insufficiently solvent to cover damages that will potentially be awarded against its outside directors, its outside directors are more exposed. Under that condition, a lead plaintiff may be able to augment its recovery by pursuing outside directors and is therefore more likely to pursue them. Nevertheless, as the top-right-hand cell of Table 3 (Corporation Insufficiently Solvent/Adequate Insurance) shows, if D&O insurance is available and the policy limits are high enough to cover potential damages, the outside directors' exposure is limited to cases in which they have committed deliberate fraud or taken illegal profits.

As the bottom-right-hand cell of Table 3 (Corporation Insufficiently Solvent/Inadequate Insurance) indicates, when a company is insolvent and D&O insurance is not sufficient to cover potential damages, the outside directors' exposure broadens to include cases in which they could be held nominally liable under section 10(b) or section 11. In addition, if D&O insurance is not available at all or is insufficient to cover legal expenses, outside directors will have to pay their own litigation costs regardless of their conduct. Outside directors can take comfort from the high scienter standard for 10(b) liability. If a misstatement has been made in disclosure documents related to a public offering, however, the standard for liability under section 11 is mere negligence, meaning that trial does pose significant risks for outside directors.

Table 3. Outside Directors' Exposure to Out-of-Pocket Liability Pursuant to Judgment in Securities Law Claims

	Corporation Sufficiently Solvent*	Corporation Insufficiently Solvent
Adequate Insurance	▪ Deliberate fraud ▪ Illegal profits	▪ Deliberate fraud ▪ Illegal profits
Inadequate Insurance	▪ Self-dealing ▪ Conscious disregard of duty ▪ Potential exposure for negligence in § 11 suits due to undertaking with SEC	▪ § 10(b): Reckless or intentional disclosure violation (damages) ▪ § 11: Failure to exercise due diligence (damages) ▪ Legal expenses once insurance is exhausted, regardless of conduct

* Sufficient solvency refers to the ability of the company to cover damages awarded against the outside directors.

b. *Corporate lawsuits*

In a shareholder suit for breach of fiduciary duty under corporate law, the solvency of the company has less impact on the outside directors' exposure to out-of-pocket liability than it does in a securities lawsuit. Under exculpatory charter provisions, which are essentially universal, the good faith standard for

outside directors' maximum exposure.

indemnification applies as well in determining nominal liability in the first place. Consequently, a director who has acted in good faith will not be held liable, in either a direct or derivative suit, so indemnification for damage payments is not relevant. The outer limit of the outside director's exposure involves cases in which she has engaged in self-dealing or gross oversight violations that constitute a conscious disregard of duty. But, once again, in the latter case, D&O insurance will potentially offer coverage up to the policy limit. Hence, as both cells of the top row of Table 4 (Adequate Insurance) indicate, so long as the outside directors have not committed deliberate fraud or taken illegal profits and their D&O policy coverage exceeds their legal expenses and damages, they will not face out-of-pocket liability.

Conversely, if a company's D&O insurance is inadequate, its outside directors will be liable for conduct held to be in bad faith—loyalty breaches and oversight failures held to constitute a conscious disregard of their duties. In addition, insolvency has two further impacts on the outside directors' risk of out-of-pocket payments in a case tried to judgment. First, whereas under normal circumstances outside directors may derive protection in derivative suits from the formation of a special litigation committee, this procedure will not be available if the company is in bankruptcy. Second, to the extent D&O insurance is not available, an outside director will have to pay his own litigation expenses regardless of the outcome of the suit. These potential ramifications of insolvency are reflected in the two cells on the bottom row of Table 4 (Inadequate Insurance).

Table 4. Outside Directors' Exposure to Out-of-Pocket Liability Pursuant to Judgment in Corporate Law Claims

<table>
<tr><th></th><th colspan="2">Corporation Solvent</th><th colspan="2">Corporation Insolvent</th></tr>
<tr><td>Adequate Insurance</td><td colspan="2">▪ Deliberate fraud
▪ Illegal profits</td><td colspan="2">▪ Deliberate fraud
▪ Illegal profits</td></tr>
<tr><td rowspan="2">Inadequate Insurance</td><td rowspan="2">Direct Suit:
▪ Loyalty breach
▪ Conscious disregard of duty</td><td>Derivative Suit:
▪ Loyalty breach
▪ Conscious disregard of duty</td><td>Direct Suit:
▪ Loyalty breach
▪ Conscious disregard of duty</td><td>Derivative Suit:
▪ Loyalty breach
▪ Conscious disregard of duty</td></tr>
<tr><td>▪ Special litigation committee may move to dismiss</td><td colspan="2">▪ Litigation expenses regardless of conduct</td></tr>
</table>

B. *The Effect of Settlement Incentives in Shareholder Suits*

Having outlined the risks that outside directors face if a case goes to trial, we turn to settlements. As seen in Part I, a settlement is far more likely than a trial in both securities and fiduciary duty suits. Moreover, the vast majority of settled suits involve no out-of-pocket payments by outside directors. This Part analyzes settlement dynamics in order to explain these empirical findings and ultimately to assess whether the send-a-message goal that motivated the *WorldCom* and *Enron* lead plaintiffs would change outside directors' liability risk if other lead plaintiffs adopt this approach.

1. *Securities lawsuits*

Settlement dynamics in securities suits differ in important ways depending on whether a company is sufficiently solvent to pay the net present value of reasonably foreseeable damages if the case goes to trial, taking into account the amount of D&O insurance that will be available. We begin by analyzing settlement incentives if a company is solvent in this sense, addressing the incentives of the company, the D&O insurer, the outside directors, and the lead plaintiff. We then analyze how settlement dynamics change when the company is insolvent.

a. *The solvent company's approach to settlement*

In a class action brought under the securities laws, plaintiffs will invariably name the company as a defendant if the company is solvent. There are strong reasons to expect the company to be willing to settle these cases and to do so without contribution from outside directors (or inside managers). In general, either the company will pay the full settlement amount or the company and the insurer will pay.

In any civil litigation, a defendant's goal generally will be to minimize the discounted cost of a lawsuit, taking into account legal expenses and the possibility of a damage payment. Settlement models show that defendants have strong incentives to share information with plaintiffs to induce them to settle and that in doing so the plaintiffs' and defendants' expectations regarding the outcome of a trial tend to converge. The potential for both sides to save on litigation costs typically will ensure that a defendant will be willing to settle a case for a payment at least equal to the amount a plaintiff is willing to accept. This theoretical result is consistent with the empirical observation that very few civil cases are tried.[146] In securities and corporate litigation, defendants' costs are usually higher than plaintiffs' costs, meaning that defendants will be willing to pay more than the minimum amount plaintiffs are willing to accept, thereby increasing the likelihood of a settlement.[147]

In a securities class action, the likelihood of a settlement is enhanced still

146. SHAVELL, *supra* note 62, at 401-03.

147. *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, L. & CONTEMP. PROBS., Summer 1985, at 5, 17-18.

further because a company may well settle for even more than management's assessment of the discounted cost of going to trial. Looking first at the company's interests, the publicity of a trial can be bad for business. Negative information can come out during a trial that was unknown to employees, customers, creditors, the securities market, and others. Furthermore, a trial can distract a company's top management from running the business. Avoidance of these negative ancillary effects of a trial will increase the amount a company can justify paying to settle a lawsuit. To the extent that the company's D&O insurance will cover the settlement, the incentive for the company to settle is even greater, and the company will be willing to pay still more.

If the executives or directors being sued are still with the company, their personal interests can also create a bias in favor of settlement. Information that comes out at trial can harm personal reputations. Moreover, if the managers are named as defendants—as is almost always the case whenever outside directors are named—their incentive to avoid personal liability will increase the likelihood that the company will settle, and settle for more.

Assuming a case does in fact settle, the company will in all likelihood agree to pay the full settlement (along with the D&O insurer) without contribution from the outside directors (or inside management). Management can justify settling on such terms because, for the reasons described above, the company would likely have been held liable for all damages awarded after trial—both directly to the plaintiffs and under its indemnification obligations to the inside managers and outside directors. If the inside managers or (much less likely) the outside directors engaged in conduct that would or might bar indemnification, these individuals may pay personally as well, either directly or because the company seeks contribution from these individuals.[148] In the course of our search for out-of-pocket payments by outside directors, we found a number of personal payments by inside managers to settle a case, including some where the company was solvent. But as a practical matter, it is unlikely that someone could challenge a settlement agreement for failing to require out-of-pocket payments.

The findings of Part I are consistent with this analysis. We found no securities cases in which a solvent company failed to settle on terms that left the outside directors' personal assets intact.

A potential exception to this analysis is a case in which management has changed hands since the events that gave rise to the lawsuit. The approach of the new management toward the former outside directors, now defendants, may range from unsympathetic to antagonistic. Assuming as we do throughout this Article that the former outside directors had indemnification agreements and that their conduct did not disqualify them for indemnification, the change in management should not make a major difference. But if there is a question regarding whether their conduct constituted bad faith, the company may not

148. *See* Exchange Act § 21D(f)(5), 15 U.S.C. 78u-4(f)(5) (2006).

only decline to indemnify the former directors but also seek out-of-pocket payments from them to settle the suit. Our search for cases of out-of-pocket liability involving this fact pattern, however, has uncovered only a few such cases involving inside managers, and none involving outside directors.

b. *The D&O insurer's approach to settlement*

Under the terms of D&O policies, the insurer's consent to a settlement is required for funds to be available.[149] Since the policy limit caps an insurer's exposure if a case goes to trial, one might expect that the insurer's consent to pay would sometimes be difficult to obtain. Seemingly, an insurer might prefer to roll the dice at trial, especially if a proposed settlement figure is close to the policy limit. If the case goes to trial, the defendants might win, or facts might come out that allow the insurer to avoid coverage.

Countervailing factors, however, explain why insurers are almost always willing to settle within the D&O policy limits. One critical factor is procedural. D&O policies, unlike most forms of insurance, allow the defendants to choose their own defense counsel, rather than rely on the insurer's counsel.[150] This provision ensures a vigorous and expensive defense, for which the insurer will pay. It also deprives the insurer of the detailed information needed to oppose a settlement that the defendant directors and their counsel favor, provided of course that the settlement is plausible.

Second, an insurer that declines to settle runs the risk that, if the defendants ultimately lose at trial and their damages exceed the policy limits, the insurer will be held liable for its refusal to settle. D&O policies typically stipulate that the insurer cannot unreasonably withhold consent to a settlement that the policyholder favors.[151] Even without such an explicit provision, D&O policies have been interpreted to contain an implied covenant of good faith and fair dealing under which insurers are considered obligated to consent to settlements within the policy limits if refusing to accept such a settlement would likely

149. 2 KNEPPER & BAILEY, *supra* note 104, § 24.10; MATHIAS ET AL., *supra* note 104, § 6.03[5][d]; OLSON & HATCH, *supra* note 99, § 12.27. The reasons an insurer might resist a settlement could include: (1) the insurer claims to have a defense to payment; (2) the defendants want to settle, but the insurer refuses; (3) multiple insurers with different layers of coverage cannot agree on how to handle the case; or (4) the inside manager and outside director defendants cannot agree on how to allocate the policy proceeds, and the insurer refuses to pay for anyone until the dispute among the defendants is resolved.

150. In insurance parlance, the D&O policy contains neither a duty (of the insurer) to defend nor a right to defend. *See generally* 2 KNEPPER & BAILEY, *supra* note 104, § 24.13; MATHIAS ET AL., *supra* note 104, § 9.05; OLSON & HATCH, *supra* note 99, § 12.23-.24; Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 2023 (1978). The reason for this departure from practice in other insurance contexts is a question beyond the scope of this Article.

151. *See* CORP. BD. MEMBER, *supra* note 108, at 11-12; 2 KNEPPER & BAILEY, *supra* note 104, § 24.10; MATHIAS ET AL., *supra* note 104, § 6.03[5][d]; OLSON & HATCH, *supra* note 99, § 12.27.

result in liability in excess of the policy limits.[152] The insurer's liability under any of these claims would extend to the full amount the defendants ultimately pay, regardless of policy limits.[153] Moreover, most states provide insureds with a cause of action against an insurer for bad faith refusal to settle. Bad faith refusal to settle results not only in liability for losses above the policy limit, but it may result in punitive damages as well.[154]

Third, if an insurer refuses to settle, the insurer will bear the cost of further litigation up to the policy limit. Especially if the company is insolvent and cannot fund a settlement itself, counsel for the directors will have an incentive to pull out all stops, at the insurer's expense, to prevent a finding of liability. If the directors lose at trial and face personal payments, an appeal is virtually certain, and a remand for further trial-level proceedings could occur. The insurer cannot closely police legal expenses without opening itself up even more to a suit for bad faith refusal to settle or breach of the covenant of good faith, now compounded by refusal to pay for a proper defense. Especially if a settlement will not exhaust the policy limit, and if going to trial may, the best option for the insurer may well be to accept a settlement even if it believes the amount paid is too high.[155]

A fourth factor is potential reputational cost. D&O insurers can receive bad press if their refusals to settle, or attempts to deny coverage, become public knowledge.[156] Insurance brokers and law firms that advise companies regarding the purchase of D&O policies can readily advise insurance buyers as to which insurance companies have a reputation for refusing to settle or contesting D&O coverage.[157] The managers of other companies will not want to face the time commitment and aggravation of a trial, let alone the possibility of an out-of-pocket payment. Refusing to settle or seeking to deny coverage

152. *See, e.g.*, 2 KNEPPER & BAILEY, *supra* note 104, § 20.02; MATHIAS ET AL., *supra* note 104, § 9.07[1]; Alan O. Sykes, *"Bad Faith" Refusal To Settle by Liability Insurers: Some Implications of the Judgment-Proof Rule*, 23 J. LEGAL STUD. 77, 78 (1994); Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers To Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1345, 1368 n.97 (1994).

153. *See* 2 KNEPPER & BAILEY, *supra* note 104, § 20.05; OLSON & HATCH, *supra* note 99, § 12.27.

154. On the nature of bad faith in this context and on the circumstances when punitive damages can be awarded, see 2 KNEPPER & BAILEY, *supra* note 104, § 20.04; MATHIAS ET AL., *supra* note 104, § 9.08[2]; Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 SETON HALL L. REV. 74, 97-99 (1994).

155. Our search for trials turned up one instance, the *Globalstar* case discussed in Appendix B, in which the company was insolvent and an insurer refused to settle within policy limits. The defendant, the company's former CEO, settled with a personal payment and is now seeking reimbursement from the insurers. We found no similar refusals to settle in cases involving insolvent companies and *outside directors*.

156. Huskins, *supra* note 103, at 207.

157. METROPOLITAN CORP. COUNSEL, AN OVERVIEW OF THE D&O INSURANCE LANDSCAPE 49 (2005) (containing interview with Gregory J. Flood, a former D&O insurance executive), *available at* http://www.metrocorpcounsel.com/pdf/2005/June/49.pdf (last visited Jan. 15, 2006).

could thus do serious harm to the insurer's future business prospects.[158]

For these reasons, insurers generally accede to settlements that defendants favor and may provide coverage even if a potential basis for denying coverage exists. Thus, if the defendants are willing to settle a securities suit within limits, the insurer will usually pay. This outcome is reflected in their past payout experience and is, therefore, presumably priced into their policies.

c. *The outside directors' approach to settlement*

In cases in which the company and its D&O insurer are willing to fund a settlement, the outside directors have good reason to agree. Some may still be tempted to go to trial to exonerate themselves. But unless they are highly confident that either the company or the insurer will cover all expenses and potential damages, going to trial is an unattractive prospect. Even if they ultimately do prevail, there is a reasonable chance that facts will come out in court that will harm their reputations.

d. *The approach of a lead plaintiff interested in maximizing recovery for the class*

One would generally expect a lead plaintiff considering settlement to attempt to maximize the class's recovery, taking into account risk and litigation costs.[159] A lead plaintiff acting in this fashion will agree to a settlement under which the defendants collectively pay a sum at least equal to its estimate of the net present value of pursuing a case through trial to final judgment.[160] That value will be determined by projecting a set of reasonably foreseeable trial outcomes, discounting those outcomes to reflect risk and the time value of money, and subtracting the present value of its own litigation costs.[161] Since the company is solvent, we assume the plaintiffs will be able to collect any damage award that a court orders.

The analysis above indicates that the company, the outside directors, and the D&O insurer will normally be prepared to agree to a settlement that is equal

158. *Id.* ("It is unlikely that an insurance carrier could maintain a meaningful share of the market if it rescinded frequently.").

159. The lead plaintiff is selected based on the size of its financial interest in the litigation and is expected to "fairly and adequately protect the interests" of the class, which presumably would be deemed to be its financial interest. FED. R. CIV. P. 23.1.

160. Lead plaintiffs may of course try to bargain for a larger settlement, but at some point, when it is clear that the choice is settlement or trial, the lead plaintiff should settle in the manner described in the text. An analysis of possible bargaining games between lead plaintiff and defendants is beyond the scope of this Article.

161. The trial award should normally include pre- and postjudgment interest, but this adjustment often will not fully reflect the difference between net present value of settling for a certain amount of money today rather than receiving the same amount at trial, given plaintiffs' personal discount rates.

to, and possibly greater than, their respective estimates of the cost of going to trial and that this figure is likely to equal or exceed the lead plaintiff's estimate of the net present value of going to trial. The fact that the overwhelming majority of securities cases settle is consistent with this prediction.

We have assumed to this point that the lead plaintiff pays (along with the class the lead plaintiff represents) the litigation costs entailed in going to trial and that the lead plaintiff makes the settlement decision. The reality is more complex because the class counsel bears some of the litigation costs and in practice has significant influence over whether the case goes to trial. Typically, a lead plaintiff's retainer agreement with class counsel provides for a contingency fee based on a percentage of the class's recovery. Unless such a fee depends on the stage at which the recovery takes place, the plaintiffs' lawyers, rather than the plaintiff class, bear the cost of going to trial instead of settling. For instance, the plaintiffs' lawyer may well get the same fee for a $10 million settlement or a $10 million judgment after trial, but the latter would entail more work. A partially countervailing factor is that once a class action settles or reaches final judgment, the court must approve legal fees. Courts often consider the time the plaintiffs' lawyers have devoted to a case in approving a fee award.[162] Thus, if a case settles early, the court may award the lawyer a fee that is lower than the previously agreed upon percentage. In addition, some fee agreements with lead plaintiffs establish different percentage fees based in part on how quickly the case is settled or a ceiling on the amount the lawyers can collect based on the number of hours worked. Under any of these scenarios, the lead plaintiff will have an interest in saving litigation costs.

Furthermore, whatever the measure of their fees, plaintiffs' lawyers are paid only if the class recovers a settlement payment or a damage award. If a case goes to trial and the plaintiffs lose, the plaintiffs' lawyers will have spent a great deal of time and money and will be paid nothing. Consequently, if an attractive settlement is available, the lawyer will exert pressure on the lead plaintiff to accept the settlement rather than go to trial at the lawyer's risk.

When all of these factors are taken together, the infrequency of trials—as well as the lack of out-of-pocket payments by outside directors of solvent companies, as reported in Part I—is not surprising. A lead plaintiff interested in maximizing the class's recovery has good reason to accept a settlement agreed to, and funded by, the company and the insurer. Consequently, the incentives of all parties to settle a case result in a much narrower scope of out-of-pocket liability exposure for outside directors than that indicated in Part II.A. When a case settles, there is generally no record created on which anyone could argue that the outside directors acted in bad faith and, therefore, should not be indemnified.[163] Nor is there usually a record created on which an insurer could

162. *See, e.g.*, Goldberger v. Integrated Res., 209 F.3d 43, 50 (2d Cir. 2000).

163. As a practical matter as well, settlements generally do not specify amounts paid with respect to an individual defendant's personal liability. Therefore, the question of

contest coverage. Thus, as reflected in Part I, at least when a lead plaintiff is acting to maximize the class's recovery, securities suits against solvent companies will in all likelihood settle on terms that leave the outside directors' personal assets intact.

e. *Insolvency and the heightened possibility of outside director liability*

Settlement dynamics, and potentially settlement outcomes, change when a company is not sufficiently solvent—taking into account available insurance—to settle a case for an amount equal to the lead plaintiff's estimate of the net present value of a damage award following trial ("the net expected damage award"). For simplicity, we analyze the case of a company that is fully insolvent.[164] The most the defendants can offer in this situation without digging into their own pockets is the D&O policy limit less litigation expenses incurred to date (the "net policy limit").

If the net policy limit is less than the plaintiffs' net expected damage award, it may be rational for the lead plaintiff not to settle for the available insurance and instead go to trial against individual officers or directors seeking their personal funds—or credibly threaten to do so and thereby extract personal funds in a settlement. Thus, insolvency creates a source of out-of-pocket liability risk for outside directors that is all but absent when a company is solvent.

Even if the net expected damage award is greater than the net policy limit, however, the lead plaintiff may nonetheless settle for the remaining insurance proceeds rather than go to trial. Whether a lead plaintiff will settle for the net policy limit or go to trial depends on the amount it expects to actually recover after trial—an amount that may well be less than the damage award. Two factors can make settlement attractive. First, plaintiffs may fear that they will be unable to collect from the individual defendants under a settlement or judgment. Second, the defendants' legal expenses will accrue as the case continues toward trial. Those expenses will be funded by the D&O insurance policy and therefore reduce the net policy limit available to fund a damage award after trial. In effect, the plaintiff class will be paying the defendants' litigation expenses out of a fixed pool of insurance money. Third, if after trial the plaintiffs collect only the net policy limit, they will not be compensated for

indemnification does not arise.

164. The main lines of our analysis would not change for a "barely solvent" company that has some assets to contribute to the settlement but is on the verge of insolvency. However, the fact that a company has some assets to contribute could complicate the decisions the plaintiffs would have to make before seeking personal payments from directors. If a plaintiff knows, for instance, that pressing for a large damage award in a settlement is likely to bankrupt the company, the plaintiff will likely refrain from doing so. The plaintiff will do so because if the company goes over the edge, the plaintiff will likely fail to collect much of what the company is theoretically obliged to pay.

the time value of money that they lose as a result of delaying their recovery. Unless the lead plaintiff can make up for these losses by extracting substantial personal payments, the class will be worse off by going to trial. Hence, even when the net policy limit is less than the plaintiffs' net expected damage award, additional conditions must be present for the lead plaintiff to go to trial—or credibly threaten to do so—rather than settle for the net policy limit.

In order for a lead plaintiff to rationally decline to settle for the net policy limit and instead opt to extract out-of-pocket payments from individual defendants, the lead plaintiff must anticipate that the expected additional amounts it will actually collect from the defendants will exceed the additional litigation expenses that the defendants will draw out of the D&O policy plus the time value of money. This means that some individual defendants must have substantial personal assets subject to judicial process. Moreover, in order for damages to be available under the damage-allocation rules, there must be a match between defendants' assets and their culpability.

In a section 10(b) case, inside managers and outside directors are subject to proportionate liability unless they have committed a knowing violation, in which case they are jointly and severally liable. Consequently, for it to be worthwhile for a lead plaintiff to forsake a settlement funded solely by D&O insurance and instead to seek personal payments, the defendants with substantial assets must have a large percentage of responsibility, or they must have committed a knowing violation. Outside directors are unlikely to have committed a knowing violation and are also unlikely to be allocated a large percentage of responsibility. A lead plaintiff therefore may be inclined to settle with the outside directors before trial without reaching a deal with other defendants. Doing so has the added benefit of allowing class counsel to simplify matters for the jury by focusing the case on more culpable or deeper-pocketed defendants.

On the other hand, the lead plaintiff will be aware that in the usual case in which a single insurance policy covers all officers and directors, the policy amount available to fund a later recovery from the inside managers will be reduced by the amount of any prior settlement with the outside directors. If the outside directors have a Side A policy that covers them alone,[165] this problem is alleviated. Typically, however, a Side A policy covering only the outside directors is an excess policy and therefore will not automatically drop down to cover a separate settlement involving only the outside directors. Consequently, in the absence of a further innovation in Side A policies for outside directors, an outside director is at risk.[166]

165. *See supra* text accompanying notes 114-20.

166. The Side A broad form difference-in-conditions policy is a common form of policy that can be purchased for outside directors alone (as opposed to officers and directors together). Although this policy contains difference-in-conditions coverage, which requires it to drop down in specific circumstances to fill gaps in the traditional D&O coverage, those circumstances are specifically defined and make no reference to a situation in which the

In a section 11 case, potential damages are often smaller than they are in a section 10(b) case, but holding expected damages constant, the outside directors' risk of a personal payment is higher. Outside director liability is much easier to prove because the standard of care is negligence rather than scienter. In addition, because nonnegligence is an affirmative defense, the directors will not be able to extract themselves from the case with a motion to dismiss. Furthermore, due to the quirk in the section 11 damage-reduction rule discussed earlier, a lead plaintiff may opt to keep the outside directors in a case through trial even if there is little chance of collecting meaningful damages from them.[167] The objective, again, will be to increase the recovery from inside managers or a third-party defendant.

Although outside directors may be exposed to settlement dynamics outside their control in section 11 cases involving insolvent companies, the fact remains that trials are uncommon. Inside managers, who likely face financial ruin if they lose at trial, settle in the vast majority of cases, as do third parties. If the other parties to a section 11 case settle, an economically motivated lead plaintiff may choose not to incur the further expense and delay entailed in pursuing the outside directors, especially if their allocation of damages is likely to be low or their personal assets are limited. A separate Side A policy for outside directors, however, would reduce the likelihood that an outside director will have to make a personal payment into a global settlement.[168]

If the lead plaintiff does go to trial against the outside directors in a section 11 case involving an insolvent company, an out-of-pocket payment is a real risk. But there is still a possibility that the outside directors' assets will remain intact. The outside directors may win, of course. But even if they lose and are held liable, they may be allocated damages within available D&O limits. To be sure, the lead plaintiff's premise for going to trial was that the net expected damage award would exceed the net policy limit even *before* incurring the litigation costs associated with the trial. Thus, an award that exceeds the net policy limit *after* trial is a substantial risk. It is still possible that they will not pay out of pocket. The other defendants will be jointly and severally liable for all damages in excess of the net policy limit, including any amount of the outside directors' allocation that the outside directors do not pay. The plaintiffs

insurers that have issued the traditional D&O policy do not agree to fund an early settlement for the outside directors alone. An insurer could nonetheless agree to fund a separate settlement in a particular case even if the company's traditional policy has not been exhausted. One can, however, imagine a policy that covers the outside directors in a separate settlement and then takes a claim against the company's traditional policy to the extent a later settlement with or judgment against the remaining defendants does not exhaust that policy's limits. A policy of that nature, however, would raise complications that go beyond what we can address in this Article.

167. *See supra* text accompanying notes 86-88.

168. Here the excess nature of the IDL policy would have no impact because either the company's traditional policy would cover the outside directors in a global settlement, or its limits would be exhausted and the IDL policy would pay out.

and the other defendants could decide that it is not worth chasing the directors for contributions. Finally, if the outside directors have a separate Side A policy, that policy may, depending on its limits, cover the damage award allocated to them.

The factors that must be present for an outside director of an insolvent company to be at risk of out-of-pocket liability in a securities case can be summarized, with some simplification of a more complex reality, in terms of two principal scenarios: the perfect storm and the can't-afford-to-win scenarios. These scenarios account for all the cases of out-of-pocket liability in the securities cases described in Part I and provide a basis for assessing the likelihood of such cases in the future.

i. *The perfect storm*

In the first scenario, which we refer to as the perfect storm, the outside directors have D&O insurance, but the lead plaintiff refuses to settle within the policy limits and either brings the outside directors to trial, or credibly threatens to do so. For a plaintiff seeking to maximize a recovery, making that decision requires three conditions to be present. The first is insolvency. More precisely, the company's net assets, plus the net policy limit, must be less than the net expected damage award. As we define the perfect storm, D&O insurance will be sufficient to cover the outside directors' litigation expenses through settlement or trial if necessary. That is, the outside directors will not be out of pocket simply because they incur litigation expenses to defend themselves. Otherwise, the outside directors will be in the can't-afford-to-win scenario discussed below, in which the directors may do better by settling than by going to trial and winning.

Second, the plaintiffs must have a reasonably strong case against the outside directors. This most likely means the case must include a sizeable section 11 claim with strong evidence of outside director culpability. A section 10(b) claim against the outside directors would satisfy this condition as well if there is unusually strong evidence of scienter and the outside directors' relative culpability is substantial for purposes of damage allocation. Otherwise, a rational plaintiff is unlikely to name and retain the outside directors as defendants through trial. In a section 11 case, the negligence standard and the damage-allocation rules make it more likely that the lead plaintiff will keep the outside directors in the case if it cannot settle with other defendants.

Third, there must be a substantial alignment between individual parties' culpability and their available assets. Two scenarios put the outside directors at risk. One possibility in either a section 10(b) or a section 11 case is that there are enough outside directors who are both wealthy and sufficiently culpable so that the expected recovery from them alone will justify a trial. The other possibility, applicable only to a section 11 case, is that inside managers and third parties are collectively wealthy and culpable enough so that their joint and several liability will make the lead plaintiff willing to go to trial against them and, because of section 11's damage-reduction twist, unwilling to settle separately with the outside directors. A combination of the two would also satisfy this condition.

If these three conditions are present, the logic described in Part II.B in which a lead plaintiff in a securities lawsuit settles without a personal payment from outside directors is weakened. The lead plaintiff may settle without such payments nonetheless, but the possibility of it not doing so becomes real. The lead plaintiff may instead go to trial against the outside directors and win a damage award against them that exceeds their D&O coverage, perhaps greatly. Or the lead plaintiff may credibly threaten to expose the outside directors to this potentially ruinous outcome and thereby extract out-of-pocket payments from them in a settlement.

As we discuss in Part II.C below, *WorldCom* and *Enron* were at least near-perfect storms. Also, Confidential Case #1, described in Part I, fits the perfect-storm scenario reasonably well, as best we can determine. In that case, several outside directors each paid a mid-six-figure amount out of pocket to settle a section 11 case. There was a large fraud leading to the company's insolvency, the outside directors had failed badly in their oversight role, the funds available under the company's D&O policy were dwarfed by reasonable estimates of the plaintiffs' net expected damage award, and several outside directors had significant wealth. Moreover, the insurer had a plausible application fraud defense to coverage, so the directors apparently would have had to go to court to force the insurer to pay the full policy limits, with no assurance of success. Finally, *Independent Energy Holdings*, a section 11 case with deep-pocketed, third-party defendants (three investment banks), also fits the perfect-storm pattern as best we can determine. The company was bankrupt and thus could not indemnify the directors, the insurer apparently had strong grounds for contesting coverage, and the D&O policy did not provide for severability as to the outside directors. Once the third-party defendants settled, however, it is unclear whether the lead plaintiff could have credibly threatened to go to trial against the outside directors alone if they declined to join the settlement. We have no information on the wealth of the outside directors.[169]

The fact that perfect storms are very uncommon should be reassuring to outside directors, but perfect storms can occur. Outside directors can reduce their likelihood of becoming a victim of one by having their company supplement its conventional D&O policy with a separate Side A policy that provides protection exclusively for the outside directors and that is sufficient in size to pay damages likely to be allocated to the outside directors in a securities fraud trial. A separate Side A policy of this type can provide protection for outside directors in a number of ways.[170] When outside directors face the

169. For background on *Independent Energy Holdings*, see *supra* note 49.

170. *See* Dan A. Bailey, *D&O Liability in the Post-*Enron *Era*, 2 INT'L J. DISCLOSURE

prospect of being taken to trial as a result of the way section 11's damage-allocation rules work, a separate policy can cover the damages they are ordered to pay in the event they lose at trial (an event that, one must keep in mind, has not occurred in decades). A separate policy can also cover the outside directors' share of a global settlement with all defendants where the total payment exceeds the policy limit of the company's traditional policy. It is also possible that separate coverage will fund a settlement with the outside directors alone, but so long as these policies are written without an explicit requirement to cover a separate settlement while funds remain in the company's traditional policy, this would require the consent of the insurer to drop down.

Separate Side A policies for outside directors only are not common today. Our analysis suggests that there is a role for such a policy, particularly one that can fund a separate settlement for outside directors in a section 11 case. The wisdom of purchasing such a policy would depend on its cost. That cost should reflect the fact that the policy offers protection against a perfect storm—by definition, a very uncommon occurrence. Whether a separate policy prevents outside directors from falling prey to a perfect storm will depend on the size of the policy and the amount of damages they face. If potential damages are large enough, as might have been the case in *WorldCom* or *Enron*, the outside directors are unlikely to be protected. But in a smaller case, they could be.

ii. *Can't afford to win*

A second scenario in which outside directors of insolvent companies have borne out-of-pocket liability is where they have no insurance or insurance that is inadequate to cover their litigation expenses through trial. Under these circumstances, the directors will incur out-of-pocket expenses by going to trial, or risk doing so, regardless of the merits of the case. Consequently, even nonculpable directors may conclude that they will do better by settling for an out-of-pocket payment than by trying the case and winning, let alone taking the risk of losing. We call this the can't-afford-to-win scenario. It applies to both securities and corporate cases.

The lack of insurance that is the predicate to this situation can stem from three causes: the company may not have purchased D&O insurance at all, the limits on its policy may be low, or the outside director's coverage may be in serious danger of being denied or rescinded, perhaps because the policy does not provide for full severability of coverage.[171] The first two causes should be

& GOVERNANCE 159, 175 (2005).

171. In some recent instances where insurers have contested coverage and refused to advance funds to officers and directors for legal expenses, courts have ruled that the insurers are obliged to make such advances until coverage issues are finally resolved. *See In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455, 465-66 (S.D.N.Y. 2005) (ruling and surveying other jurisdictions requiring that insurer must advance defense's costs pending resolution of its claims); Associated Elec. & Gas Ins. Servs. Ltd. v. Rigas, 382 F. Supp. 2d

highly unusual today, since virtually all public companies in the United States reportedly have D&O insurance and coverage limits have been rising in response to higher settlement payments. As for denial or rescission of coverage, if an outside director has a state-of-the-art D&O policy, the insurer will typically not have a basis for withholding coverage, let alone for refusing to advance funds pending resolution of a coverage dispute. In particular, policies with full severability clauses are readily available today, even if not all companies insist on them.

Several of the out-of-pocket cases listed in Part I fit the can't-afford-to-win scenario. These include *Ramtek* and *Baldwin-United*, cases in which the company was insolvent and had no D&O policy, as well as Confidential Cases #2 and #3, where the companies were insolvent and D&O insurance was low and contested. It is also possible that Confidential Case #1 was a can't-afford-to-win case rather than a perfect storm. We were told that the directors settled in part because, with the insurance policy being small and contested, they feared they might pay more in legal fees to go to trial and win than they would pay by settling.

In a case where coverage is contested but potentially sufficient to fund defense costs, another possibility is that the plaintiffs, the insurer, and the directors will eventually settle, and the insurer will pay all damages and legal expenses. In the meantime, however, the directors will have paid their own litigation expenses and perhaps damages as well. If this occurs, an outside director will not be out of pocket as we have been using the term, but he will lose the time value of money for his outlays. He will also suffer considerable discomfort in not knowing whether the insurer will ultimately pay. The *Friedman's Jewelers* and *Peregrine* cases, discussed in Part I, offer examples of delayed payment. In the *Friedman's Jewelers* litigation,[172] it now appears likely that the outside directors will not end up out of pocket, but in the interim, they paid legal expenses themselves and lost the time value of money. In the *Peregrine* case, the outcome is uncertain, but some out-of-pocket payments appear likely.

2. *Fiduciary duty suits*

Settlement incentives in fiduciary duty suits largely mirror those at play in securities suits, but there are some important differences. The company's solvency or insolvency is not as much a factor in derivative suits, where indemnification of damage payments and amounts paid in settlement is not permitted. In a direct suit, if the case goes to trial and the plaintiff proves the requisite bad faith, the company will not be permitted to indemnify the outside

685 (E.D. Pa. 2004) (same). As explained below, however, the insurers involved in some of the cases described in Part I did refuse to advance defense costs.

172. *See In re* Friedman's, Inc. Sec. Litig., 385 F. Supp. 2d 1345 (N.D. Ga. 2005).

directors either. On the other hand, it generally can indemnify them for amounts paid in settlement.

We address derivative and direct suits separately. As above, we assume a plaintiff and its counsel will settle a case for a payment equal to the net expected damage award.[173] The first question, therefore, is under what circumstances such a settlement will be possible for the outside directors without dipping into their own funds.

In a derivative suit alleging oversight failure, the business-judgment rule, exculpatory charter provisions, and the procedural rules discussed above make the plaintiff's prospect of success at trial extremely low. Only highly unusual cases will get past a motion to dismiss, let alone past a motion for summary judgment. Consequently, suits based on such allegations even against inside managers are rarely brought and, if brought, are often dismissed or settled for small damage payments or no damages at all.[174] So long as a company's D&O policy is intact with reasonable limits, the outside directors should be protected from such a suit unless their conduct has been truly abysmal.

A derivative suit that alleges a breach of the duty of loyalty poses a greater risk to the outside director. A breach of the duty of loyalty is not protected by an exculpatory charter provision or the business-judgment rule. D&O insurance may cover the director depending on whether the loyalty breach constituted deliberate fraud or the taking of illegal profits. If, however, an outside director's conduct falls within these coverage exclusions, the outside director will be exposed to a significant risk of out-of-pocket liability. But even where a breach-of-loyalty claim can be brought, a plaintiff seeking to maximize a recovery will often have no incentive to go to trial and expose the conduct of the outside directors in a way that threatens the availability of D&O insurance proceeds. A settlement within policy limits is therefore often possible.

In a direct suit alleging oversight failure, the outside directors are protected by the business-judgment rule and exculpatory charter provisions, which again make the plaintiff's likelihood of success remote. In addition, if the company is solvent, the outside director will usually be indemnified for amounts paid in settlement, though not if the case goes to trial and the plaintiff proves the outside director acted in bad faith—as it must in order to win the underlying case.[175] If the company is solvent, this asymmetry between the potential recovery after trial and the potential recovery in a settlement creates a strong

173. In a derivative suit, the lawyer may be willing to settle for less since attorneys' fees can be paid by the corporation regardless of whether there is a monetary recovery. *See* Coffee, *supra* note 4, at 23-24; Romano, *supra* note 37, at 55. For simplicity, this analysis does not take account of this factor and assumes that the plaintiff's objective is to maximize the recovery.

174. *See* Thompson & Thomas, *Public and Private Faces*, *supra* note 125, 1775-76 (noting that derivative suits are rare relative to class actions, and commonly are dismissed or settle for nonmonetary relief); *see also* sources cited *supra* note 37.

175. *See supra* text accompanying notes 151-54.

incentive on both sides to settle on terms that support indemnification.

Finally, the risk of out-of-pocket liability posed by a direct suit for breach of the duty of loyalty depends on the nature of the violation. If self-dealing is involved, the outside directors will be exposed, just as they are in a derivative suit for a loyalty breach. But the most common direct suit for a breach of the duty of loyalty is a suit by minority shareholders challenging a transaction that favors a major or controlling shareholder or inside managers.[176] In those cases, the controlling shareholder will be named as a defendant as well and, so long as it is solvent, the controlling shareholder will be a more attractive source of recovery than the outside director. In addition, it is common practice for major shareholders to indemnify their representatives on other companies' boards.[177]

So, are outside directors at risk for out-of-pocket liability in fiduciary duty suits? Yes, but the risk in cases alleging oversight failure is very low so long as the company has a state-of-the-art D&O policy and the outside directors have agreements providing for indemnification to the full extent permitted by law.

If the outside directors' D&O coverage is inadequate, there is some risk if an oversight failure is extreme or the directors' conduct can be cast as a breach of loyalty. Especially if an outside director is wealthy, a plaintiff may credibly threaten to go to trial seeking to prove bad faith or disloyalty, and the director may then choose to settle with an out-of-pocket payment. This appears to have been the dynamic leading to the settlement in *Fuqua*. The fact that *Fuqua* is the only case we found involving a Delaware company since the Delaware legislature enacted section 102(b)(7) indicates that the likelihood of this occurring is very small.

The can't-afford-to-win scenario can also occur in the fiduciary duty suit context. If a company is insolvent and D&O insurance is inadequate, an outside director could choose to settle rather than fight. Confidential Case #3, which was a creditor suit against directors of a non-Delaware company, seems to fit this pattern.

Finally, if an outside director has engaged in direct self-dealing, she is at risk. Indemnification will not be available for expenses, damages, or amounts paid in settlement whether a case is derivative or direct. Moreover, such conduct may constitute deliberate fraud or the taking of illegal profits, in which case D&O coverage would be unavailable. As we have said, however, the concern over outside director liability does not center on liability for self-dealing.

C. *Lead Plaintiff Motivated To "Send a Message"*

In announcing the *WorldCom* settlement, Alan Hevesi, Comptroller of the State of New York and trustee of the state pension plan that served as lead

176. *See* Part I, *supra*; *cf.* Thompson & Thomas, *supra* note 30, at 173.

177. DEL. CODE ANN. tit. 8 § 45(a) (2005).

plaintiff in that case, explained that the outside directors' out-of-pocket payments were intended to send "a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent."[178] He further stated, "We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud."[179] The *Enron* settlement likely reflected a similar motive on the part of the lead plaintiffs, the Regents of the University of California, although the lead plaintiffs were less vocal about their objectives.[180] Commentators in the business, legal, and popular press predict that other lead plaintiffs, especially politically ambitious heads of public pension plans, will follow Hevesi's lead—and that outside directors are therefore now at substantial risk of losing their personal assets.[181] Some lead plaintiffs, motivated by a combination of political advantage and their views of good policy, may well want to extract personal payments from outside directors whom they believe have been less than vigilant. But desires aside, what are their prospects of success? Commentators have ignored this key question.

This Part analyzes the limits to lead plaintiffs' ability to extract a personal payment from outside directors in order to "send a message." We conclude that a lead plaintiff is likely to be able to extract such payments only under narrow circumstances. Moreover, doing so outside the context of a perfect storm or can't-afford-to-win scenario will generally require the lead plaintiff to sacrifice the interest of the class in maximizing its recovery. This would violate the duty that both the lead plaintiff and class counsel owe to the class, and at least in extreme cases, it would potentially create liability exposure for both of them. To simplify the analysis, we focus only on securities suits.[182] We also limit our analysis to cases involving state-of-the-art D&O coverage, and we assume that the outside directors have acted in good faith and have bylaws or agreements

178. Press Release, Office of the New York State Comptroller, *supra* note 3.

179. *Id.*

180. *See* Ben White, *Former Directors Agree To Settle Class Actions*, WASH. POST, Jan. 8, 2005, at E1 (quoting William Lerach, chief counsel for the plaintiffs in *Enron*, as saying that the settlement will "send a message").

181. *See, e.g.*, John R. Engen & Charlie Deitch, *"Chilling" (What Directors Think of the* Enron/WorldCom *Settlements)*, CORP. BD. MEMBER MAG., Mar./Apr. 2005, *available at* http://www.boardmember.com/issues/archive.pl?article_id=12143&V; Anne Fisher, *Board Seats Are Going Begging*, FORTUNE, May 16, 2005, at 204; Joann S. Lublin et al., *Directors Are Getting the Jitters—Recent Settlements Tapping Executives' Personal Assets Put Boardrooms on Edge*, WALL ST. J., Jan. 13, 2005, at B1; Suzanne McGee, *The Great American Corporate Directors Hunt*, INSTITUTIONAL INVESTOR, Apr. 1, 2005, at 32; Peter J. Wallison, *The WorldCom and Enron Settlements: Politics Rears Its Ugly Head*, FIN. SERVS. OUTLOOK, Mar. 2005, at 1; Memorandum, Skadden, Arps, Slate, Meagher & Flom LLP, *WorldCom*/*Enron* Settlements—Implications for Directors (Jan. 2005), http://www.skadden.com/Index.cfm?contentID=51&itemID=998.

182. The analysis for fiduciary duty suits basically tracks that of securities suits with the important qualification that a plaintiff is highly unlikely to have a strong fiduciary duty claim for an oversight failure.

providing for indemnification to the full extent permitted by law.[183]

Once again, we divide the analysis into two situations: one in which the company is solvent and another in which the company is insolvent.

1. *Solvent company*

As explained above, there is good reason to expect that a solvent company will offer to settle a case for more than the net present value of the case to the plaintiff class and that the settlement will be funded either by corporate funds, insurance proceeds, or a combination of both.[184] Moreover, even if the plaintiffs win at trial, the company will also be liable along with the outside directors and inside managers, and the company, the insurer, or both may well offer to pay the full damage award.[185]

The question, therefore, concerns the circumstances under which a lead plaintiff intent on sending a message would reject an otherwise desirable settlement offer, credibly threaten to proceed to trial, and in the event the plaintiff wins, take whatever actions are necessary to collect from the outside directors rather than the company—when the same dollars are available from either source. If the lead plaintiff can credibly threaten to pursue outside directors' personal funds in these ways, then the outside directors will either agree to contribute personal funds to a settlement or take their chances at trial. Since one would expect the outside directors to be risk-averse, many would presumably settle. If the lead plaintiff's threat is not credible, however, then the outside directors will call the lead plaintiff's bluff and decline to make an out-of-pocket payment. The lead plaintiff will then accept the settlement funded by the company and the insurer or, less likely, proceed to trial. If a trial occurs and the plaintiff wins, the company and the insurer will pay the damages.

Can such a threat be credible? We think not. In a securities case, the company is primarily liable for all damages, and the case is easier to prove

183. We exclude extreme scenarios in which the outside directors have committed deliberate fraud or taken illegal profits from the company. If an outside director's conduct is proved to be this extreme, neither D&O insurance nor indemnification will be available. The lead plaintiff's decision to pursue out-of-pocket payments from the outside directors will come down to litigation costs and the amount of wealth that can be extracted from the outside directors. On the one hand, the outside directors are unprotected. On the other hand, the litigation may be a losing proposition for a lead plaintiff and her attorney. One out-of-pocket case discussed in Part I may have involved this scenario—the *Lone Star Steakhouse* derivative suit, in which directors agreed to rescind the repricing of stock options, and one director who had exercised his options agreed to repay his gains. As stated at the outset of this Article, these scenarios are not the scenarios that motivate the concern over outside director liability. We therefore pursue them no further here.

184. *See supra* text accompanying notes 173-77. In characterizing a company as solvent, we assume it is sufficiently solvent to make the settlement payment.

185. It is of course possible that the outside directors will fail to meet the "good faith" prerequisite to indemnification. Even in that situation, the company will be primarily liable for the full damage award.

against the company than against outside directors.[186] So, as a threshold matter, a lead plaintiff will be hard pressed to justify the risk and expense of trying a case against outside directors when the company is solvent. The lead plaintiff may initially name the outside directors as defendants to pressure the company to settle sooner or for a larger payment. Trying the case against the outside directors, however, cannot increase the class's recovery if the case is pursued to judgment, and it will increase the cost to the plaintiff class and its lawyers, who will therefore resist.

In a securities class action, the court must select the "most adequate" plaintiff as lead plaintiff. The potential plaintiff with the "largest financial interest in the relief sought by the class" is presumed to be most adequate, but that presumption may be rebutted if it is shown that such party "will not fairly and adequately protect the interest of the class."[187] Once selected, a lead plaintiff owes a fiduciary duty to the class.[188] Thus, if a lead plaintiff intent on sending a message compromises the total potential recovery in a case involving outside directors by rejecting an otherwise reasonable settlement put forward by a company and its insurer, the lead plaintiff would risk removal and liability to the class.

The most obvious way for this scenario to develop would be for the lead plaintiff to proceed to trial and lose. Even a decision to proceed to trial could prompt other shareholders to petition the court to order the lead plaintiff to accept a company's settlement offer or explain why rejecting the offer was in the interest of the class. Furthermore, a lead plaintiff's lawyer has an independent duty to the class and may have an obligation to petition the court to replace a lead plaintiff that does not act to maximize the recovery.[189] Therefore, it is highly unlikely that a lead plaintiff and class counsel will pursue out-of-pocket payments from outside directors when the corporation is solvent.

Assume, nonetheless, that the lead plaintiff in fact proceeds to trial and the court holds that the outside directors are responsible for a portion of the damages awarded. The company and the insurer then proffer payment in full. Would the lead plaintiff pursue further legal action, and incur legal fees, seeking to force the outside directors to contribute? The lead plaintiff would lack a plausible argument that doing so is in the interest of the class. To make matters worse, it is unclear that a demand for contribution would succeed. The damage rules applicable under section 10(b) and section 11 are unclear on how liability is to be allocated among defendants when the company is solvent.[190] It is also unclear whether the lead plaintiff even has standing to complain so long

186. *See supra* text accompanying notes 90-95.

187. Securities Exchange Act of 1934 § 21D, 15 U.S.C. § 78u-4(f) (2006).

188. *See In re* Cendant Corp. Sec. Litig., 404 F.3d 173, 203 (3d Cir. 2005).

189. *See* Pettway v. Am. Cast Iron Pipe Co., 576 F.2d 1157, 1176 (5th Cir. 1978); Mandujano v. Basic Vegetable Prods., Inc., 541 F.2d 832, 835 (9th Cir. 1976).

190. Since the company is fully liable, the percentage-of-responsibility concept is unworkable for a solvent company. *See supra* notes 81-84 and accompanying text.

as full payment has been offered by *someone*.

Beyond all this, there remains the issue of indemnification. In a section 10(b) case, the directors would be indemnified if their conduct did not involve a lack of good faith. Consequently, in order to credibly threaten to go to trial, the lead plaintiff must have strong proof that the outside directors failed to meet this standard.[191] In a section 11 case, the company would have agreed with the SEC to submit indemnification claims to a court for a determination of whether indemnification in that case is "against public policy as expressed in the [Securities] Act."[192] Thus, it is possible that the directors would be denied indemnification for a section 11 claim even if they acted in good faith. As stated above, however, it is uncertain how a court would rule on this issue.[193]

Consequently, when a company is solvent, a lead plaintiff intent on extracting personal payments from its outside directors would have to reject an attractive settlement offer funded by the company and the insurer and, instead, litigate—or credibly threaten to litigate—complex factual issues and uncertain legal issues. Litigating these issues would be time-consuming and expensive for the class and the class counsel. Moreover, the effort would be transparent and could subject the lead plaintiff and lead counsel to removal, adverse publicity, and perhaps even liability. The likelihood that a lead plaintiff will undertake such a litigation effort against the outside directors of a solvent company is remote. The fact that lead plaintiffs have not undertaken such an effort to date is consistent with this conclusion. In sum, the send-a-message scenario, in all likelihood, requires an insolvent company, which was the case in *WorldCom* and *Enron*.

2. *Insolvent company*

Our analysis of the feasibility of the send-a-message scenario involving an insolvent company again begins by considering the circumstances under which, and at what cost, a lead plaintiff could reject a settlement funded by the insurer and credibly threaten to go to trial to extract a personal payment from outside directors. Since the company is insolvent, the most the directors can offer—without digging into their own pockets—is an amount equal to the net policy limit.

To extract out-of-pocket payments from outside directors in a settlement, a lead plaintiff must be able to credibly threaten to go to trial against the outside directors and to win a judgment that will result in the outside directors having

191. As stated in Part II.A.1, *supra*, the extent of overlap between the scienter standard for liability under section 10(b) and the lack of good faith standard for denying indemnification is unclear.

192. Regulation S-K, 17 C.F.R. § 229.512(h)(3) (2006).

193. Of course, there is also D&O coverage. Even if the company were prevented from paying all damages directly or through indemnification, the D&O insurance policy would be available to the outside directors up to its limits.

to make out-of-pocket payments. To go to trial without sacrificing the class's economic interest, the net present value of the expected recovery must be greater than the net policy limit at the time a settlement is considered, which means the elements of a perfect storm must be present. In particular, there must be at least one deep-pocketed defendant who will be allocated a high percentage of responsibility—not necessarily an outside director in a section 11 case.

To convince the outside directors that they will incur out-of-pocket liability as a result of going to trial, the lead plaintiff must have strong proof of outside director liability, which means that in all likelihood the case must contain a section 11 claim. In addition, the lead plaintiff must be able to show that the amount of damages that will be allocated to an outside director will likely be in excess of his D&O coverage. As explained above, unless the outside directors have a separate D&O policy or priority in payment over the inside managers, the fact that a trial is economically more attractive than settling for the net policy limits implies that, if the outside directors lose at trial, damages allocated to them will likely exceed the coverage available to them under the company's primary policy.[194] But if the outside directors have insurance coverage that is separate from the inside managers' coverage, they may go to trial and still pay out of pocket. Whether they pay would depend on the amount of coverage.

In other words, the only way the lead plaintiff can extract personal funds from the outside directors without sacrificing the recovery of the class is for the elements of a perfect storm to be present and for the outside directors to lack sufficient insurance coverage that is separate from the inside managers' coverage. What if the outside directors do not have separate coverage and the lead plaintiff is willing to sacrifice the recovery of the class to send a message, but only up to a point? What factors determine the extent of the sacrifice required? If the expected recovery is less than the net policy limits offered in a settlement, the lead plaintiff probably has some leeway. Estimates of the expected recovery are uncertain and subject to judgment. Within some range, outside directors may view a lead plaintiff's threat to go to trial as credible. Moreover, with financial ruin as a possible consequence, risk aversion will push them in the direction of making an out-of-pocket payment even if they disagree with the lead plaintiff's estimates. This scenario might be termed a near-perfect storm. But there is a limit—if it is highly likely that the net present value of going to trial is substantially less than the net policy limit, not only might the outside directors call the lead plaintiff's bluff, but members of the

194. *See supra* text accompanying notes 160-61. The total policy, by hypothesis, was less than expected damages prior to incurring the cost of going to trial. Consequently, the policy is unlikely to cover the collective damages awarded after trial against all outside directors and inside managers. On the other hand, if the outside directors have separate coverage from the inside managers or priority in coverage, they may not bear out-of-pocket liability. This would depend on the damages allocated to them and the amount of coverage available to them.

class and class counsel might also rebel at the lead plaintiff's refusal to accept an attractive settlement.

D. *The* WorldCom *and* Enron *Settlements: What Factors Allowed the Lead Plaintiffs To Extract Personal Payments?*

In early 2005, WorldCom and Enron announced unprecedented settlement agreements under which outside directors would pay $25 million and $13 million, respectively, out of their own pockets. In both, the extraction of personal payments was a central demand of the lead plaintiff. In *WorldCom*, the explicit goal of the lead plaintiff was to send a message to future boards. A similar goal was likely present in *Enron*, even though the lead plaintiff did not state this explicitly. Why did these plaintiffs succeed?

1. *The* WorldCom *settlement*

Between 1999 and 2002, WorldCom CEO Bernard Ebbers, CFO Scott Sullivan, and other WorldCom executives orchestrated a multibillion-dollar accounting fraud that ended in the telecommunication company's bankruptcy, the largest in U.S. history at the time. In addition to WorldCom executives, the participants in the fraud—witting and unwitting—included the WorldCom outside directors, WorldCom auditor Arthur Andersen, WorldCom's primary investment banker Salomon Smith Barney, Salomon Smith Barney's parent Citigroup, and sixteen other investment banks. A securities class action followed, naming these parties as defendants.[195]

By spring of 2005, all defendants had settled for amounts totaling over $6 billion, the largest recovery ever in a securities class action. Aside from the sheer magnitude of the fraud and the recovery, a striking aspect of the settlement was the fact that the company's twelve outside directors agreed to pay a total of $24.75 million out of their own pockets, in addition to the $35 million that WorldCom's D&O insurers paid.[196] The payment was reported to

195. Corrected First Amended Class Action Complaint of Lead Plaintiff Alan G. Hevesi, Comptroller of the State of New York, as Administrative Head of the New York State and Local Retirement Systems and as Trustee of the New York State Common Retirement Fund, on Behalf of Purchasers and Acquirers of All WorldCom, Inc. Publicly Traded Securities at 15, *In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455 (S.D.N.Y. 2005) [hereinafter *WorldCom* Complaint].

196. Gretchen Morgenson, *Ex-Directors at WorldCom Settle Anew*, N.Y. TIMES, Mar. 19, 2005, at C1; Ben White, *WorldCom Ex-Leaders Reach Deal in Lawsuit: Directors Personally Will Pay $20 Million to Shareholder Class*, WASH. POST, Mar. 19, 2005, at E1; Shawn Young, *Ex-WorldCom Directors Reach Pact*, WALL ST. J., Mar. 21, 2005, at A6. In January 2005, the announced settlement included ten outside directors paying a total of $18 million. The March settlement included an eleventh outside director and a total of $20.2 million. One director, Chairman of the Board Bert Roberts, Jr., settled separately for approximately $5.5 million. *See Former WorldCom Chairman To Pay $5.5 Million Settlement*, N.Y. TIMES, Mar. 22, 2005, at C4 [hereinafter *Chairman To Pay $5.5 Million*].

equal twenty percent of the directors' combined net worth, excluding primary residences, retirement accounts, and certain marital property.[197] Initially, the lead plaintiff announced a separate settlement with most of the outside directors in January 2005. That settlement required a ruling by the judge in the case that the section 11 damage-reduction rule would require a reduction in the other defendants' damages equal to only the amount the outside directors paid. The judge, however, declined to make such a ruling and, instead, interpreted the statutory damage rule literally to require a reduction in the other defendants' damages equal to the outside directors' full percentage of responsibility.[198] In response, the settlement with the outside directors was withdrawn. Within a few months, the remaining deep-pocketed third-party defendants settled, thereby eliminating the concern over the section 11 damage-reduction rule, and the settlement with the outside directors was reinstated.

In terms of the analysis above, what factors explain the outside directors' out-of-pocket payments? Was there a perfect storm?[199] First, WorldCom was insolvent, and its net policy limits were far less than the expected value of its damage award against the company's officers and directors. The section 11 claim against the directors amounted to $11 billion.[200] Consequently, even a very small amount of proportionate liability for the inside managers (other than those who directly committed the fraud and hence might not be covered by the policy) and the outside directors would have swamped the company's D&O insurance. WorldCom's D&O policy limit was $100 million, $15 million of which had already been spent on litigation expenses at the time of the settlement.[201] Furthermore, the insurers on the hook for the remaining $85 million had initiated policy rescission efforts, alleging fraud in the application. The policy, like most policies at that time, did not provide for severability as to the outside directors, and the outside directors did not have separate coverage.[202] The fact that the insurers ultimately paid only $35 million into the

197. White, *supra* note 196; Shawn Young, *WorldCom Deal Was a Difficult Balancing Act*, WALL ST. J., Jan. 13, 2005, at B6. The percentage of personal wealth Roberts paid in his independent settlement was substantially higher than the twenty percent demanded from the other eleven directors. *See Chairman To Pay $5.5 Million*, *supra* note 196.

198. *In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455 (S.D.N.Y. 2005); *see supra* text accompanying notes 85-88.

199. The directors' legal expenses were covered by insurance, so they were not in a can't-afford-to-win situation.

200. Morgenson, *supra* note 196.

201. On the coverage, and what happened to it, see Memorandum of Settling Director Defendants Submitted in Connection with Preliminary Approval of Their Settlement of the Class Claims, *In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455 (S.D.N.Y. 2005).

202. Ben White, *Directors Run Risk of Paying Penalties Out of Their Pockets*, WASH. POST, Jan. 20, 2005 at E1. The excess insurers were Continental Casualty Co., SR International Business Insurance Co., Twin City Fire Insurance Co., Starr Excess Liability Insurance International Limited, Associated Electric & Gas Insurance Services Limited, Gulf Insurance Co., and National Union Fire Insurance Company of Pittsburgh, Pennsylvania. *See In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d at 463 n.9.

settlement suggests that there was a basis for the insurers' position.[203]

Second, the case involved a very large section 11 claim. During the period of the fraud, the company had made two of the largest bond offerings ever.

Third, more than ample alignment existed between wealth and culpability among defendants. Among the outside directors there was considerable wealth. Assuming the $25 million that they paid into the settlement accurately reflected the settlement calculation, their collective wealth was in excess of $125 million. Assuming sufficient evidence of culpability, the outside directors alone were rich enough for the lead plaintiff to make a credible threat to take them to trial. In addition, the inside managers were wealthy and culpable. But more importantly, several deep-pocketed third-party defendants apparently would have had difficulty sustaining a due diligence defense.

The remaining question concerns the strength of the evidence against the outside directors. At the time of the settlement, the plaintiffs' case against the outside directors consisted primarily of a section 11 claim based on alleged misstatements and omissions in registration statements that WorldCom filed in connection with bonds it had issued in May 2000 and May 2001.[204] The plaintiffs alleged that the outside directors were liable for (1) accounting fraud, (2) failure of the registration statements to disclose loans the company had made to CEO Bernard Ebbers, and (3) failure of the registration statements to disclose the inadequacy of board oversight of WorldCom's acquisitions.[205] At least for the first two claims, the misstatements and omissions clearly occurred, and disclosure was required. Consequently, the outside directors' only defense to liability was the due diligence defense provided for in section 11.

The outside directors had a reasonably strong due diligence defense regarding the accounting fraud. Because the financial statements were based on the authority of an expert, the company's auditor Arthur Andersen, the directors would have had to show only that they "had no reasonable ground to believe and did not believe" that the financial statements contained material misstatements or omissions. Reports by Bankruptcy Court Examiner Dick Thornburgh (Thornburgh Report)[206] and a special investigative committee

203. Dave Lenckus, *WorldCom Settlement Unravels: Outside Directors To Face D&O Coverage Battle*, BUS. INS., Feb. 9, 2005, at 3.

204. The plaintiffs had section 15 and section 20(a) claims as well. Their 10(b) claim had been dismissed. *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 431 (S.D.N.Y. 2005).

205. *WorldCom* Complaint, *supra* note 195, at 204-44.

206. *See* Third and Final Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom, Inc., et al., No. 02-13533, 2002 WL 1732646 (S.D.N.Y. Jan. 26, 2004) [hereinafter Thornburgh Report]. Prior to issuing this report, Mr. Thornburgh issued two interim reports. First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, *In re* WorldCom, Inc., No. 02-13533, 2002 WL 1732646 (S.D.N.Y. Nov. 4, 2002); Second Interim Report of Dick Thornburgh, Bankruptcy Examiner, *In re* WorldCom, Inc., No. 02-13533, 2002 WL 1732646 (S.D.N.Y. June 9, 2003).

appointed by WorldCom (Special Committee Report)[207] support this position.

The Thornburgh and Special Committee Reports found that WorldCom's board and the audit committee were exceedingly passive and utterly failed to perform their oversight responsibilities. For instance, the Special Committee Report stated that WorldCom's Audit Committee "played so limited a role in the oversight of WorldCom that it is unlikely that any but the most flagrant and open financial fraud *could* have come to their attention."[208] On the other hand, the reports concluded that the outside directors did not know about the accounting fraud, that management had actively hid the fraud from them, and that Arthur Andersen had assured them that the financial statements did not raise any problems. The Special Committee Report stated:

> We have found no evidence that the Board or the Audit Committee in fact knew of the accounting improprieties. Nor have we found any glaring red flags that should have led the Board or the Audit Committee to become aware of it [sic]. The Board and the Audit Committee were given information that was both false and plausible.[209]

Addressing the involvement of the Audit Committee, the Thornburgh Report similarly observed:

> There is no evidence that [the Audit Committee] had any knowledge of the capitalization of line costs prior to its discovery in June 2002. Moreover, the Audit Committee was given categorical assurances by Arthur Andersen as to the absence of any concerns with regard to the integrity of the Company's financial statements. Thus, there did not appear to be any significant "red flags" that came to their attention prior to June 2002 that, had they been acted upon, would have led to the discovery of the accounting irregularities. Indeed, once the Internal Audit Department became aware of the improper line cost

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207. *See* DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. (2003), http://news.lp.findlaw.com/hdocs/docs/worldcom/Bdspcomm60903rpt.pdf. This committee consisted of board members who had been appointed after the fraud was uncovered. Because the company itself would not have had standing to bring a suit under securities law, the Thornburgh and the Special Committee Reports did not directly address these causes of action. Nonetheless, the facts described in the reports and the judgments of the reports' authors regarding those facts are relevant to securities actions.

208. DENNIS R. BERESFORD ET AL., *supra* note 207, at 278 (emphasis in original). The Final Thornburgh Report found that the Audit Committee bore responsibility for failing to detect the fraud to the extent that it defined its duties narrowly and deferred to management and the auditor. Thornburgh Report, *supra* note 206, at 260.

The accounting manipulations were relatively simple. Beginning in 1999 and extending into 2000, the company improperly offset its increasing line costs—amounts paid to third parties to carry WorldCom customers' voice and data—by improperly drawing down line-cost reserves. This inflated the company's reported earnings by $3.3 billion. In addition, from 1999 to 2001, the company improperly inflated reported earnings by releasing revenues and other reserves in amounts that totaled at least $633 million. By 2001, when reserves had been exhausted, the company inflated earnings by mischaracterizing its line costs as capital expenditures. This mischaracterization extended into 2002 and increased reported earnings by a total of $3.8 billion. DENNIS R. BERESFORD ET AL., *supra* note 207, at 271-79.

209. DENNIS R. BERESFORD ET AL., *supra* note 207, at 277.

> entries, its officers and staff aggressively pursued investigation of those entries and notified the Audit Committee as appropriate. The Audit Committee properly proceeded to have the improprieties investigated and disclosed.[210]

Absent any red flags, a board is permitted to rely on the auditor's work.[211] These findings therefore suggest that the WorldCom outside directors may well have been able to establish a due diligence defense for the accounting fraud.

If a jury were to find the outside directors liable for the accounting fraud under section 11, it might nonetheless have found their relative culpability to be very low for purposes of allocating damages. But potential total damages were so large that it would not have taken a very large fraction of total damages to exceed the D&O coverage and bankrupt the outside directors.[212]

The second claim against the outside directors involved loans and loan guarantees to Bernard Ebbers totaling over $250 million. Ebbers needed the loans and guarantees because he had used WorldCom stock to secure personal loans, and he faced margin calls as WorldCom's share price declined. The plaintiffs alleged that the May 2001 registration statement violated section 11 because it did not disclose that the loans and guarantees were made without adequate collateral, at below-market interest rates, and without board approval.

The evidence in support of this claim was strong. Both the Thornburgh and Special Committee Reports were highly critical of how the WorldCom board dealt with the loans and the guarantees.[213] The Special Committee Report states: "In making these loans and guarantees, WorldCom assumed risks that no financial institution was willing to assume. . . . [W]e do not understand how the Compensation Committee or the Board could have concluded that these loans were in the best interests of the Company . . . ."[214] Given such findings, the outside directors could well have had difficulty mounting a successful due diligence defense with respect to disclosure of the loans and the guarantee.[215] But it is unclear whether a significant portion of the plaintiffs' losses were attributable to the failure to disclose the loans and guarantees. The overwhelming source of losses was the accounting fraud. Moreover, Ebbers

210. *Id.* at 296-97.

211. *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994); *In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455, 462-63 (S.D.N.Y. 2005); Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 688 (S.D.N.Y. 1968).

212. In a panel discussion held at the Weinberg Center for Corporate Governance at the University of Delaware on November 10, 2005, Sean Coffey, class counsel in *WorldCom*, reported that in a mock trial he conducted with four separate juries, the juries on average allocated twenty percent of the responsibility to the directors collectively.

213. Thornburgh Report, *supra* note 206, at 220-30; DENNIS R. BERESFORD ET AL., *supra* note 207, at 292-93.

214. DENNIS R. BERESFORD ET AL., *supra* note 207, at 292-93.

215. The outside directors would also have had to prove that they had no reasonable ground to believe that their own failures to act were material. In terms of size, the materiality of the loans could be questioned, but the fact that they were part of an overall pattern of mismanagement eliminates the possibility that a court would have ruled that the loans did not need to be disclosed.

surely would have been allocated the lion's share of the damages attributable to the fraudulent loan transactions.

The third element of the plaintiffs' section 11 claim against the outside directors was the failure of WorldCom's registration statements to disclose the fact that the board's oversight of the company's acquisitions was inadequate. The Thornburgh Report supported these allegations, stating that from 1999 onwards, the board had become increasingly passive and that this passivity extended to "the Board's approval of multi-billion dollar transactions proposed by WorldCom's former management on the basis of virtually no data."[216] The outside directors would have had difficulty with a due diligence defense against this claim since they would have had to prove that they engaged in reasonable investigation into their own mishandling of WorldCom's acquisitions.[217] Thus, with respect to this issue, the plaintiffs had strong evidence of liability, and the board's relative culpability would have been high. However, there are questions both as to whether disclosure was required and whether a significant portion of the plaintiffs' losses was attributable to acquisition-related omissions.

Putting these pieces together, *WorldCom* was probably a perfect storm or at least a near-perfect storm: WorldCom was insolvent; D&O insurance coverage was a small fraction of potential damages and may have been unavailable in the end; the outside directors were wealthy; and the investment bank defendants were a source of billions of dollars in damages. Before the investment banks agreed to settle the case, the lead plaintiff could credibly threaten to bring the outside directors to trial.[218] Thus, at the time of the outside directors' initial agreement, the conditions of a perfect storm seem to have been present. Later, after the initial settlement had been withdrawn and the investment banks agreed to settle, did the situation change? Could the outside directors have successfully called the lead plaintiff's bluff and refused to settle once the deep-pocketed third parties were committed? It seems unlikely. The outside directors were wealthy enough to allow the lead plaintiff to credibly threaten to take them to trial even without the investment banks as codefendants. Did the lead plaintiff lose $24 million in litigation costs or the equivalent in terms of delay as a result of insisting on out-of-pocket payments in that amount? Again, it seems unlikely. The third-party defendants' refusal to settle drove the timing of the settlement, including the delay of the outside directors' settlement, and once the third parties settled, the prior settlement with the outside directors was apparently reinstated immediately. Thus, based on the limited information

216. BERESFORD ET AL., *supra* note 207, at 372. The Special Committee Report was particularly critical of the board's lack of involvement in the Intermedia acquisition, concluding that there were "many reasons to believe that a properly informed, non-passive WorldCom Board would have rejected the amended Intermedia transaction." *Id.* at 375.

217. The outside directors would have also needed to have shown they had reasonable grounds to believe they did not have to disclose the inadequacy of their own oversight.

218. For an illustration of what the plaintiffs would have lost by settling separately with the outside directors, see Coffee, *supra* note 4, at 13.

available, *WorldCom* seems to have been a perfect storm, and if not a perfect storm, it was at least near-perfect storm.

Did the lead plaintiff compromise the interest of the class in maximizing the recovery? Probably not. The lead plaintiff needed to keep the outside directors in the case to avoid the impact of section 11's damage-reduction rule. On the other hand, the class did not need to extract $24 million from them. The question, which we are not in a position to answer, is whether extracting these payments resulted in greater defense costs charged against the policy.

2. *The* Enron *settlement*

Enron's fraud came to light in late 2001, when Enron announced that it was restating its financial statements for the years 1997 to 2001. By the end of the year, Enron had filed for bankruptcy. Plaintiffs described what Enron had done as "'an enormous Ponzi scheme, the largest in history,' . . . involving illusory profits 'generated by phony, non-arm's-length transactions with Enron-controlled entities and improper accounting tricks.'"[219] Securities class actions followed against Enron's outside directors as well as its senior executives, Enron's auditor Arthur Andersen, various investment and commercial banks, and others. Total damages claimed amounted to approximately $25 billion.[220]

In October 2004, ten of Enron's former outside directors settled with the Regents of the University of California, the lead plaintiff. The agreement remained confidential until January 2005 because the parties wanted court approval for the allocation of the remaining insurance proceeds, which totaled $200 million at the time of settlement.[221] The agreement ultimately provided that the outside directors would pay $13 million out of their own pockets, the D&O insurers would pay $187 million, and $13 million would be set aside to cover future litigation expenses of nonsettling executives.[222] The outside directors' out-of-pocket payments were set to equal ten percent of the proceeds the directors had received from selling Enron shares while the company's share

219. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 613 (S.D. Tex. 2002) (quoting the Lead Plaintiff's Consolidated Complaint). Bernard Black was an expert witness for the plaintiffs in *Enron*, but the case against the outside directors settled prior to his involvement.

220. *See Enron Shareholders' Move Against Banks Is Rebuffed by Judge*, N.Y. TIMES, Feb. 28, 2003, at C5; Tom Fowler, *Lawsuits Against Enron Executives May Not Reach Trial Until October 2005*, HOUS. CHRON., July 10, 2003, at D3. An ERISA suit was also filed against the directors on behalf of beneficiaries of retirement plans set up by Enron under which outside directors ultimately made out-of-pocket payments. *See* Part III, *infra*.

221. Excess Insurers' Joint Response to Certain Insureds Oppositions to Application for Preliminary Injunctions and Motion To Dismiss or Stay Interpleader Based on Subject Matter Jurisdiction and Arbitration Provisions, *In re Enron*, 235 F. Supp. 2d 549; *see also In re Enron*, 235 F. Supp. 2d at 554.

222. Kurt Eichenwald, *Ex-Directors of Enron To Chip in on Settlement*, N.Y. TIMES, Jan. 8, 2005, at C1.

price was inflated by the accounting fraud.[223] The lead plaintiff viewed the settlement as extracting ill-gotten trading gains.[224] Nevertheless, there also was a send-a-message element to the case. Plaintiffs' counsel stated: "The settlement is very significant in holding these outside directors at least partially responsible. Hopefully, this will help send a message to corporate boardrooms of the importance of directors performing their legal duties."[225]

What explains the lead plaintiff's success in extracting out-of-pocket payments from the Enron outside directors? Was *Enron* a perfect storm? First, like WorldCom, Enron was insolvent, and its net policy limits were a small fraction of the plaintiffs' expected damage award. Total damages sought were $25 billion. At the time of the settlement, there was $200 million of insurance coverage remaining on a $350 million policy, and the insurers were no longer contesting coverage.[226]

Second, as in *WorldCom*, there was a large section 11 claim against the outside directors. Damages sought under that claim were $1 billion. The case also involved a much larger section 10(b) claim, but the outside directors had succeeded in having that claim dismissed against them. The section 10(b) claim remained, however, against the inside managers and third-party defendants. [227]

Third, as in *WorldCom*, an alignment of culpability and wealth existed among many defendants. Several of Enron's directors were wealthy.[228] In

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223. *Id.*

224. James Holst, general counsel for the lead plaintiff, said of the deal, "It's especially significant that these outside directors were made to disgorge some of their insider trading proceeds." Dale Kasler, *Enron Board Members Settle California University-Led Lawsuit for $168 Million*, SACRAMENTO BEE, Jan. 8, 2005, at D1 (quoting Holst).

225. *See* White, *supra* note 196.

226. Enron's litigation expenses were accruing against the policy at a rate of $6.5 million per month. Former Outside Directors' Brief in Support of Application for Preliminary Injunction Against All Persons Named as Party Defendants in the Interpleader Action, *In re Enron*, 235 F. Supp. 2d at 549.

227. The section 10(b) claim against the outside directors had been dismissed for failure to raise a strong inference of scienter. *In re Enron*, 235 F. Supp. 2d at 638.

228. If the $13 million settlement payment was equal to ten percent of the proceeds from the sale of Enron stock during the period of the fraud, then total proceeds amounted to $130 million. Robert Belfer, one of the outside directors, had owned Enron shares for many years, as his father had sold Belco Petroleum to Enron's predecessor. The Belfer family, which also had wide interests in real estate, held Enron securities that were worth $2 billion at the market peak. Mitchell Pacelle & Cassell Bryan-Low, *Family Loses Big on Enron*, GLOBE & MAIL, Dec. 5, 2001, at B13. While he held eighty percent of his shares as the company descended into bankruptcy, the twenty percent that he sold left him with over $100 million from this source alone. *In re Enron*, 235 F. Supp. 2d at 638. Director Ronnie Chan was a billionaire real estate developer from Hong Kong. Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 873 (2005). At the time of Enron's downfall, members of Enron's board included Norman P. Blake, Jr. (Chair, President, and CEO, Comdisco), John H. Duncan (Former Chair of the Executive Committee, Gulf & Western Industries), Paulo V. Ferraz Periera (Executive Vice President, Group Bozano), Frank Savage (CEO, Savage Holdings), and Herbert S. Winokur, Jr. (Chair, CEO, Capricorn Holdings). *See* Marianne M. Jennings,

addition, the inside managers were wealthy, and the net assets of most of the third-party defendants were substantial.

The remaining question concerns how strong the evidence was against the outside directors and what percentage of liability was likely to be allocated to them. The *Enron* fraud was far more complex than the *WorldCom* fraud. It involved numerous transactions designed to obfuscate the company's financial condition and enrich some of its senior executives.[229] The most egregious transactions were related-party transactions in which the counter-parties were special-purpose entities managed by senior Enron executives (including its CFO). Several reports describe the transactions in detail. We rely on the Report of the Permanent Subcommittee on Investigations of the Senate Committee on Governmental Affairs (Senate Report)[230] and the Report of the Special Committee of the Enron Board chaired by William Powers (Powers Report).[231]

As in *WorldCom*, independent investigations of Enron outline convincing evidence that fraudulent transactions occurred and that the company's registration statements contained material misstatements and omissions. Therefore, the strength of the plaintiffs' case against the outside directors depended on whether the outside directors could have proved a due diligence defense under section 11.

Some of the alleged disclosure violations in this case involved audited financial statements, meaning that the outside directors would have to prove only that they "had no reasonable ground to believe and did not believe" that the registration statements contained material misstatements or omissions.[232] The due diligence defense as applied in the context of an "expertised" part of a registration statement does not, however, allow board members to remain passive in the face of red flags.[233] This would have posed some difficulties for the outside directors. For instance, with regard to one related-party transaction, known as Raptor I, the board was told that there was a risk of accounting scrutiny.[234] The Powers Report considered this a red flag that should have led the board to ask its Audit and Compliance Committee to assess the issue further

Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance—Restoration of Active Virtue in the Corporate Structure To Curb the "YeeHaw Culture" in Organizations, 3 WYO. L. REV. 387, 402-03 (2003).

229. *See* John R. Kroger, Enron*, Fraud, and Securities Reform: An* Enron *Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 73-82 (2005).

230. PERMANENT SUBCOMM. OF INVESTIGATIONS OF THE S. COMM. ON GOVERNMENTAL AFFAIRS, THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70 (2d Sess. 2002) [hereinafter SENATE REPORT].

231. WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORPORATION (2002), *available at* http://news.findlaw.com/hdocs/enron/sicreport020102.pdf [hereinafter POWERS REPORT].

232. Securities Act § 11(b)(3), 15 U.S.C. § 77k(b)(3) (2006).

233. *In re* Software Toolworks, Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994).

234. POWERS REPORT, *supra* note 231, at 158.

and "to conduct a probing discussion with Andersen."[235] Both the Powers and the Senate Reports were highly critical of the board's oversight failure.[236]

In addition, according to the Senate Report, Arthur Andersen met with the Audit Committee periodically and informed the Committee that the company's accounting practices were "high risk," tended to "push limits," and were "at the edge" of acceptable practice.[237] A corporate governance expert testifying before the Committee stated that such characterizations were "a giant red flag."[238] Nonetheless, the Audit Committee members apparently did not seek to understand the practices that gave rise to these concerns or to question Arthur Andersen regarding the reason for these characterizations.[239] While Arthur Andersen ultimately did give Enron a clean audit opinion each year, the Senate Report concluded that the board had failed in its duty to ensure that the company engaged in responsible financial reporting.[240] Thus, with respect to "expertised" parts of the registration statements underlying the section 11 claims against the outside directors, the outside directors might not have succeeded in showing that they had reasonable grounds to believe the financial statements were accurate.

Furthermore, many of the alleged section 11 violations did not relate to matters lying within the expertise of accountants. The independent investigations of Enron raised substantial doubt regarding the board's oversight of the creation and implementation of the special-purpose entities; these entities constituted major conflicts of interest for certain Enron executives. The Powers Report described the transactions related to these entities as "fundamentally flawed."[241] It further stated that the board "put many controls in place, but the controls were not adequate, and they were not adequately implemented."[242] The board delegated some review responsibilities to the Audit and Compliance Committee, but the Powers Report states that the committees carried out the reviews "only in a cursory way."[243] With respect to some of the conflict-of-interest transactions, the Powers Report summarized Special Committee's views as follows:

> After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of

235. *Id.*

236. *Id.* at 156-58; SENATE REPORT, *supra* note 230, at 43-50.

237. SENATE REPORT, *supra* note 230, at 4, 29-30; *see also In re* Enron Corp. Sec., Derivative & ERISA Litig., 258 F. Supp. 2d 576, 640 (S.D. Tex. 2003).

238. SENATE REPORT, *supra* note 230, at 109 (quoting Charles Elson).

239. *Id.* at 29-36.

240. *Id.*

241. POWERS REPORT, *supra* note 231, at 9.

242. *Id.* at 148.

243. *Id.*

> the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented . . . . As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure . . . that they were fair to Enron.[244]

It thus seems that the outside directors would have had substantial difficulty arguing that they engaged in reasonable investigation with respect to the misstatements and omissions in the 1999 and 2000 registration statements about the related party transactions. Accordingly, it appears likely that if the case had gone to trial, the outside directors would have been found liable under section 11.

In sum, *Enron* seems to have been a perfect storm and was at least a near-perfect storm. Was the class's interest in maximizing its recovery compromised as a result of the lead plaintiff's insistence on personal payments by the outside directors? Did it cost more than $13 million to extract those payments? It seems unlikely, but there is no way to know for sure. Finalizing the settlement deal required months of skirmishing as the various parties sought to resolve how much of Enron's D&O insurance should be set aside to cover future litigation expenses of nonsettling executives.[245] The litigation expenses associated with that skirmishing were charged against Enron's D&O policy and reduced the amount ultimately available to the class. It is impossible to say, however, how much of the additional litigation expense was attributable to the lead plaintiff's demand for personal payments from the outside directors.

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In sum, *WorldCom* and *Enron* were probably perfect storms or at least near-perfect storms. In both cases, it is entirely plausible that a plaintiff that simply wanted to maximize the recovery for the class could credibly threaten to go to trial if the directors had refused to settle with out-of-pocket payments; there was a strong possibility that damages awarded at a trial would have been financially devastating to the outside directors. Under these circumstances, the lead plaintiff in both cases had considerable leverage, and the insistence on extracting personal payments likely did not reduce the amount the class would have otherwise recovered. Although the send-a-message rhetoric of the lead plaintiff in *WorldCom* and the lead counsel in *Enron* was new, the outcome of each case was driven by the presence or near-presence of the elements of a perfect storm. In the absence of those elements, there is no reason to expect that

244. *Id.* at 23.

245. *See* Eichenwald, *supra* note 222.

a lead plaintiff would have been able to extract personal payments from outside directors. In that respect, these cases do not herald a significant change in the risk of out-of-pocket liability facing outside directors, The cases certainly do not stand for the proposition that a lead plaintiff can extract personal payments from outside directors at will simply because of a desire to send a message.

III. OTHER POTENTIAL SOURCES OF OUTSIDE DIRECTOR LIABILITY

We have thus far discussed outside directors' out-of-pocket liability risks in private lawsuits for breach of fiduciary duty under corporate law and for section 10(b) and section 11 violations under the securities laws. In this Part, we address, in less detail, two other related sources of liability that outside directors face. One source of risk is an SEC enforcement action under the securities laws. The second is liability under ERISA, which imposes fiduciary duties on individuals responsible for the administration of company pension plans. Duties arising under ERISA can be enforced by a private suit or in a civil action brought by DoL.[246] In both areas, outside directors face some risk that government officials will seek out-of-pocket payments, especially in the wake of the recent high-visibility governance failures.[247] However, this risk has been small to date and seems likely to remain so.

Our analysis of additional potential sources of liability risk is not exhaustive.[248] We do not address laws governing discrimination and related workplace issues, as courts have generally construed these laws to exclude director liability.[249] We also do not discuss environmental law, even though environmental statutes are sometimes framed with sufficient breadth to create theoretical risk for outside directors.[250] To our knowledge, however, neither private plaintiffs nor regulators have sought to pursue outside directors under

246. ERISA § 404, 29 U.S.C. § 1104 (2006); *see also* ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2) (2006) (authorizing the U.S. Secretary of Labor to bring a suit for breach of fiduciary duty).

247. In jurisdictions other than the United States, outside director liability is, if anything, more uncommon, and the few instances that have arisen have been the result of a regulator treating a case as sufficiently high profile or egregious to justify pursuing the directors even though the legal expenses and related costs were much greater than the amount likely to be recovered. *See* Bernard S. Black & Brian R. Cheffins, *Outside Director Liability Across Countries*, 84 TEX L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=438231 (surveying outside director risk in Australia, Britain, Canada, France, Germany, and Japan).

248. *See* MATHIAS ET AL., *supra* note 104, §§ 4.03-.05 (2003) (discussing liability under environmental and other laws).

249. 1 KNEPPER & BAILEY, *supra* note 104, at ch. 7.

250. For instance, courts have consistently found that strict liability provisions in the Comprehensive Environmental Response, Compensation, and Liability Act apply to both the corporation and responsible directors and officers. *See* 42 U.S.C. §§ 9601-9630 (2006); *see also* 1 KNEPPER & BAILEY, *supra* note 104, § 10.04.

those statutes.[251]

We also do not address risk under industry-specific laws governing sectors such as banking, insurance, and utilities. Some risk does exist under such laws, with banking law being the clearest example.[252] A number of our survey respondents mentioned the risk faced by outside directors of banks and savings and loans (S&Ls) following the S&L crisis of the 1980s, when the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) brought suits against officers and directors of failed S&Ls.[253] Banks' and S&Ls' D&O insurance policies contained industry-specific regulatory exclusions for coverage losses stemming from an FDIC or RTC action. Those cases, therefore, have little if any relevance to director liability in general.

Most of the government's actions against directors of failed banks and S&Ls involved privately held institutions. We did not make an effort to identify cases in which outside directors of publicly held banks or S&Ls made out-of-pocket payments, but we did come upon one such case. First Republic Bank (Dallas) made out-of-pocket payments to settle an FDIC suit based on oversight failure. At that time, however, D&O insurance policies contained regulatory exclusions for coverage losses stemming from an FDIC or RTC action. An insurance carrier won a suit to avoid paying on a $15 million policy, leaving only a second $1 million policy in place, and the defendants were paying their own legal fees. Thus, the case had strong can't-afford-to-win elements.[254] In another case, the Office of the Comptroller of the Currency obtained a $40,000

251. William Knepper and Dan Bailey explain:

> [D]espite the frightening . . . liability exposures . . . that exist, the expected flood of civil D&O pollution lawsuits has not noticeably materialized to date. One explanation for this surprising civil liability phenomenon may be the absence of insurance coverage for such claims against directors and officers. D&O insurance policies have historically excluded from coverage all pollution-related claims. Therefore, without the "deep pocket" created by insurance protection, corporate officials may not be attractive targets for parties seeking significant monetary recovery.

1 KNEPPER & BAILEY, *supra* note 104, § 10.04.

252. Under federal banking law, for example, a federally chartered bank can sue its directors for gross negligence in approving loans. This cause of action is derivative, so indemnification is not available. Additionally, it is not affected by a section 102(b)(7) charter provision because the federal cause of action overrides the state limit on liability. *See* Federal Deposit Insurance Act, § 2(11), 12 U.S.C. § 1821 (2006); Atherton v. Fed. Deposit Ins. Corp., 519 U.S. 213 (1997) (providing an example of where the FDIC brought such an action in its role as receiver for a failed bank).

253. *See, e.g.*, M. Mazen Anbari, *Banking on a Bailout: Directors' and Officers' Liability Insurance Policy Exclusions in the Context of the Savings and Loan Crisis*, 141 U. PA. L. REV. 547, 551-52 (1992).

254. *See* David LaGesse & Charles B. Camp, *Ex-First Republic Execs Crying Foul; FDIC Lawsuit Forced Payment, Strained Relations*, DALLAS MORNING NEWS, Feb. 2, 1993, at 1D (describing the settlement); *see also Accord Seen in Bank Suit*, N.Y. TIMES, Jan. 25, 1993, at D2 (describing how $1 million of the $23 million settlement came from insurance); *First Republic Bank Settlement in Question*, DALLAS MORNING NEWS, Dec. 20, 1992, at 6H (describing a suit by insurer to avoid liability).

civil penalty against one outside director of Hamilton Bank (Miami).[255] These cases have limited relevance to director liability in general.

A. *SEC Enforcement Actions*

We turn first to SEC enforcement but begin by limiting the scope of our inquiry. First, we focus on civil rather than criminal liability. Federal securities statutes generally impose criminal penalties for violations, with authority to prosecute resting with the U.S. Department of Justice, which often acts in cooperation with the SEC.[256] Criminal sanctions, however, usually require that the offender has willfully or knowingly violated the rule in question. This rule likely explains why no criminal prosecution has been brought against an outside director for oversight failures.

Self-dealing is potentially a different story. Outside directors rarely have self-dealing opportunities, but if they exploit one, criminal sanctions are possible. We found one such case in our search for SEC civil enforcement proceedings. In 2002, Frank Walsh, an outside director at Tyco, agreed to plead guilty and pay a $2.5 million fine to settle criminal proceedings resulting from an improper $20 million finder's fee that Tyco paid him in connection with a Tyco acquisition.[257]

Our analysis of SEC enforcement also excludes insider trading and a related source of liability—the forfeiture of short-swing trading profits by officers, directors, and shareholders having ten percent or more of a company's outstanding shares under section 16(b) of the Exchange Act.[258] The SEC's enforcement of insider-trading rules has generated a number of out-of-pocket payments by outside directors.[259] Nonetheless, insider trading is not the sort of

255. *In re* Ronald Lacayo, Treasury Stipulation & Consent Order No. 2003-52 (May 15, 2003), *available at* http://www.occ.treas.gov/FTP/EAs/ea2003-52.pdf.

256. *See* Anish Vashista et al., *Securities Fraud*, 42 AM. CRIM. L. REV. 877, 932-34 (2005).

257. SEC v. Walsh, SEC Litig. Release No. 17,896, 2002 SEC Lexis 3193 (Dec. 17, 2002); Hiawatha Bray, *Ex-Tyco Director To Pay $22.5 Million; Settles Charges Linked to Firm's CIT Purchase*, BOSTON GLOBE, Dec. 18, 2002, at C1. We discuss the civil aspects of this case *infra* note 273 and accompanying text.

258. *See* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 23-29, 174-75 (1999) (discussing sources of insider-trading liability under federal securities law, including section 16(b) of the Exchange Act).

259. The SEC typically seeks disgorgement of trading profits, a civil penalty, and sometimes a bar from acting as an officer or director of a public company. A nonexhaustive search located ten such cases. For each, we list in a parenthetical the director's name; the compan(ies) at which he was an outside director; the trading profit disgorged; the civil penalty; and the length of any bar from serving as a public company officer or director. All cases were settled except as noted, and all directors paid prejudgment interest. The cases, in reverse chronological order, were:

> (1) SEC v. Martin, SEC Litig. Release No. 19,205, 2005 WL 973111 (Apr. 27, 2005) (John Martin, Good Guys, Inc., $76,360.52 disgorgement, $73,625 penalty, five-year officer-director bar);

misconduct that worries most outside directors, in large part because they can avoid risk readily by refraining from trading in company shares or by only trading in accordance with a predetermined schedule.[260]

Federal securities law authorizes the SEC to petition a court to impose monetary penalties on any person who violates the securities laws and to order disgorgement of illegal profits.[261] To check for instances in which outside directors paid penalties or disgorged profits, we relied on: (1) the survey and legal database searches described in Part I and Appendix A, (2) additional searches of SEC litigation releases,[262] and (3) interviews with current and

(2) SEC v. Glick, SEC Litig. Release No. 18,675, 2004 WL 868785 (Apr. 22, 2004) (Allen Glick, MetroWest Bank and Banknorth Group, Inc., $98,823.50 disgorgement, $165,875.25 penalty, permanent officer-director bar);

(3) SEC v. Willard, SEC Litig. Release No. 18,379, 2003 WL 22245925 (Sept. 30, 2003) (DeWalt Willard, Ag-Chem Equipment Co., $73,287 disgorgement, $107,478 penalty);

(4) SEC v. Licht, SEC Litig. Release No. 16,062, 1999 WL 71591 (Feb. 16, 1999) (Roger Licht, Medco Containment Servs., Inc. and Synetic, Inc., $43,445.30 disgorgement, $87,607.50 penalty);

(5) SEC v. Farrell, No. 95-6133T, 1996 WL 788367, at *11 (W.D.N.Y. 1996) (summary judgment against Thomas J. Farrell, Rochester Community Savings Bank, $32,187.50 disgorgement, $32,187.50 penalty, permanent officer-director bar, pled guilty to related criminal case, eighteen-month sentence); *see also* Jonathan D. Epstein, *Former N.Y. Thrift Director Admits Insider-Trading Guilt*, AM. BANKER, Mar. 12, 1996, at 6;

(6) SEC v. Frame, SEC Litig. Release No. 14,614, 1995 WL 502435 (Aug. 24, 1995) (Robert Frame, Rochester Community Savings Bank, $10,278.82 disgorgement, $61,079.83 penalty); *see also* Jonathan D. Epstein, *More Insider Trading Charges at Rochester*, AM. BANKER, Sept. 1, 1995, at 6;

(7) SEC v. Conant, SEC Litig. Release No. 14,525, 1995 WL 358175 (June 7, 1995) (Herbert Conant, BancFlorida Fin. Corp., $13,500 disgorgement, $13,500 penalty);

(8) SEC v. Cotton, SEC Litig. Release No. 14,429, 1995 SEC Lexis 1088 (May 4, 1995) (Ralph Cotton, Electromedics, $20,496 disgorgement, $61,830 penalty);

(9) SEC v. Rothbart, SEC Litig. Release No. 13,188, 1992 WL 52903 (Mar. 11, 1992) (Stanley Rothbart, Jan Bell Marketing. Inc., $180,105 disgorgement, $91,500 penalty); *see also* Helen Huntley, *Jan Bell Director Unloaded Stock Before Price Fell*, ST. PETERSBURG TIMES, Mar. 29, 1990, at 1E; and

(10) Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 353 (Del. 1993) (Fred Sullivan, Technicolor, Inc., $14,000 disgorgement).

260. On the safe harbor available, see *supra* note 73 (citing Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2006)).

261. *See* 15 U.S.C. § 78u-2(a) (2006) (describing the authority of the SEC to seek civil penalties); *see also* Vashista et al., *supra* note 256, at 927.

262. A search of the LexisNexis Combined SEC No-Action Letters and Releases Database under the search terms “civil penalty” and either “outside director” or “independent director” yielded twenty hits, including the *Chancellor Corp.* case discussed *infra* note 272. The SEC sought a civil penalty only against Chancellor’s CFO and its accountants, not against its outside director. Another hit involved an outside director, but the underlying offense was insider trading. A search under “director” and “restitution” but not “broker” yielded 142 hits. The only outside director case involved Frank Walsh of Tyco, which is discussed *supra* note 257 and in accompanying text.

A search of the LexisNexis SEC Decisions Database under “outside director” and “civil action” produced forty-nine hits, three of which involved an outside director paying a civil penalty. In each case, the underlying offense was insider trading. A search using the terms “penalty” and either “outside director” or “independent director” yielded 129 hits, but the only case of note that did not appear in other searches was *SEC v. Excal Enterprises*, which is discussed *infra* note 264. A search under “director” and “civil penalty” was not feasible former SEC officials and with lawyers who represent defendants in SEC proceedings.[263] We did not uncover a single instance where SEC enforcement has yielded a civil penalty against an outside director for oversight lapses.[264]

At the same time, SEC officials have publicly stated that a number of ongoing SEC investigations include outside directors.[265] According to press reports, the SEC has notified three individuals who served on the audit committee of publisher Hollinger International of its intention to pursue civil proceedings.[266] Civil penalties are a possible sanction in these cases, but whether the SEC will seek them is as yet unknown. If an outside director pays a civil penalty, the director cannot count on being reimbursed by the usual sources because the SEC currently insists, as a condition for settling an action seeking such a penalty, that the penalty be paid personally, even if indemnification or D&O insurance would otherwise be available.[267] On the other hand, the SEC, when it has settled actions seeking civil penalties from insiders, has not objected to reimbursement for legal expenses.[268]

While some SEC actions seeking penalties against outside directors for oversight failure are certainly possible, it seems unlikely that the SEC will begin to seek such penalties very often. The SEC likely recognizes—and if need be, market participants will be vigorous in reminding it—that it may deter

because it yielded 1477 hits. A partial search within this set of hits produced some additional insider-trading cases involving outside directors and some cases where a director's inside or outside status was unclear.

263. Within the SEC, we spoke with former SEC Commissioner and General Counsel, Harvey Goldschmid, and former SEC Enforcement Director, Stephen Cutler. Telephone Interview with Stephen Cutler (Dec. 13, 2005); Telephone Interview with Harvey Goldschmid (Oct. 10, 2005).

264. In *SEC v. Excal Enterprises*, SEC Litig. Release 14,651, 1995 SEC Lexis 2492 (Sept. 26, 1995), Charles Ross was listed as a "former outside director" and paid a civil penalty of $50,000 to settle SEC proceedings alleging active participation in the preparation of false reports and lying to auditors. Ross, however, was not a true outside director because he was a senior executive for one of the company's divisions. *See* James Grieff, *Assix Plans a Restructuring into Three Divisions*, ST. PETERSBURG TIMES, Aug. 28, 1990, at 1E.

265. *See* Remarks by Alan Beller, Head of SEC's Division of Corporation Finance, Am. Bar Ass'n Webcast (Dec. 14, 2005), http://www.connectlive.com/events/secadvisory 1205/. Several interviewees also told us about these investigations.

266. *See* Richard Siklos, *SEC Puts 3 Hollinger Directors on Notice*, N.Y. TIMES, Dec. 15, 2005, at C1.

267. For discussion of the SEC's policy and examples of nonreimburseable penalties, see *Testimony Concerning Global Research Analyst Settlement: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (May 7, 2003) (statement of William H. Donaldson, SEC Chairman) (describing SEC settlement with two analysts, Henry Blodget and Jack Grubman, in which half of Blodget's $4 million settlement and half of Grubman's $15 million settlement were treated as noninsurable and non-tax-deductible penalties); Floyd Norris, *6 from Xerox To Pay S.E.C. $22 Million*, N.Y. TIMES, June 6, 2003, at C1 (reporting that for a $22 million settlement by six Xerox officers, the company reimbursed the six for $19 million and paid their legal costs; the remaining $3 million were nonindemnifiable fines).

268. *See* Norris, *supra* note 267; Goldschmid Interview, *supra* note 263.

qualified individuals from serving if it acts too aggressively against directors in cases involving oversight failure, as opposed to self-dealing. A further important protection for outside directors is that the dollar limits on civil penalties remain fairly low. The maximum likely exposure is $100,000 per offense.[269] This is low enough that, for many directors, the risk of loss will be primarily reputational rather than financial.

The SEC, in addition to seeking monetary penalties and disgorgement of profits, can bar a director who has committed securities fraud from serving as an officer or director of a public company. The statutory standard for such an order is that "the person's conduct demonstrates unfitness to serve as an officer or director of [a public company]."[270] For the SEC to show unfitness, it must demonstrate a likelihood that the misconduct will be repeated.[271] In the absence

269. The maximum civil penalty depends on the nature of the crime and the potential for harm resulting from the actions. The highest category of fines is for a violation involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," which results in a "significant risk of substantial losses . . . to other persons." The maximum fine for this category is the greater of $100,000 per offense or the director's pecuniary gain as a result of the violation. An outside director usually will not have a pecuniary gain. Securities Act § 20(d)(2)(C), 15 U.S.C. § 77t(d)(2)(C) (2006); Exchange Act § 21(d)(3)(B)(iii), 15 U.S.C. § 78u(d)(3)(B)(iii) (2006).

270. Until 2002, the SEC needed a court order to impose such a bar. Securities Act § 20(e), 15 U.S.C. § 77t(e) (2006); Exchange Act § 21(d)(2), 15 U.S.C. § 78u(d)(2) (2006). The Sarbanes-Oxley Act, enacted in 2002, allows the SEC to impose this sanction in an administrative cease-and-desist proceeding, subject to appeal to a court of appeals. *See* Securities Act § 8A(f), 15 U.S.C. § 77h-1(f) (2006); Exchange Act § 21C(f), 15 U.S.C. § 78u-3(f) (2006) (added by Sarbanes-Oxley Act § 1105). The judicial review provisions are in Securities Act § 9(a), 15 U.S.C. § 77i(a) (2006), and Exchange Act § 25(a), 15 U.S.C. § 78y(a) (2006). The SEC has not yet used this administrative power.

In lieu of seeking formal sanctions, the SEC has occasionally issued reports concluding that outside directors did not meet their obligations under the securities laws. These reports are exercises in public shaming and do not involve financial sanctions. For the most recent examples of such reports, see Report of Investigation Pursuant to Section 21(A) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co., Exchange Act Release No. 34-39157, 1997 WL 597984 (Sept. 30, 1997) (criticizing the conduct of outside directors Eben Pyne and Charles Erhart); In the Matter of W.R. Grace & Co., Order Instituting Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934 Making Findings and Ordering Respondent To Cease and Desist, Exchange Act Release No. 34-39156, 1997 WL 600685 (Sept. 30, 1997) (finding that the company failed to adequately disclose retirement benefits received by former CEO J. Peter Grace, Jr., as well as a proposed transaction between the company and J. Peter Grace III); Report of Investigation in the Matter of the Cooper Companies, Inc. as It Relates to the Conduct of Cooper's Board of Directors, Exchange Act Release No. 34-35082, 1994 WL 707149 (Dec. 12, 1994) (criticizing Cooper's Board of Directors for not responding vigorously to the evidence that officers had engaged in several fraudulent schemes).

271. *See* SEC v. Patel, 61 F.3d 137, 141-42 (2d Cir. 1995) (reversing district court's approval of the lifetime director-officer ban against an officer-director-founder because the district court did not explain why repeat violations were likely without the ban); *see also* Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit To Serve"?*, 70 N.C. L. REV. 1489 (1992).

of self-dealing or an extraordinary lapse in oversight, this threshold is difficult to meet. The high threshold likely explains why we have found only one case in which the SEC has sought to bar an outside director from serving as an officer or director based on an oversight failure. This instance involved Rudolph Peselman, an outside director of Chancellor Corp., a company afflicted by fraudulent accounting. In 2005, Peselman settled SEC proceedings by agreeing to a permanent bar from serving as a director or officer of a public company.[272]

In sum, while careless or incompetent outside directors face theoretical financial risk due to SEC enforcement, they have had little to fear up to this point in time. Moreover, while future SEC actions seeking penalties against inattentive outside directors are certainly possible, it seems likely that directors' future risk will continue to be principally loss of reputation rather than direct financial loss.

Self-dealing is a different matter. If an outside director receives an improper personal gain, the SEC can seek disgorgement of the ill-gotten gains and potentially a civil penalty as well. The one instance we found in which an outside director made an out-of-pocket payment as a result of SEC enforcement (insider-trading cases excepted) illustrates this point. The case in question was discussed earlier as an instance of criminal liability—i.e., Frank Walsh's receipt of an undisclosed $20 million finders' fee from Tyco. It was clearly within the Tyco board's power to approve the fee, which Walsh received for introducing Tyco to CIT Financial, a corporation that Tyco acquired in 2001 for $9 billion. However, neither Walsh nor Tyco CEO Dennis Kozlowski disclosed the fee to the board. After the facts came to light, the SEC obtained disgorgement of the $20 million from Walsh. Since he had given half of the fee to charity, he ended up $10 million poorer, as well as paying a $2.5 million fine to close the parallel criminal investigation.[273]

B. *ERISA*

A fairly new source of liability risk for outside directors is ERISA. ERISA class action suits resemble securities class actions, but they are brought on behalf of employees whose retirement plans hold company shares.[274] These plans can be either employee stock ownership plans (ESOPs), whose principal

272. *See* SEC v. Chancellor Corp., SEC Litig. Release No. 19,177, 2005 SEC Lexis 800 (Apr. 11, 2005) (announcing settlement); SEC v. Adley, SEC Litig. Release No. 18,104 (Apr. 24, 2003) (announcing initiation of proceedings), http://www.sec.gov/litigation/litreleases/lr18104.htm. For citations to officer-director bar cases against *insiders*, see 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION §§ 5087-5092 (3d ed. 1989).

273. *See* SEC v. Walsh, SEC Litig. Release No. 17,896, 2002 SEC Lexis 3193 (Dec. 17, 2002); Bray, *supra* note 257, at C1.

274. On the overlap between ERISA class actions and securities law class actions, see Susan J. Stabile, *I Believed My Employer and Didn't Sell My Company Stock: Is There an ERISA (or '34 Act) Remedy for Me?*, 36 CONN. L. REV. 385, 386-88 (2004).

purpose is to invest in company shares, or self-directed defined contribution 401(k) plans, for which an investment in company shares is one option.[275] If the shares were purchased while the company's market price was inflated by improper disclosures, the employees can attempt to show that the outside directors were ERISA fiduciaries, that they failed to adequately supervise the plan, and that they should therefore be held liable for employee losses when the shares later decline in value.[276]

The special PSLRA pleading and discovery rules that protect directors in securities fraud cases do not apply in an ERISA class action.[277] Nonetheless, outside directors have a realistic opportunity to succeed in a motion to dismiss an ERISA class action. The plaintiffs must show that the outside directors were ERISA fiduciaries under standards that remain murky for lack of decided cases.[278] The plaintiffs must also make a prima facie showing of negligence by the outside directors in carrying out their ERISA duties. This differs from the section 11 pleading rule, where due diligence is an affirmative defense, and a lead plaintiff's failure to plead facts supporting a lack of diligence cannot be used as a basis for an outside director's motion to dismiss. In addition, getting a class certified in ERISA proceedings can be problematic.[279]

If an ERISA class action is not dismissed at a preliminary stage, however, outside directors face joint and several liability rather than the proportionate liability they face under section 10(b) and section 11 claims.[280] In addition, outside directors who are found to be ERISA fiduciaries face a high standard of care. They are required to act "with the care, skill, prudence, and diligence . . .

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275. *See In re* Schering-Plough Corp. ERISA Litig., 420 F.3d 231, 235-36 (3d Cir. 2005) (confirming that beneficiaries under self-directed defined contribution plans can sue ERISA fiduciaries). These suits are brought derivatively by the beneficiaries on behalf of the plan. Theoretically, liability can exist for any company pension plan, but litigation to date has been limited to employee losses from investing in the company's own shares.

276. *See, e.g.*, *In re* Enron Corp. Sec., Derivative & ERISA Litig., 284 F. Supp. 2d 511, 683-84 (S.D. Tex. 2003) (rejecting defendant directors' motion to dismiss claims brought by Enron employees); John D. Hughes, *Lethal Combination; ERISA Claims Pair Up with Securities Class Actions*, D&O ADVISOR, Apr. 1, 2005, at 33; Jeffrey Mamorsky, *Empty Nest Eggs; Directors Get the Blame for Bankrupt Pension Plans*, D&O ADVISOR, Sept. 4, 2004, at 31.

277. *See* Stabile, *supra* note 274, at 421.

278. *See In re Enron*, 284 F. Supp. 2d at 543-46; Jones, *supra* note 36, at 1 ("Among the unanswered questions in ERISA cases is exactly who, if anyone, is responsible when these plans go south. The issue is "'one of the first fights' in the cases . . . . [P]laintiffs . . . generally want to 'put the fiduciary hat on as broad a group as possible,' including directors. But defendants argue that primary fiduciary responsibility rests solely with those who directly oversee the plan.").

279. *See* Frank Cummings, *ERISA Litigation: An Overview of Major Claims and Defenses*, 2003 A.L.I-A.B.A. 1099, 1279-82 (2004) (summarizing class action requirements in ERISA litigation).

280. ERISA § 405(a), 29 U.S.C. § 1105(a) (2006) (specifying that an ERISA fiduciary is liable for breaches of other fiduciaries if she has knowledge of the breaches of others or her own breach of duty has enabled other fiduciaries to breach their duties).

that a prudent man acting in a like capacity and familiar with such matters would use" and face liability for negligence in failing to so act.[281] Since care and skill are assessed in terms relative to those of someone "acting in a like capacity and familiar with such matters," rather than the care and skill of an average person, this standard is often called a "prudent expert" standard.[282] The outside directors do benefit, however, from a rebuttable presumption that they acted reasonably in investing plan assets in shares of the employer company or in allowing employees to do so.[283]

While ERISA dates from the 1970s, ERISA class actions based on a decline in the value of company shares remain fairly novel, with only a handful prior to 2000 and, as yet, no completed trials. Thus, we can only predict tentatively the risks outside directors will face going forward. It appears that the risk is likely to be similar to that of securities class actions.

ERISA lawsuits are direct suits by the plan against the company and its directors. Thus, as in securities suits, directors are entitled to indemnification by their companies so long as they have acted in good faith. In addition, while D&O policies usually exclude ERISA claims, most companies typically carry separate insurance against ERISA liability that covers the company and its directors and officers.[284] Hence, as in securities law claims, outside directors should face meaningful risk in an ERISA class action only if the company is insolvent and cannot indemnify them.

Moreover, the settlement dynamics that induce settlements within policy limits in securities class actions where the company is insolvent, or nearly so, should operate similarly in ERISA litigation. ERISA insurance policies are usually similar to D&O policies in structure, with a single limit covering both legal expenses and damages of the company, its officers, and its directors.[285] This means plaintiffs who pursue the directors' personal assets will deplete the available deep pocket of the ERISA policy by causing the defendants to incur higher legal expenses. As a result, even if expected damages exceed the policy limits, the plaintiffs will often do better to settle fairly quickly within those limits. The settlement incentives of employee-plaintiffs in ERISA litigation thus roughly mirror those of shareholder-plaintiffs in a securities class action. Much of our perfect-storm analysis of securities suits should therefore carry

281. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (2006).

282. *See* Paul J. Wessel, *Job Creation for Union Members Through Pension Investment*, 35 BUFF. L. REV. 323, 339-41 (1986) (discussing the "prudent expert" standard).

283. On the rebuttable presumption that company shares are a suitable investment, see *In re* Schering-Plough Corp. ERISA Litig., 420 F.3d 231, 239 (3d Cir. 2005); Wright v. Or. Metallurgical Corp., 360 F.3d 1090, 1097-99 (9th Cir. 2004); Kuper v. Iovenko, 66 F.3d 1447, 1458-59 (6th Cir. 1995).

284. *See* ERISA § 410(b), 29 U.S.C. § 1110(b) (2006) (permitting a plan to purchase insurance for a fiduciary). The terms of these policies are similar to D&O policies. *See* John Conley, *Bear Fright; Market Volatility Strikes Fear in Fiduciaries*, RISK MGMT., Sept. 1, 2000, at 28 (indicating that big companies always have ERISA insurance coverage).

285. *See* Conley, *supra* note 284, at 28.

over to ERISA suits.

The risk of personal payment could well be higher for a DoL suit. The risk here is that DoL officials could demand out-of-pocket payments from outside directors when companies fail due to managerial fraud, in order to deter weak oversight of pension-plan portfolios. The one ERISA case involving out-of-pocket payments by outside directors we know of fits this pattern. A private lawsuit by Enron employees, and a parallel suit brought by the DoL, alleged that the company's outside directors were ERISA fiduciaries and had breached their duty by failing to appoint trustees for two employee pension plans that held Enron shares and suffered $1.5 billion in losses when the company collapsed.[286] The private lawsuit settled for $85 million, the limit of Enron's ERISA insurance policy. The DoL, however, separately obtained out-of-pocket payments from the outside directors totaling $1.5 million.[287] A declared rationale for the lawsuit was to "strengthen the American workforce's confidence in their retirement savings."[288] The personal payments that the DoL demanded likely were intended as a warning to directors that their personal assets could be at risk if they fail to fulfill obligations they take on as pension-plan fiduciaries.

Whether the DoL will treat Enron as unique, or whether it will seek recovery against outside directors' personal assets in other cases, is unclear at this point. Nevertheless, the DoL is likely to be cautious. DoL officials will be sensitive to the risk that if the DoL regularly pursues personal payments from directors at companies with ESOPs or similar plans, companies may abandon these plans. No Secretary of Labor will want to be known as the Secretary who killed ESOPs.

In sum, regulatory actions are a genuine risk for outside directors of public companies. But the risk has been small to date, and political constraints on regulators make it likely that their frequency will remain low.

CONCLUSION

As an empirical matter, out-of-pocket liability for outside directors over the last several decades has been rare. Our extensive investigation has unearthed

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

287. *See Enron Employees Agree to $86.5 Million Settlement*, BESTWIRE, May 14, 2004; Ellen E. Schultz, *Enron Employees To Settle Retirement Suit for $85 Million*, WALL ST. J., May 13, 2004, at A2; *Texas Plaintiffs Ask Court To Put Their Brand on $85M Enron ERISA Policy*, ANDREWS CORP. OFF. & DIRECTORS LIAB. LITIG. REP., Apr. 8, 2002, at 4 (reporting that Enron's ERISA policy provided $85 million for damages plus $10 million for legal expenses).

288. *See, e.g.*, Press Release, U.S. Dep't of Labor, U.S. Labor Department Sues Enron, Executives, and Plan Officials for Failing To Protect Workers (June 26, 2003), http://www.dol.gov/opa/media/press/ebsa/EBSA2003350.htm.

about a dozen instances since 1980, including the *WorldCom* and *Enron* settlements. Many fit within what we call a can't-afford-to-win scenario that would not arise today so long as a company has a state-of-the-art D&O policy and standard indemnification agreements for outside directors. The remainder fit what we have termed a perfect storm or near-perfect storm. The infrequency of out-of-pocket liability reflects a complex interaction among substantive legal rules, procedural rules, indemnification, D&O insurance policy terms, and settlement dynamics. The result has been, and in all likelihood will remain, a narrow window of liability exposure limited to perfect and near-perfect storms.

The new send-a-message objective of some lead plaintiffs, illustrated by the *WorldCom* and *Enron* settlements, may raise outside directors' risk of out-of-pocket liability somewhat, but their risk remains very low. It may be true, as some fear, that those settlements will inspire other lead plaintiffs to attempt to extract personal payments from outside directors. But such efforts, if undertaken, will rarely, if ever, succeed absent a perfect or near-perfect storm. Moreover, absent a perfect storm, they can succeed only if the lead plaintiff is willing to sacrifice the interest of the class in maximizing its recovery—a risk lead plaintiffs and class counsel should hesitate to assume. It is also likely that lead plaintiffs will understand the limits they face in pursuing outside directors' assets, as well as the risk of scaring good directors away from serving if they pursue personal payments. If so, the landmark *WorldCom* and *Enron* settlements will stand as rare, and perhaps beneficial, signals that if outside directors utterly disregard their oversight obligations—in just the wrong circumstances—then out-of-pocket liability can result.

The complex liability regime in which outside directors operate was not enacted as a single piece of legislation implementing a grand design. It is the product of episodic legislation at the state and federal levels, coupled with private contractual responses in the D&O insurance market. The result is a peculiar legal environment in which public companies are engulfed by litigation but outside directors are rarely touched financially. The peculiarity of this legal regime becomes clear if one focuses on the preconditions for out-of-pocket liability risk to be present. To oversimplify just a bit:

(1) The principal source of out-of-pocket liability risk is section 11 of the Securities Act because the standard of conduct is negligence, and the outside directors have the burden of proving an absence of negligence. Thus, a precondition of outside directors' liability is, in all likelihood, that their company has made a public offering that is large relative to its D&O policy limits. If the outside directors fail to detect a misstatement in the offering documents, or in periodic filings incorporated by reference in the offering documents, they risk liability if they are deemed to have been negligent. Outside the context of a public offering, however, a negligent failure of oversight would not result in liability. For example, the outside directors in *Disney* may have been as bad as

or worse than those in *WorldCom* and *Enron*. Yet, while the Delaware Chancery Court judge deciding the *Disney* fiduciary duty case believed that the outside directors "underperformed"[289] and that their conduct "fell significantly short of the best practices,"[290] the judge found no liability because the directors had met the much lower standard of care imposed by corporate law.

(2) There must be evidence that the board did a poor job, even if it is quite unlikely that greater vigilance would have led the directors to detect the core problems.

(3) The company's problems must be deep enough to cause bankruptcy, thus removing the company as a source of indemnification or payment of a judgment or settlement. *WorldCom* and *Enron* qualified on this count; but high-visibility governance failures at other companies did not, so their outside directors faced minimal risk.

(4) One or preferably several outside directors or other defendants—e.g., inside managers, investment banks, or other third parties—must be wealthy enough to be worth chasing.

(5) The company's D&O insurance policy must have gaps, or its coverage limit must be low relative to investor losses in the public offering. In other words, the directors must have failed to spend enough of the shareholders' money to buy a state-of-the-art insurance policy with high enough limits to support a settlement.

(6) Finally, the likelihood of out-of-pocket liability increases if the accounting scandal is sufficiently visible and the directors' oversight failure appears sufficiently bad that a lead plaintiff decides to make an example of the outside directors.

Deterrence by occasional lightning strike, we might call this.

Yet, the limited out-of-pocket risk that we observe may well be sensible from a policy perspective. The limited deterrence provided by out-of-pocket liability is supplemented by market incentives, reputation, and other soft incentives, including the substantial nuisance of being sued. A significantly higher level of risk for outside directors could well deter good candidates from serving and make directors who do serve excessively cautious and process-conscious, which could reduce rather than enhance company value.

The stable and perhaps sensible nature of this low out-of-pocket risk regime is supported by a comparative analysis.[291] Outside directors in other developed countries have similarly low levels of out-of-pocket liability—very

289. *In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113, at *227 (Aug. 9, 2005).

290. *Id.* at *4.

291. Black & Cheffins, *supra* note 247.

low, but not zero. The United States is unique, however, in the high level of litigation surrounding outside directors. One is thus led to wonder whether low-liability risk, coupled with substantial lawsuit volume, makes sense as a policy matter. This intriguing question must be left for another day. Analysis of the desirable levels of nominal and out-of-pocket liability should be based, however, on the factual foundation established by this Article. Despite a large number of lawsuits being filed, outside directors of U.S. public companies have rarely paid out of their own pockets and are unlikely to start doing so, particularly if they have state-of-the-art D&O policies.

APPENDIX A. SURVEY DESIGN

As part of our effort to find instances where outside directors of public companies made out-of-pocket payments and to track down corporate and securities law cases that went to trial, we conducted a survey of practitioners involved in various facets of litigation where outside directors are defendants. That survey ultimately included: (1) lawyers at firms that represent plaintiffs, defendants, and insurers in corporate and securities lawsuits; (2) executives at major D&O insurance companies; (3) D&O brokers; (4) public-pension-plan administrators; and (5) litigation consultants. In selecting survey participants, we began with lists of firms heavily involved in relevant areas of litigation and then expanded our survey based on leads given to us by the survey participants. For instance, if a lawyer at a large defense firm told us about a case that another firm had litigated or about a smaller firm that she knew to be heavily involved in securities litigation, we would contact that firm. If one lawyer suggested that we also contact another lawyer at the same or another firm, either in general or with regard to a particular case, we endeavored to do so.

For defense lawyers, we began with the NALP Directory of Legal Employers to identify the largest law firms with substantial securities or corporate litigation practices in Atlanta (two firms), Delaware (four firms), Chicago (five firms), Los Angeles (three firms), New York (ten firms), San Francisco/Silicon Valley (six firms), and Texas (three firms). For plaintiffs' firms, we began with the ten firms involved in the largest number of cases settled between 1997 and 2004, as listed in a Cornerstone Research report on securities class action settlements.[292] For lawyers that represent insurers as monitoring counsel, we asked insurers for the names of firms that represent them. We supplemented these lists with lawyers who had been involved in cases in which out-of-pocket payments were made or cases that went to trial. We further supplemented this list with lawyers who have written treatises or other publications on D&O liability or insurance.

For D&O insurance brokers, we contacted the top seven brokers listed in Tillinghast's 2004 survey of D&O insurance and ranked according to their market share of retail accounts.[293] The firms we interviewed serve approximately forty-eight percent of the market and include those firms that are generally recognized as serving the bulk of publicly held corporations. For D&O insurers, we contacted the largest seven companies as listed in the Tillinghast survey based on either primary policy count or premium volume for primary policies. The D&O insurers that we interviewed had an aggregate market share of seventy-three percent based on primary policy count and eighty

292. LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, POST-REFORM ACT SECURITIES SETTLEMENTS 14 (2004), http://www.cornerstone.com/fram_res.html

293. TILLINGHAST-TOWERS PERRIN, *supra* note 78, at 73.

percent based on premium volume.

For each law firm we surveyed, we contacted by telephone or e-mail the head of the litigation or securities litigation department, a senior lawyer listed on the firm website as a D&O specialist, or another senior partner. In some cases, that person referred us to one or more other partners. In other cases, that lawyer contacted his partners and passed on to us the information they gave him. For each D&O broker and insurer, we made calls or sent e-mails to executives having broad knowledge of the claims.

We asked each interviewee whether she had been involved in or knew of a securities or corporate case since 1980 that went to trial or in which an outside director had made an out-of-pocket payment, either for damages or legal expenses. In addition, we asked each interviewee to contact other members of her firm or company to see whether they had relevant information to pass on to us. As far as we know, our interviewees' firms did not have systematic databases containing the information we were seeking—cases going to trial and cases in which outside directors made personal payments.

We asked each interviewee whether she could suggest other people at other organizations that might have knowledge of either cases going trial or cases of outside director out-of-pocket payments. In following these leads, we spoke to many individuals at other law firms, D&O insurers, and organizations that were not on our initial survey list—including institutional investors, litigation consultants, and others with specialized expertise in corporate and securities litigation and D&O insurance.

Some firms on our initial survey list or firms to which we were referred either declined to participate or failed to return our calls or e-mails. In addition, some of our survey participants asked that their involvement not be disclosed. Other than those firms, we list below the law firms, D&O insurers, and D&O brokers that participated in our survey. Our understanding with the individuals with whom we spoke was that we would list the name of their firm or company in this Appendix but not identify sources of information about particular cases.

LAW FIRMS THAT PRIMARILY REPRESENT DEFENDANTS OR INSURERS
(listed by location of home office)

Atlanta

Alston & Bird
King & Spalding
Parker, Hudson, Rainer & Dobbs

Chicago

Boundas, Skarzynski, Walsh & Black
Hanson Peters Nye
Jenner & Block
Kirkland & Ellis
Mayer, Brown, Rowe & Maw
Neal Gerber Eisenberg
Reardon Golinkin & Reed
Sachnoff & Weaver
Sidley Austin
Walker Wilcox Matousek
Winston & Strawn

Delaware

Morris, Nichols, Arsht & Tunnell
Potter Anderson & Corroon
Richards, Layton & Finger
Skadden, Arps, Slate, Meagher & Flom (Delaware office)
Young Conaway Stargatt & Taylor

Los Angeles

Gibson, Dunn & Crutcher
Latham & Watkins
O'Melveny & Myers
Quinn Emanuel Urquhart Oliver & Hedges

New York

Anderson Kill & Olick
Cleary Gottlieb Steen & Hamilton
Cravath, Swaine & Moore
Davis Polk & Wardwell
Debevoise & Plimpton
Edwards Angell Palmer & Dodge
Fried, Frank, Harris, Shriver & Jacobson
Kramer Levin Naftalis & Frankel
Milbank, Tweed, Hadley & McCloy
Paul, Weiss, Rifkind, Wharton & Garrison
Proskauer Rose
Shearman & Sterling
Simpson Thacher & Bartlett
Skadden, Arps, Slate, Meagher & Flom
Sullivan & Cromwell
Wachtell, Lipton, Rosen & Katz
Weil, Gotshal & Manges
Willkie Farr & Gallagher
Wilson Elser Moskowitz Edelman & Dicker

San Francisco/Silicon Valley

Bergeson
Bingham McCutchen
Keker & Van Nest
Morrison & Foerster
Orrick, Herrington & Sutcliffe
Pillsbury Winthrop Shaw Pittman
Shartsis Friese
Wilson Sonsini Goodrich & Rosati
Tucker Ellis & West

Texas

Baker Botts
Fulbright & Jaworski
Vinson & Elkins

Washington, D.C.

Covington & Burling
Howrey
Ross, Dixon & Bell
Wiley Rein & Fielding
Williams & Connolly
Wilmer Cutler Pickering

Other Locations

Bailey Cavalieri (Columbus)
Bryan Cave (St. Louis)
Duane Morris (Philadelphia)
Jones Day (Cleveland)
Keating Muething & Klekamp (Cincinnati)
Mintz Levin Cohn Ferris Glovsky and Popeo (Boston)
Perkins Coie (Seattle)

FIRMS PRIMARILY ON PLAINTIFFS' SIDE

Barrack, Rodos & Bacine
The Baskin Law Group
Berger & Montague
Lieff, Cabraser, Heimann & Bernstein
Lerach Coughlin Stoia Geller Rudman & Robbins

Berman DeValerio Pease Tabacco Burt & Pucillo
Bernstein Liebhard & Lifshitz
Bernstein, Litowitz, Berger & Grossmann
Chimicles & Tikellis
Cohen, Milstein, Hausfeld & Toll
Labaton Sucharow & Rudoff
Grant & Eisenhofer
Hoeffner & Bilek
Keller Rohrback
Kirby McInerney & Squire
Milberg Weiss Bershad & Schulman
Stull, Stull & Brody
Susman Godfrey
Pomerantz, Levy, Haudek, Block & Grossman
Scott + Scott
Shalov Stone & Bonner
Sirianni Youtz Meier & Spoonemore
Stoll Stoll Berne Lokting & Shlachter
Wolf Haldenstein Adler Freeman & Herz

D&O INSURERS

ACE Insurance
Admiral Insurance Company
AIG
Chubb Group of Insurance Companies
Genesis Insurance Company
Old Republic International Corporation
The Hartford
XL Group

D&O BROKERS

ABD Insurance & Financial Services
Aon Corporation
Carpenter Moore Insurance Services
Marsh
Willis Group
Woodruff-Sawyer & Co.
William Gallagher Associates

APPENDIX B. DETAILS OF SECURITIES AND CORPORATE LAW TRIALS

Table 1 in Part I provides summary information on the securities and corporate law trials analyzed in this Article. This Appendix provides additional details on the securities and corporate law trials listed in Table 1, plus limited details for additional securities trials that fell outside the bounds of Table 1. To our knowledge, to date there have been no trials of ERISA cases based on a decline in the value of company shares.[294] We excluded trials seeking only or principally injunctive relief, often against tender offers or mergers, as well as cases claiming violation of Exchange Act Rule 14d-10, which requires a tender offer bidder to pay the same price for all shares.[295]

A. *Securities Law Trials*

Table B1 lists the twenty-five post-1980 federal and state securities law trials we found. Trial years are approximate for some early trials. Because of a combination of lack of personal involvement in these trials and potential fading memories among our interviewees, our confidence in the completeness of this list is lower for the earlier part of this time period than for the last decade. Some federal securities cases also include state claims; a couple include RICO claims.[296]

Only seven of these verdicts involved outside directors as defendants. In one other case, *Safety-Kleen*, outside directors were named, but they settled during trial. In all but one of the completed trials involving outside directors, the defendants won and the company was solvent, so it could have indemnified the directors if the verdict had come out the other way. In the remaining case (*MiniScribe*), the outside director was William Hambrecht of the Hambrecht & Quist investment bank, who was indemnified by his firm.

294. *See* CORNERSTONE RESEARCH, *supra* note 35; *see also* Telephone Interview with Adel Turki, Vice President, Cornerstone Research (Nov. 2, 2005) (providing details on the report, as its principal author).

295. *See generally* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS (2d ed. 1995 & Supp. 2003-2004) (discussing some of the takeover and Exchange Act Rule 14d-10 cases).

296. For partial lists of securities trials, see Pamela A. MacLean, *Securities Class Action Trials on the Rise*, NAT'L L.J., Aug. 8, 2005, at P1; Michael C. Tu, *Ten Years After the Reform Act: Trends in Securities Class Action Trials*, 19 SEC. REFORM ACT LITIG. REP. 475 (2005). *See also* Bruce T. Carton, *See You in Court: Examing* [sic] *the Recent Spike in Securities Class Action Trials*, SCAS ALERT, July 2005, *available at* http://slw.issproxy.com/securities _litigation_blo/2005/07/see_you_in_cour.html.

Table B1. Securities Law Trials Against Public Companies and Directors, 1980-2005

Company	Federal or State	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at the Time of Trial	Plaintiff Win
Marshall Field[297]	Federal & State	10(b), 14(e)	1980	Yes	Yes	No
Marathon Oil Co.[298]	Federal	10(b)	1981	Yes	Yes	No
Northwest Industries[299]	Federal	10(b)	1983	No	Yes	Yes
Chemtronics[300]	Federal	11	1984	Unknown	Yes	No
KDI Corp.[301]	Federal	9(a)	1988	No	Yes	Yes
Katy Industries[302]	Federal	10(b)	1989	No	Yes	No
Kulicke & Soffa Industries[303]	Federal	10(b)	1990	No	Yes	Yes
Sierra Health Services[304]	Federal	10(b) 11	1990	No	No	Yes

297. *See* Panter v. Marshall Field & Co., 486 F. Supp. 1168 (N.D. Ill. 1980) (directed verdict for defendants), *aff'd*, 646 F.2d 271 (7th Cir. 1981).

298. *See* Radol v. Thomas, 772 F.2d 244 (6th Cir. 1985); Telephone Interview with Defense Counsel (2005). The case involved a claim of misdisclosure by Marathon in connection with U.S. Steel's 1981 acquisition of Marathon. Plaintiffs moved to dismiss the outside directors prior to trial, but the outside directors opposed the motion in order to clear their names. The directors were both indemnified and insured.

299. *See* Mayer v. Northwest Indus., Inc., No. 82-C-658, 1984 U.S. Dist. LEXIS 22738 (N.D. Ill. Oct. 16, 1984); Telephone Interview with Defense Counsel (2005).

300. *See* Steinberg v. Chem-Tronics, Inc., 786 F.2d 1429 (9th Cir. 1986); *CHEM-TRONICS; Federal Jury Decides that Chem-Tronics and Five Individual Defendants Did Not Violate Federal Securities Law*, BUS. WIRE, June 26, 1984; *Chem-Tronics Is Cleared in Shareholder's Suit*, WALL ST. J., June 27, 1984; Interview with Plaintiff's Counsel (2005). Plaintiff's counsel's best recollection was that only officers were sued; the *Wall Street Journal* story reports that "directors" were sued.

301. *See* Matthey v. KDI Corp., 699 F. Supp. 135 (S.D. Ohio 1988); *Unclaimed Money To Fund UC Law Professorship*, CINCINNATI POST, May 11, 1991, at 5A (discussing ultimate outcome of the case); *US Breach Costs Ariadne $17 mil.*, HERALD (Australia), Dec. 21, 1988; Interview with Plaintiff's Counsel (2005).

302. *See* Leventhal v. Katy Indus., Inc., No. 85-459-JJF, 1989 U.S. Dist. LEXIS 17509 (D. Del. Sept. 1, 1989) (denying motion for new trial); Telephone Interview with Plaintiffs' Counsel (2005).

303. *Securities Class Action Alert*, Apr. 1990, at 46 (on file with authors).

304. *Security Class Action Alert*, July 1990, at 57; *Security Class Action Alert*, May 1991, at 21 (on file with authors).

Company	Federal or State	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at the Time of Trial	Plaintiff Win
Apple Computer[305]	Federal	10(b)	1991	No	Yes	Yes
MiniScribe[306]	State	Disclosure	1992	Yes	No	Yes
First Service Bank for Savings[307]	Federal	10(b)	1992	No	No	Yes
American Continental Corp.[308]	Federal	10(b) 11	1992	No	No	Yes
Lockheed[309]	Federal	10(b)	1992	Yes	Yes	Against Company, Not Directors
ATV Systems[310]	Federal	10(b) 11	1993	No	No	Yes
Legent[311]	Federal	10(b)	1994	No	Yes	No
Information Resources[312]	Federal	10(b)	1994	Yes	Yes	No

305. *See In re* Apple Computer Sec. Litig., No. C-84-20148(A)-JW, 1991 WL 238298 (N.D. Cal. Sept. 6, 1991). This case produced a $100 million jury verdict against two Apple Computer officers, which was settled after trial for $11.5 million. The officers were indemnified and insured. *See* Mark Cursi, *Apple Verdict Could Change Securities Cases; Experts Anticipate Larger Demands in Settlements*, RECORDER, June 6, 1991, at 1; Tu, *supra* note 296, at 479 n.6.

306. *See* Moran, *supra* note 26; Pender, *supra* note 26, at B1. A related federal securities suit was settled. *See* Adriel Bettelheim, *Fraud Suits Settled MiniScribe Tab: $128.1 Million*, DENVER POST, June 3, 1992.

307. *Securities Class Action Alert*, Oct. 1992, at 75; *Securities Class Action Alert*, June 1993, at 30-32 (on file with authors).

308. *In re* Am. Cont. Corp./Lincoln Savings & Loan Sec. Litig., 140 F.R.D. 425 (D. Ariz. 1992); *In re* Am. Cont. Corp./Lincoln Savings & Loan Sec. Litig., 1994 U.S. App. LEXIS 13184 (Feb. 8, 1994).

309. *See* NL Indus. v. Lockheed Corp., No. CV 90-1950-RMT(Sx), 1992 U.S. Dist. LEXIS 22650 (C.D. Cal. May 29, 1992); *Lockheed Settlement of $27 Million Ends NL Industries Dispute*, WALL ST. J., Feb. 25, 1994, at B4; Jim Mitchell, *Jury Awards $30 Million to Simmons*, DALLAS MORNING NEWS, Dec. 8, 1992, at 1D; Telephone Interview with Defense Counsel (2005).

310. *Securities Class Action Alert*, Aug. 1993, at 25 (on file with authors).

311. *See* Bentley v. Legent Corp., 849 F. Supp. 429 (E.D. Va. 1994), *aff'd per curiam sub nom.*, Herman v. Legent Corp., 50 F.3d 6 (4th Cir. 1995); Telephone Interview with Plaintiff's Counsel (2005). The suit was against Legent and three of its officers.

312. Grassi v. Info. Res., Inc., 63 F. 3d 596 (7th Cir. 1995); Telephone Interview with Plaintiff's Counsel (Mar. 2, 2006).

Company	Federal or State	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at the Time of Trial	Plaintiff Win
System Software Associates[313]	Federal	10(b)	1994	No	Yes	No
Geriatric & Medical Companies[314]	Federal	10(b)	1995	No	Yes	Yes
Landmark Graphics[315]	Federal	10(b)	1995	No	Yes	No
ICN Viratek[316]	Federal	10(b)	1996	No	Yes	Hung Jury, Then Settled
American Pacific[317]	Federal	10(b) 11	1996	No	Yes	No
Digitran[318]	Federal	10(b)	1996	No	Yes	Yes
NAI Technologies[319]	Federal	10(b)	1996	No	Yes	No
U.S. Banknote[320]	Federal	10(b)	1998	No	Yes	Yes

313. *See* Schwartz v. Sys. Software Assocs., Inc., 32 F.3d 284 (7th Cir. 1994) (affirming defense verdict); Telephone Interview with Plaintiffs' Counsel (2005); Telephone Interview with Defense Counsel (2005).

314. Geriatric & Med. Co., Inc. Pearl v. Geriatric & Med. Ctrs., 1996 U.S. Dist LEXIS 1559 (E.D. Pa. 1996).

315. *See* Malek v. Landmark Graphics, No. 4:92-CV-00800 (S.D. Tex. 1995) (settled without court opinion); *Class Action Securities Suit*, BUS. WIRE, July 14, 1995; Interview with Plaintiffs' Counsel (2005).

316. *See In re* ICN/Viratek Sec. Litig., No. 87-CIV.-4296, 1996 WL 164732 (S.D.N.Y. Apr. 9, 1996); Tu, *supra* note 296, at 475; Interview with Plaintiffs' Counsel (2005). The suit against company and officers resulted in a hung jury, followed by settlement.

317. Telephone Interview with American Pacific Counsel (Mar. 3, 2006); *see also* Abromson v. Am. Pac. Corp., 114 F.3d 898 (9th Cir. 1997).

318. *Jury Cleras Grant Thornton LLP in Audits of Utah Manufacturing Company*, PR NEWSWIRE, Oct. 29, 1996.

319. *Securities Class Action Alert*, Oct. 1996, at 65 (on file with authors).

320. *Securities Class Action Alert*, Feb. 1997, at 53; *Securities Class Action Alert*, Oct. 1997, at 9-11 (on file with authors).

Company	Federal or State	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at the Time of Trial	Plaintiff Win
Tricord Systems[321]	Federal	10(b)	1997	No	Yes	No
Biogen[322]	Federal	10(b)	1998	Yes	Yes	No
Howard Savings Bank[323]	State	Disclosure	1998	No	No	Yes
Helionetics[324]	Federal	10(b)	2000	No	No	Yes
National Semi-Conductor[325]	State	Secondary Trading	2000	Yes	Yes	No
Garment Capitol[326]	Federal	14(a)	2000	No	Yes	No
Applied Magnetics[327]	State	Disclosure	2001	No	No	No

321. *See In re* Tricord Sys., Inc. Sec. Litig., No. 3-94-746, 1996 U.S. Dist. LEXIS 20943 (D. Minn. Apr. 5, 1996); *Tricord Absolved in Securities Fraud Case*, MINNEAPOLIS/ST. PAUL BUS. J., June 16, 1997, http://www.bizjournals.com/twincities/stories/1997/06/16/daily4.html (last visited Feb. 8, 2006).

322. *See* Lazar v. James, No. 94-CV-12177-PBS (D. Mass. 1998); *In re* Biogen Sec. Litig., 179 F.R.D. 25 (D. Mass. 1997); Lisa Seachrist, *Biogen Urges Law Changes After Fraud Case Victory*, BIOWORLD TODAY, May 8, 1998; Tu, *supra* note 296, at 480 (describing the *Biogen* case).

323. *See* Gutman v. Howard Sav. Bank, 748 F. Supp. 254 (D.N.J. 1990); *Sophisticated Investors Weren't Comparatively Negligent by Buying Ailing Bank's Stock*, BANK BAILOUT LITIG. NEWS, Aug. 31, 1998. This was an individual action, rather than a class action, brought under New York and New Jersey common law of fraud, based on misdisclosure following a stock-for-stock acquisition, which induced the target's shareholders to hold the acquirer's shares. The judgment against the bank's president, former president, and CFO was covered by D&O insurance. *See also* Interview with Plaintiffs' Counsel (2005).

324. Email from Plaintiff's Counsel (Mar. 2, 2006).

325. Forge v. Nat'l Semiconductor Corp., No. CV770082 (Cal. Super. Ct. 2000); Sukhjit Purewal, *Class Loses in Santa Clara Securities Fraud Suit*, RECORDER, July 13, 2000, at 2.

326. *See* Koppel v. 4987 Corp., No. 96-Civ.-7570-HB, 2001 WL 47000 (S.D.N.Y. Jan. 19, 2001), *aff'd sub nom.* Greenberg v. Malkin, 2002 WL 287782 (2d Cir.); Interview with Plaintiffs' Counsel (2005).

327. *See* Kennilworth Partners II LP v. Crisman, No. C-00-3218-VRW, 2001 U.S. Dist. LEXIS 106 (N.D. Cal. Jan. 5, 2001) (rejecting motion to remove case to federal court).

Company	Federal or State	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at the Time of Trial	Plaintiff Win
Everex Systems[328]	Federal	10(b)	2002	No	Yes	No
Number Nine Visual Technology[329]	Federal, Individual Action	10(b)	2003	No	Yes	No
Daimler-Chrysler[330]	Federal, Individual Action	10(b), 14(a)	2004	No	Yes	No
Clarent[331]	Federal	10(b)	2005	No	No	Yes
Safety-Kleen[332]	Federal	10(b)	2005	Yes, But Settled at Trial	No	Yes
Thane International[333]	Federal	10(b)	2005	No	Yes	No

328. Howard v. Hui, No. C-92-3742-CRB, 2001 WL 1159780 (N.D. Cal. Sept. 24, 2001); *see also* Brenda Sandburg, *Ex-CEO Not Liable in Federal Trial: Case Involving Defunct Everex Is One of Few of Its Kind To Be Tried*, NAT'L L.J., Feb. 18, 2002, at A17. The defendant's legal expenses were covered by the D&O policy. *See* Telephone Interview with Defense Counsel (2005). There was an earlier trial in the same case in 1998, also with a defense verdict. *See* Howard v. Hui, No. C-92-3742, 1998 WL 795186 (N.D. Cal. Nov. 3, 1998), *rev'd and remanded*, 228 F.3d 1057 (9th Cir. 2000); Tu, *supra* note 296, at 476.

329. *See* KA Invs. LDC v. Number Nine Visual Technology Corp, No. CIV.A.00-10966-DPW, 2002 WL 31194865 (D. Mass. Aug. 26, 2002). No outside directors were named as defendants.

330. *See* Tracinda Corp. v. DaimlerChrysler AG, 364 F. Supp. 2d 362 (D. Del. 2005); Telephone Interview with Defense Counsel (2005). Daimler-Chrysler settled a shareholder class action arising out of statements by Chairman Jurgen Schrempp when Daimler-Benz acquired Chrysler, but the company went to trial and won an individual action brought by investor Kirk Kerkorian. The defendants at the time of trial were the company and two officers; one outside director was initially named but won a motion to dismiss.

331. The plaintiffs won only a limited victory. They lost against the accountants, PriceWaterhouseCoopers, won on one count against Clarent's former CEO, and promptly settled with him for $900,000. *See* Jeff Chorney, *Ernst & Young Prevails in Rare Class Fraud Trial*, RECORDER, Feb. 22, 2005, at 1; Amy Kolz, *In re Clarent Corporation Securities Litigation*, CORPORATE COUNSEL, May 2005, at 41.

332. *See* Corrective Order and Written Opinion Granting Judgment as a Matter of Law Against Winger and Humphreys, *In re* Safety-Kleen S'holders Litig., No. 3:00-1145-17 (D.S.C. 2005); Dave Lenckus, *D&O Insurers To Pay Safety-Kleen Fraud Suit Settlement Costs; Judge Imposes Award on Execs*, BUS. INS., May 2, 2005, at 4; Interview and E-mails with Plaintiff's Counsel (Nov. 2005).

333. *See* Miller v. Thane Int'l, Inc., 372 F. Supp. 2d 1198 (C.D. Cal. 2005); John Ryan, *Defense Wins Rare Securities Class Action: Thane Triumphs in Marketing Dispute on Listing of Stock*, L.A. DAILY J., June 6, 2005; Tu, *supra* note 296, at 477.

Table B2 lists the nine additional post-1980 federal securities cases involving companies and their officers and directors that settled during trial (after the plaintiffs had begun to present their case, but before the jury delivered a verdict). Table B2 also lists the *Safety-Kleen* case that appears in Table B1 because the claims against the outside directors settled during the trial while the case against the officers was tried to verdict. For a couple of the partial trials, we were not able to determine whether outside directors were still involved in the case at time of trial.

Table B2. Partial Securities Law Trials Against Public Companies and Directors, 1980-2005

Company	Federal or State Law	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at Trial
Sambo's[334]	Federal	10(b)	1985	Yes	No
Disney[335]	Federal	10(b)	1989	Yes	Yes
Kay Jewelers[336]	Federal	10(b)	1991	No	Yes
Ramtek[337]	Federal	10(b), 11	1992	No	No
Zenith Laboratories[338]	Federal	10(b)	1993	Yes	No

334. The case against the outside directors was dismissed on directed verdict at the end of plaintiff's case. *See* Kreindler v. Sambo's Rest., Inc., No. 79-Civ.-4538 (WK), 1985 WL 389 (S.D.N.Y. Jan. 16, 1985); Kreindler v. Sambo's Rest., Inc., No. 79-Civ.-4538 (WK), 1981 WL 1684 (S.D.N.Y. Sept. 23, 1981); Edward Labaton, *A View from the Trenches*, 38 ARIZ. L. REV. 513 (1996); Interview with Plaintiff's Counsel (2005).

335. *See* Heckman v. Ahmanson, 214 Cal. Rptr. 177 (Ct. App. 1985) (discussing an earlier decision in a related derivative case, which was later consolidated with the securities case); Cara Applebaum, *Big Suits: West*, AM. LAW., Sept. 1989 (describing the settlement); Al Delugach, *Disney-Steinberg 'Greenmail' Trial Nears Opening Day*, L.A. TIMES, June 19, 1989, § 4, at 1; Interview with Defense Counsel (2005).

336. *In re* Kay Jewelers Sec. Litig., No. 90-1663A (E.D. Va. 1991). The case settled for $3 million, which was within D&O policy limits. *See* Elisa Williams, *Suit Charges Kay Falsified SEC Data*, WASH. TIMES, Mar. 23, 1990, at C3; Interview with Plaintiff's Counsel (2005).

337. *See In re* Ramtek Sec. Litig., No. C-88-20195-RPA, 1991 WL 56067 (N.D. Cal. Feb. 4, 1991); Interview with Plaintiffs' Counsel (Nov. 17, 2005); Interview with Underwriter's Counsel (Nov. 28, 2005). We discuss this case in Part II, *supra*, as involving an out-of-pocket payment by two outside directors who settled prior to trial. The remaining defendants—three insiders, the accountants (Arthur Young), and the underwriter (Seidler Amdec)—settled during trial.

338. The suit was against two officers and a nonexecutive chairman who represented the majority shareholder. It settled during trial within policy limits. *See In re* Zenith Lab. Sec. Litig., No. 86-3241A, 1993 WL 260683 (D.N.J. Feb. 11, 1993); John C. Coffee, Jr., *Claims Made Settlement: An Ethical Critique*, N.Y.L.J., July 15, 1993; Interview with Plaintiff's Counsel (2005).

Company	Federal or State Law	Nature of Claim	Year of Trial	Outside Directors Named	Company Solvent at Trial
Equitec Financial Group[339]	Federal	10(b), 14(a)	1995	No	No
People's Bank Bridgeport CT[340]	Federal	10(b)	1999	No	Yes
Wells Fargo[341]	Federal, Individual Action	10(b)	1999	No	Yes
AT&T[342]	Federal	10(b)	2004	No	Yes
Safety-Kleen[343]	Federal	10(b)?	2005	Yes	No
Globalstar Telecomm.[344]	Federal	10(b)	2005	No	No

In three of the partial trials (*Sambo's*, *Zenith Laboratories*, and *Safety Kleen*), the company was insolvent and outside directors were named as defendants, thus posing the risk of personal payment if the trial had gone to

339. *See In re* Equitec Sec. Litig., No. 90-2064CAL (N.D. Cal. Oct. 19, 1990); Mark V. Boennighausen, *Tentative $35M Deal in Equitec Case*, RECORDER, Apr. 14, 1994; Interview with Plaintiffs' Counsel (2005). The case against two Equitec officers was dismissed during trial. The case against Smith Barney, Dean Witter, and Equitec's controlling shareholder, Hallwood Group, settled later in the trial.

340. Silverberg v. People's Bank, 2000 WL 502621 (D.Conn. Mar. 17, 2000); *Securities Class Action Alert*, Jan. 2000, at 60 (on file with authors); Telephone Interview with Plaintiff's Attorney (Mar. 3, 2006).

341. Norwest Bancorp agreed to buy First State Bank of Austin, then shortly thereafter announced it would acquire Wells Fargo, causing a price drop. First State was privately held, and it sued Wells Fargo and its CEO (Norwest's former CEO). *See* Long v. Wells Fargo & Co., No. 1:98-CV-00751 (W.D. Tex. 1999); Interview with Plaintiffs' Counsel (2005).

342. *See In re* AT&T Corp. Sec. Litig., No. 00-CV5364(GEB), 2002 WL 31190863 (D.N.J. Jan. 30, 2002); Tu, *supra* note 296, at 477. All defendants except AT&T Chairman C. Michael Armstrong won motions to dismiss.

343. *See* Corrective Order and Written Opinion Granting Judgment as a Matter of Law Against Winger and Humphreys, *In re* Safety-Kleen Bondholders Litig., No. 3:00-1145-17 (D.S.C. 2005); Lenckus, *supra* note 332; Interview with Plaintiff's Counsel (2005).

344. This suit was brought only against the former CEO of Globalstar and was settled for $20 million, which was within policy limits. We discuss it in Part II, *supra*, as the one example we know of where the insurer's refusal to settle led to a trial and, in this instance, to an individual defendant settling with personal funds and then pursuing a claim against the insurer. Globalstar was principally a section 10(b) case, plus what plaintiffs' counsel described as a "weak" section 11 claim on which a directed verdict for the defendants was entered at the end of the plaintiffs' case. *See In re* Globalstar Sec. Litig., No. 01-Civ.-1748(SHS), 2003 WL 22953163 (S.D.N.Y. Dec. 15, 2003); *see also* Schwartz v. Twin City Fire Ins. Co., No. 05-CV-7943 (S.D.N.Y. 2005) (entailing a suit by the CEO to recover settlement and legal fees from D&O insurers); Interview with Defense Counsel (2005); Interview with Plaintiffs' Counsel (2005); Stanford Securities Class Action Clearinghouse, http://securities.stanford.edu/1017/GSTRF01/ (last visited Feb. 14, 2006).

verdict and the damage award had exceeded policy limits. In *Sambo's*, the directors' out-of-pocket risk in fact appears to have been slight. The claims involved only section 10(b), and the case against the outside directors was sufficiently weak for the judge to grant a directed verdict for the directors at the close of the plaintiffs' case. The plaintiffs had made a pretrial settlement offer within policy limits, so if the directors had been held liable for more than these limits, they may have had a claim against the insurer based on unreasonable refusal to settle.[345]

In *Zenith Laboratories*, the trial involved two officers and the firm's nonexecutive chairman of the board. The parties settled within the D&O policy limits before the trial concluded. The chairman represented the firm's controlling shareholder and would likely have been indemnified by the controlling shareholder in the event of a loss at trial that exceeded policy limits.

In *Safety-Kleen*, the defendants at the time of trial were six outside directors and two officers. Three other outside directors were named as defendants, but the claims against them were dismissed prior to trial. The case against the six outside directors who went to trial was settled close to the end of the proceedings within the D&O policy limits. The officers, who lived in Canada, appeared only through counsel and were found liable. The judge found the case against them so clear that he found liability as a matter of law and did not submit the case to the jury.

In addition to securities law trials involving a company and/or its officers and directors, there have been a number of securities law trials involving other types of defendants. In our search, we found the following: four trials involving only accountants, investment banks, or other secondary defendants;[346] two cases against secondary defendants that settled during trial;[347] one trial against

345. It is possible that the decision to reject the within-limits settlement offer and go to trial was accompanied by an agreement between the directors and the insurer that the insurer would pay any damages. Plaintiff's counsel advised us that all settlement negotiations were with counsel for the D&O insurer, which is consistent with directors not facing significant personal exposure. Telephone Interview and E-mails with Plaintiff's Counsel (2005).

346. The completed trials involving only secondary defendants are: (1) Robbins v. Koger Prop., Inc., 116 F.3d 1441 (11th Cir. 1997) (dismissing company and directors from a suit against Deloitte & Touche); (2) *In re* Health Mgmt., Inc., Sec. Litig., No. CV-96-0889(ADS) (involving a case against BDO Seidman); *see also* Michael Riccardi, *Accounting Fraud Trial Breaks New Ground*, N.Y.L.J., Oct. 29, 1999, at 1 (describing defense's win); (3) *In re* Melridge, Inc. Sec. Litig., 837 F. Supp. 1076 (1993) (prevailing plaintiff against underwriter Boettcher & Co., while directors and officers settled prior to trial); *see also* Margaret Cronin Fisk, *Notable Settlement*, NAT'L L.J., Dec. 6, 1993; Interview with Plaintiffs' Counsel (2005); (4) Mark v. FSC Sec. Corp., 870 F.2d 331 (6th Cir. 1989) (involving section 10(b) and section 12 claims, where plaintiffs sued a broker-dealer to recover losses on unregistered limited partnership interests, lost at trial, but won a new trial on their section 12 claim for failure to register an offering).

347. The partial trials against secondary defendants are: (1) against Arthur Andersen in the *WorldCom* case—*see In re* WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455 (S.D.N.Y. 2005); Tu, *supra* note 296, at 477—and (2) against First Union Bank for assisting a fraudulent investment fund (Cypress Funds)—*see* Jenni Bergal, *Investors Accuse Bank in*

the general partner of real estate limited partnerships;[348] and one default judgment in which the defendants did not appear at trial.[349]

B. *Corporate Law Trials*

To search for corporate law trials, we took several steps. We relied, once again, on the steps described above for securities trials, including attending to accounts of trials in news stories and asking our interviewees if they knew of any corporate trials. We also searched Westlaw's MBUS-CS Database, which is a multistate database of business law cases.[350] For derivative suits, we carried out two searches. One used the terms "derivative suit" and "outside director." The other used the terms "derivative suit" and "independent director." For direct suits, we used the terms "damages" and "independent director" or "outside director." Each search was then narrowed by using the term "trial" in the "locate within" feature. This produced 136 hits for derivative suits and 235 hits for direct suits, which we read to locate actual trials in which plaintiffs sought damages from outside directors.[351]

Table B3 lists the five post-1980 derivative suits we found where there was a trial involving a claim for damages against outside directors of a public company. Some also include direct claims. The plaintiffs won two of these cases (*ASG* and *MAXXAM*), but the outside directors did not make out-of-pocket payments in either one.[352]

Securities Case, ORLANDO SENTINEL, Aug. 7, 2003, at C3; *CYPRUS FUNDS: Bogus Securities Investors Recover from FL Bank*, CLASS ACTION REP., Aug. 29, 2003.

348. *See In re* Real Estate Assocs. Ltd. P'ship, 223 F. Supp. 2d 1109 (C.D. Cal. 2002); *Chimicles & Tikellis LLP Announces $120 Million Judgment Entered by Federal District Court*, PR NEWSWIRE, Apr. 30, 2003, http://www.forrelease.com/D20030430/phw035.P2.04302003113713.12595.html; *Chimicles & Tikellis LLP Announces $83 Million Settlement of REAL Partnerships Class Action Has Received Court's Preliminary Approval*, PR NEWSWIRE, Aug. 28, 2003, http://www.forrelease.com/D20030828/phth035.P2.08282003171915.10157.html.

349. *See In re* Equisure, Inc. Sec. Litig., No. 97-CV-2056 (D. Minn. 1998) (involving a default judgment against defendants for $45.3 million entered May 12, 1998); *Equisure Fraud Case Switches Focus to Officers*, MINNEAPOLIS-ST. PAUL BUS. J., Dec. 11, 1998; Stanford Securities Class Action Clearinghouse, http://securities.stanford.edu/1001/EQE97/.

350. The Westlaw MBUS-CS Database includes corporate law decisions from all states with various effective starting years but with coverage from at least 1990 onwards.

351. With derivative suits, the total of 136 hits was calculated by adding together the 64 hits derived from the "derivative suit" and "outside director" search and the 72 hits derived from the "direct suit" and "independent director" search. The total of 136 will double count cases where the terms "outside director" and "independent director" were both used in the same judgment. The searches ran will have missed trials involving outside directors who were identified simply as "directors," without the adjective "outside" or "independent." We did not find it feasible to rerun the searches without these adjectives because of the large number of hits generated. For instance, the search under "director" and "derivative suit" yielded 1512 hits. The search under "director" and "damages" yielded 10,000 hits, which is the upper limit of hits Westlaw will respond with on any search.

352. *See* Part I, *supra*.

Table B3. Derivative Suit Trials Against Outside Directors of Public Companies, 1980-2005

Company	Jurisdiction	Year of Trial	Plaintiff Win Against Outside Directors	Damages Paid by Outside Directors
ASG Industries[353]	Delaware	1984	Yes	No
Tesoro Petroleum[354]	W.D. Tex (Delaware law)	1987	No	No
Tremont[355]	Delaware	1996	No	No
MAXXAM[356]	Delaware	1997	Yes	No
Disney[357]	Delaware	2005	No	No

Table B4 lists the twelve post-1980 direct suit trials we found involving fiduciary duty claims against outside directors of public companies.[358] In direct lawsuits, indemnification will generally be available as long as the company is solvent. Thus, the directors' risk in going to trial is less than in derivative cases. In derivative suits, indemnification by the company for damages is not available—leaving D&O insurance and, in some instances, payment or indemnification by another party as the available deep pockets if damages are

353. *See* Associated Imports, Inc. v. ASG Indus., Inc., No. 5953, 1984 WL 19833 (Del. Ch. June 24, 1984) (involving a freeze-out case, both direct and derivative). Associated Imports was controlled by Fourco. Its six-member board included two officers of ASG and four officers of Fourco. All approved a freeze-out transaction, on terms that the court determined were unfair to ASG. Despite their direct interest on both sides of the transaction, the four Fourco officers fit within our broad definition of outside directors. The case was apparently then settled with revised consideration paid by Fourco.

354. *See* Interview with Plaintiff's Counsel (2005).

355. *See* Kahn v. Tremont Corp., No. CIV-A-12339, 1996 WL 145452, at *1 (Del. Ch. Mar. 21, 1996) (challenging a company's purchase of shares in a corporation which shared the same controlling shareholder, with self-dealing by the controlling shareholder being the core allegation).

356. *See In re* MAXXAM, Inc./Federated Dev. S'holders Litig., No. CIV.A.12111, 1997 WL 187317, at *1 (Del. Ch. Apr. 4, 1997) (alleging self-dealing by controlling shareholder).

357. *See In re* Walt Disney Co. Derivative Litig., No. 15452, 2005 Del. Ch. LEXIS 113, at *1 (Aug. 9, 2005) (holding that directors did not breach their fiduciary duties in connection with the hiring and termination of corporation's president).

358. In *Merriman v. Smith*, 599 S.W.2d 548 (Tenn. Ct. App. 1979), and *Rowen v. Le Mars Mutual Insurance Co. of Iowa*, 282 N.W.2d 639 (Iowa 1979), the courts issued appellate decisions addressing issues arising from trials that involved inside and outside directors of insurance companies who allegedly breached duties owed to their companies when the companies were acquired. We doubt the companies involved were publicly quoted, but we were unable to confirm this. In both cases, the claims brought against the outside directors failed.

awarded.[359]

Table B4. Direct Corporate Lawsuits Against Outside Directors of Public Companies, 1980-2005

Company	Jurisdiction	Year of Trial	Plaintiff Win	Damages Paid by Outside Directors
Trans Union (Van Gorkom)[360]	Delaware	1985	Yes	Yes
U.S. Sugar[361]	Delaware	1985	Yes	No
Fairchild Camera and Instrument[362]	Delaware	1988	No	No
Avia Group[363]	Oregon	1988	No	No
Remington Arms[364]	Delaware	1990	No	No
Technicolor[365]	Delaware	1991	No	No
Unimation[366]	Delaware	1991	No	No

359. On indemnification and insurance in corporate law trials, see Part II.A.2.d, *supra*.

360. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (involving a takeover case).

361. Kahn v. U.S. Sugar Corp., 1985 WL 4449, at *14 (Del. Ch. Dec. 10, 1985) (involving a freeze-out case). The court found that the fair value of U.S. Sugar shares was $72, versus the $68 deal price. U.S. Sugar subsequently paid $4.7 million to settle the case. Rosalind Resnick, *U.S. Sugar Makes Deal with 1,400 Shareholders*, MIAMI HERALD, June 3, 1986, at 5D.

362. Citron v. Fairchild Camera & Instrument Corp., No. CIV-A-6085, 1988 WL 53322, at *1 (Del. Ch. May 19, 1988) (alleging that directors of a takeover target improperly favored the bidder).

363. *See* Meg Rottman, *Court Rules for Avia in Suit Against Holders*, FOOTWEAR NEWS, Nov. 7, 1988; Lisa Williams, *Opposition Is Mounting to Reebok-Avia Deal: Class Suit Filed*, FOOTWEAR NEWS, Mar. 23, 1987; Telephone Interview with Plaintiffs' Counsel (2005).

364. Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490 (Del. Ch. 1990) (involving a freeze-out case where the controlling shareholder of a public company acquired all of the shares of the public company on allegedly unfair terms).

365. Cinerama, Inc. v. Technicolor, Inc., No. CIV-A-8358, 1991 WL 111134 (Del. Ch. June 24, 1991) (involving a freeze-out case). The case was appealed. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d. 345 (Del. 1993). There was a retrial of the issues where the appeal was successful. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994).

366. *See* Van de Walle v. Unimation, Inc., No. CIV-A-7046, 1991 WL 29303 (Del. Ch. Mar. 7, 1991) (involving a takeover case). Plaintiffs sued Unimation's parent company, Condec, and all Unimation directors (most of whom were Condec insiders), claiming that Condec had sold Unimation too cheaply.

Company	Jurisdiction	Year of Trial	Plaintiff Win	Damages Paid by Outside Directors
Tad's Enterprises[367]	Delaware	1996	Yes	Unlikely
Unocal Exploration[368]	Delaware	1999	No	No
Bally Entertainment[369]	Delaware	2001	No	No
Emerging Communications[370]	Delaware	2004	Yes	No
Pennzoil[371]	Texas (Del. Law)	2005	No	No

Plaintiffs won four of the direct suit trials. In one (*U.S. Sugar*) the company paid to settle the case, and in another (*Emerging Communications*) the controlling shareholder and D&O insurance paid the damages. The result—payment by the controlling shareholder and perhaps D&O insurance—likely was the same in a third case (*Tad's Enterprises*), although we could not confirm this. *Van Gorkom* is the only confirmed direct suit trial that resulted in the outside directors making an out-of-pocket payment.

We did not search systematically for partial fiduciary duty trials, but we are aware of one derivative suit.[372] We are also aware of four trials of direct suits

367. Ryan v. Tad's Enters., Inc., 709 A.2d 682 (Del. Ch. 1996) (involving a freeze-out case). The company, Tad's Enterprises, sold its primary business in an asset sale; the controlling shareholders then completed a freeze-out merger. Of Tad's three directors, two were the controlling shareholders, and the third was their personal counsel, Mr. Bressler. The court awarded $754,000 in damages. The transactions took place in 1988, soon after the adoption of Delaware section 102(b)(7), and Tad's apparently did not have a section 102(b)(7) charter provision in place. *Id.* at 685-89, 706. It is possible that Bressler paid some amount out of pocket, but more likely that the controlling shareholders and Tad's paid the full amount. He was likely also entitled to indemnification.

368. *In re* Unocal Exploration Corp. S'holders Litig., 793 A.2d 329 (Del. Ch. 2000) (involving a takeover case).

369. Parnes v. Bally Entm't Corp., No. Civ.-A.-15192, 2001 WL 224774, at *1 (Del. Ch. Feb. 23, 2001) (consisting of a takeover case where it was alleged that directors of the target company improperly favored the bidder).

370. *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.-A.-16415, 2004 WL 1305745 (Del. Ch. May 3, 2004) (consisting of a freeze-out case). Chancellor Jacobs found liability on the part of the controlling shareholder and one outside director, Mr. Muoio, whom Jacobs judged to have breached his duty of loyalty based on circumstantial evidence. *Id.* at *40. On the fact the controlling shareholder and the D&O insurer paid the damage award, see Stipulation of Settlement, filed in the Delaware Chancery Court on November 16, 2004.

371. *See* Pate v. Elloway, No. 01-03-00187-CV, 2003 WL 22682422 (Tex. Ct. App. Nov. 13, 2003) (involving a takeover case); David Marcus, *Two Decades Later, Pennzoil, Take Two*, CORP. CONTROL ALERT, Dec. 2005, at 10. Bernard Black was an expert witness for the plaintiffs in this case. The defendants were indemnified by Shell Oil Co., which had acquired Pennzoil.

372. The case involved Computer Associates. The court found on the pleadings that a

that included claims for damages against outside directors and that settled either during trial or after trial but before a judgment was issued.[373]

stock grant to officers exceeded the maximum number of shares authorized by the company's plan. The insiders then returned the shares, making moot the outside directors' possible liability. *See* Sanders v. Wang, No. 16640, 1999 WL 1044880 (Del. Ch. Nov. 8, 1999); William M. Bulkeley, Executives Set To Give Back Company Stock, WALL. ST. J., Apr. 6, 2000, at B15.

373. These cases were: (1) *M&F Worldwide Corp*., in which outside directors were defendants, involved a rescission of a challenged transaction with a controlling shareholder was reached mid-trial. *See In re* M&F Worldwide Corp. S'holders Litig., 799 A.2d 1164 (Del. Ch. 2002). Bernard Black was an expert witness for a plaintiff in a related case involving the same transaction. The outside directors would have been both indemnified and protected by a section 102(b)(7) charter provision (there was no claim of misconduct that would limit either source of protection) and insured for any expenses incurred.

(2) *American Medical International* (1991), in which a director made a takeover bid that was rejected, involved a suit against the company and its independent chairman. The case against the chairman settled mid-trial, and the rest of the case settled while the jury was deliberating. The company was solvent, and the chairman was both indemnified and insured; the insurer disputed coverage based on the insured-versus-insured exclusion, but ultimately the insurer covered the chairman's settlement. *See* Telephone Interview with Defense Counsel (2005); *see also AMI Civil Fraud Suit Settled for $16 Million*, PR NEWSWIRE, Aug. 13, 1991; Judith Nemes, *AMI Completes Refinancing, Settles Suit*, MODERN HEALTHCARE, Aug. 19, 1991.

(3) The 1989 *Disney* case, listed as a partial securities trial in Table B2, *supra*, also involved derivative claims against the Disney directors.

(4) *Fine v. Sokol*, No. 18868 (Del. Ch. 2001), involved a freeze-out case with First Medical Group, which settled in early 2006 after trial but before judgment. *See* Interview with Delaware Vice-Chancellor Leo Strine (2005).