REWARDING OUTSIDE DIRECTORS

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ABSTRACT

While they often rely on the threat of penalties to produce deterrence, legal systems rarely use the promise of rewards. In this Paper, we consider the use of rewards to motivate director vigilance. Measures to enhance director liability are commonly perceived to be too costly. We, however, demonstrate that properly designed rewards regimes could match the behavioral incentives offered by negligence-based liability regime but with significantly lower costs and more political appeal. We further argue that the market itself cannot implement such a regime in the form of equity compensation for directors. We conclude by providing preliminary sketches of three alternative reward regimes. While this paper focuses on outside directors, the implications of our analysis extend to other gatekeepers as well.

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INTRODUCTION

The proper role of sanctions in motivating boards of directors to monitor for company misconduct is a familiar issue in corporate governance. On one hand, the law has long been reluctant to hold directors liable for negligently supervising managers. Indeed, U.S. corporate law goes far to insulate directors from such liability because, it is said, directors would otherwise hesitate to serve or would become overly risk averse. On the other hand, the law has also been reluctant to give directors a free pass for all misconduct short of intentional wrongdoing—presumably because lawmakers fear that doing so would leave dangerously little incentive for boards to monitor CEOs. As might be expected, moreover, the tension between distrusting boards and fearing liability has stimulated awkward doctrine and a considerable literature about the costs and benefits of liability in the complex setting

of the boardroom.[1] This paper adds to that literature obliquely. We do not attempt to assess the optimal level of liability in the boardroom. Instead, we look beyond the traditional debate over the desirable scope of liability to explore a logical alternative to liability: namely, the possibility of employing rewards to motivate directors.

Although the law conventionally relies on penalties to influence behavior,[2] we argue here that penalties lose much of their enforcement advantage over rewards as misconduct becomes a matter of negligence rather than intention, and regulated behavior becomes increasingly opaque, especially in market settings. An important class of examples includes "gatekeepers" such as accountants, lawyers, underwriters, and independent directors, who, while not wrongdoers themselves, may nevertheless be able to prevent misconduct by virtue of their positions.[3] The law employs liability to motivate some—but not all—of these actors. For example, auditors, who have an explicit monitoring methodology, are often held liable for negligence,[4] while directors, whose responsibilities are far less clear-cut, are seldom held liable for negligent oversight.[5] One difference is that the direct cost of negligence-based liability for directors is presumably high because directorial negligence is peculiarly difficult to define and identify (i.e., the legal error rate is likely to be high). Another difference is the dense latticework of contractual risk shifting devices—such as insurance, indemnification, and exculpatory charter provisions—that insulates

[1] *See, e.g.,* Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine,* 57 VAND. L. REV. 53 (2004).

[2] Scholars have studied the use of rewards to motivate private law enforcement. *See* Gary S. Becker & George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1 (1974); William M. Landes and Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1 (1975); A. Mitchell Polinsky & Steven Shavell, *Corruption and Optimal Law Enforcement,* 81 J. PUB. ECON. 1 (2001). *See also* J. Falkinger & H. Walther, *Rewards versus Penalties: On a New Policy Against Tax Evasion,* 19 PUB. FIN. Q. 67 (1991) (developing a model for using rewards to induce tax compliance).

[3] *See* Reinier Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53 (1986) (defining "gatekeepers" as private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers).

[4] *See* ROBERT J. HAFT & MICHELE H. HUDSON, LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS, Ch. 5 (2005).

[5] *See* Bernard Black et. al., *Liability Risk for Outside Directors: a Cross Border Analysis,* 11 EUR. FIN. MGT. 153 (2005) (a comparative study finding that outside directors very rarely bear out-of-pocket liability for failure to monitor management).

directors from what little liability the substantive law does impose.[6] Given that these obstacles largely disqualify liability as an instrument for motivating directors, we ask in this paper whether rewards might be a more workable substitute for liability where directorial incentives to monitor are deemed to be too weak. Put differently, assuming that legal intervention is required to improve directorial oversight, we consider whether rewards can outperform liability in incentivizing directors to monitor management.

To be sure, we are not the first to suggest that positive incentives might improve boardroom performance. A large body of literature on directorial compensation parallels the literature on directorial liability (although the two rarely intersect).[7] A principal theme of the compensation literature is that directors ought to be paid in equity—options or restricted stock—like senior managers, and for much the same reason: to align their financial interests with those of shareholders. Put more strongly, many commentators view equity compensation as *the* principal answer to the board's incentive problems,[8] and some might argue that firms can *automatically* induce effective monitoring by implementing the right sort of high-powered equity compensation in the boardroom.

We disagree for reasons that we elaborate in this paper. Good corporate governance may indeed require that directors take an equity stake in their companies. But whatever the wisdom of such equity compensation, it cannot substitute for personal liability as a monitoring incentive. Indeed, as we discuss at length, high-powered equity compensation may even deter monitoring when honest scrutiny might uncover negative information about a company that will reduce its share price. Like equity compensation, the ideal monitoring regime for the boardroom should

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[6] *See* Bernard Black et. al., *Outside Director Liability*, 58 STAN. L. REV. (forthcoming, 2006) at 129-134 (providing an overview of the insulating effect of D&O insurance and indemnification).

[7] *See also* Eric L. Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation, and Securities Litigation* (May 4, 2004), *available at* www.ssrn.com (corporate governance arrangements, executive compensation, and shareholder litigation are all substitutes for incentivizing managers).

[8] *See, e.g.,* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems,* 48 J. FIN. ECON. 831 (1993) (encouraging directors to hold substantial equity interests would provide better oversight incentives); Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 689–92 (1995) (paying directors in stock will "incentivize outside directors in the large public corporation to eschew their traditional passivity"); Wei Shen, *Improve Board Effectiveness: the Need for Incentives,* 16 BRIT. J. MANG. S81, S86 (2005) (to improve board effectiveness, directors should be compensated primarily with company stock and be required to buy a significant amount of company stock upon joining the board).

reward rather than penalize directors. The similarity ends here, however. In other respects, the ideal regime more closely resembles negligence-based liability: it is best structured as a low-frequency, high-impact incentive regime in which each director' conduct is evaluated *ex post*—for the most part, after the discovery of management wrongdoing.

Our discussion is organized as follows. Part II expands on the limitations and costs of negligence-based liability as a device for motivating directorial monitoring. Part III argues that a reward regime with incentive effects similar to negligence-based liability might escape some of its costs. Part IV demonstrates that equity compensation cannot substitute for the incentive effects of liability, however salubrious its effects might be in other respects. Part V addresses the practicality of reward regimes that can mimic liability incentives by providing rough sketches of the institutional framework and funding of three possible regimes. Finally, Part VI concludes by briefly considering the extension of reward regimes to other classes of gatekeepers in corporate and securities law.

II. THE LIMITS OF DIRECTORIAL LIABILITY

The best evidence of the costs of imposing negligence-based liability on corporate directors is that the law very rarely does it, either in the U.S. or anywhere else.[9] The best evidence that the question is a close one, however, is that there are exceptions and ambiguities that leave open the possibility of liability in exceptional circumstances.

A. The (Very Limited) Scope of Negligence-Based Liability

Under U.S. law, directors enjoy protection from liability for failing to detect misconduct—or for failing to attend to other aspects of company business—on two levels: the level of substantive law and the level of private risk-shifting devices authorized by law.

Consider first a thumbnail sketch of director liability under substantive law. Under state law, the principal fiduciary duty governing disinterested directors is the

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[9] *See* Black et. al., *supra* note 6.

duty of care; [10] that is, the injunction that directors must act "with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[11] In the aptly-named *Caremark* decision,[12] the Delaware Chancellor held that the duty of care encompasses an oversight function, which includes a duty to ensure that appropriate "information and reporting systems" exist to provide the board of directors with accurate and adequate information to assess corporate compliance with legal requirements.[13] The duty of care is qualified, however, by the so-called business judgment rule, which bars courts form inquiring into the content of the board's business decisions.[14] As a result, it is seldom possible to challenge a board's decisionmaking except when, as a result of gross negligence or bad faith, the protections of the business judgment rule do not attach. The few cases in which directors actually face a risk of personal liability under state corporate law, then, are those in which the board has been grossly negligent in its procedures—i.e., dealing with obviously important matters in a cursory fashion[15]--or in which the failure to question obvious wrongdoing was so blatant as to suggest intentionality and bad faith.[16] Some commentators believe that this procedural focus is desirable,[17]

[10] There is some uncertainty concerning the extent to which disinterested directors have an independent duty of good faith under Delaware law. For a comprehensive analysis, see Hillary A. Sale, *Delaware's Good Faith,* 89 CORNELL L. REV. 254 (2004). **Mention recent Disney case which casts doubt on the reach of such doctrine.**

[11] *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1994); MODEL BUSINESS CORPORATION ACT § 8.30(b) (1984).

[12] In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968–70 (Del. Ch. 1996).

[13] The jurisprudence concerning directors' oversight duty is still in its infancy, and there are no clear standards prescribing what type of monitoring directors have to undertake in order to discharge these duties. *See, for example,* Jack B. Jacobs, *The Delaware Supreme Court: Looking to the Future,* 8 M&A LAW. No. 2 (2004) (noting that Delaware law concerning the board's obligation to oversee management is "developed hardly at all"); Charles M. Elson & Christopher L. Gyves, In Re Caremark: *Good Intentions, Unintended Consequences,* 39 WAKE FOREST L. REV. 691, 701 (2004) (arguing that the *Caremark* decision leaves unclear exactly what directors would need to do to meet their oversight duties).

[14] *See* E. Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments,* 153 U. PENN. L. REV. 1399, 1421-1428 (2005).

[15] *See* Smith v.Van Gorkom, 488 A.2d 858 (Del. 1985).

[16] In re Emerging Communications, Inc. Shareholders Litigation, 2004 WL 1305745, (Del.Ch., June 30, 2004).

[17] *See, e.g.,* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 672 (2002) (offering an altruism-based justification for the process-oriented nature of the business judgment rule); Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001).

while others do not.[18] But what is important for our purposes is that directors currently face very little risk of liability for negligent oversight.

Federal law is equally reticent to impose personal liability for oversight failure on directors. The principal exception to this rule is Section 11 of the 1933 Act, which holds directors to a negligence-type standard in connection with misrepresentations in the prospectus accompanying public offerings of securities.[19] By contrast, directors are liable under the 1934 Act only if they are shown to have acted with "scienter," i.e., engaged in knowing misconduct.[20] In this regard, it is instructive to note the federal response to reports about the role director passivity in facilitating financial debacles at Enron, Worldcom, and other companies that fell victim to financial fraud in the early years of the decade.[21] The Enron cohort of scandals sparked numerous calls for subjecting directors to negligence-based liability for failure to exercise proper vigilance.[22] But the federal response—the Sarbanes Oxely Act and the regulations in its aftermath—did not expand director liability. Instead, these reforms focused on regulating board independence and assigning increasing responsibilities to specialized committees, such as the audit committee.[23] In particular, very little in the new regulations addresses the scope of directors' oversight obligations.[24] To the contrary, the SEC has refused to prescribe the manner

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[18] See Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board Of Directors,* 53 DUKE L. J. 517, 567 (2003) (positing that so long "as adherence to procedural standards, coupled with the retention of outside professionals, is sufficient to insulate directors from personal accountability, there is little reason to expect directors to monitor management closely").

[19] *See* Hillary A. Sale. *Independent Directors as Securities Monitors,* at XX, (January 30, 2006). U Iowa Legal Studies Research Paper No. 05-38, *available at* http://ssrn.com/abstract=879791.

[20] *See* Sale, *id.* at XX. *See also* Suraj Srinivasan, *Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements*, 43 J. ACCT. RES. 291 (2005) (finding that outside directors of companies that restated their financials face little discipline through SEC action or private litigation).

[21] *See* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CINN. L. REV. 1233 (2003) (describing director passivity at Enron); Floyd Norris, *Ebbers and Passive Board Blamed for Worldcom Woes*, N.Y. TIMES, June 10, 2003, at C1 (describing findings concerning director conduct at Worldcom); David S. Hilzenrath, *How a Distinguished Roster of Board Members Failed to Detect Company's Problems,* WASH POST, June 16, 2003, at E1 (same).

[22] *See, e.g., Lisa M. Fairax, Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty through Legal Liability,* 42 HOUS. L. REV. 393 (2005).

See Fairfax, *id.,* at 400-405.

[24] *See* Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors,* 53 DUKE L. J. 517, 572 (2003) (noting that it is unclear to what extent members of the audit committee are responsible for making

in which members of the audit committee should execute their oversight responsibilities.[25]

Below state and federal substantive law, moreover, there is a second level of legal insulation for corporate directors in the form of state law authorization for a variety of private risk-shifting devices. For example, Delaware law explicitly endorses corporate permissive indemnification (and in some cases, mandatory indemnification) and insurance of virtually all directorial liability costs do not result from a judgment of fraud or similar intentional wrongdoing. Moreover, virtually all states now authorize companies to adopt charter provisions exculpating directors from monetary liability for breaching the duty of care.[26] Finally, the common practice of settling derivative litigation and class actions against directors—the principal mechanisms for enforcing the director's monitoring obligations—assures that only a tiny percentage of cases are ever adjudicated. The vast majority of lawsuits either are dismissed or settled—after the company and or its insurer picks up the tab.[27] The bottom line is that directors almost never bear out-of-pocket liability expenses.[28]

B. The Costs of Negligence-Based Liability

Why is the law reluctant to impose negligence-based liability on directors for faulty monitoring? The usual explanation is that the costs outweigh the benefits as the result of a large probability of legal error. That is, the courts would have a high error rate deciding in hindsight whether individual directors acted reasonably,[29] and

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independent assessments of the quality of issuers' internal controls, financial statements, and financial reports).

[25] *See* Final Rule: Standards Relating To Listed Company Audit Committees, SEC Release No. 33-0820 (Apr. 9 2003) (the SEC position is that "specific decisions regarding the execution of the audit committee's oversight responsibilities, as well as decisions regarding the extent of desired involvement by the audit committee, are best left to the discretion of the audit committee").

[26] *See* J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies,* 38 U. RICH. L. REV. 317, 332 n.93 (2004) (by 2003, all fifty states adopted statutes enabling corporations to limit or eliminate personal liability for directors).

[27] The SEC may attempt to limit companies' ability to indemnify directors. *See* Black et. al., *supra* note 6, at 130.

[28] In the well-publicized cases of Enron of Worldcom, outside directors agreed to pay substantial amounts to settle securities class action lawsuits. On the implications of these settlements, see Michal Klausner et al., *Outside Directors' Liability: Have WorldCom and Enron Changed the Rules*?, 71 STAN. LAW. 36 (2005).

[29] *See, e.g.,* Veasey, *supra* note 14, at 1424. **Specific references in the context of oversight function?**

plaintiffs' lawyers would compound their errors by pursuing actions against directors with little real regard for the merits.[30] A high error rate, in turn, would impose significant risk-bearing costs on directors.[31] At a minimum, directors would demand insurance against negligence-based liability risk or compensation for bearing it. It follows that if out-of-pocket negligence-based liability were common, either D&O insurance premia would be an order of magnitude higher than today, or directors would receive much larger fees, or—the most likely outcome—premia and fees would both increase significantly. But to the extent that firms were able to insure the expected liability costs of their directors, they might blunt the incentive function of negligence-based liability. Thus, it might be necessary to consider limiting D&O insurance coverage and indemnification arrangements in order to maintain liability incentives, and it surely would be necessary to void charter provisions insulating directors from monetary liability for breach of their duty of care.

If directors were unable to shift liability risk, however, companies would face additional costs that might far exceed the direct risk-bearing costs of their directors. One of these costs is the agency cost of risk-distorted decisionmaking by the board, the other is a diminished pool of candidates from which to recruit new directors.[32] Both of these costs are well known and widely discussed. The agency cost is the danger that negligence-based liability would induce directors to make overly cautious decisions, or otherwise overinvest in compliance.[33] Consider, for example, the possible losses that might follow from a board's decision to select a cautious CEO over an entrepreneurial one, or to impose a rigid, hierarchical management structure over a flexible one.

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[30] *See, e.g.,* Roberta Romano, *The Shareholder Suit: Litigation without Foundation?,* 7 J. LAW ECON. & ORG. 55 (1991).

[31] It might also create perverse incentives to ignore misconduct. *See* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994)

[32] Given the cost of expanding directors' liability and the existence of market incentive for directorial oversight, many scholars argue that directors should face only a minimal risk of out-of-pocket liability. *See, e.g.,* Bernard Black et al., *Outside Director Liability: A Policy Analysis,* J. INST. & TH. ECON, (forthcoming 2006), at 15. We elaborate on this question in Part V.A.4, *infra*.

[33] Economists have shown that negligence standards might induce defendants to be overly cautious when courts are prone to error. *See* Louis Kaplow & Steven Shavell, *Accuracy in the Determination of Liability*, 37 J. L. & ECON 1 (1994); Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards,* 2 J. L. ECON. & ORG. 279 (1986).

Similarly, liability creates a problem of recruitment for boards insofar as it might lead many potential directors to refuse to serve.[34] It is no answer to say that companies could always raise board fees to offset an enhanced risk of negligence-based liability. Offering outside directors substantially higher fees might undermine their independence and further decrease their willingness to take risks.[35] Moreover, potential directors have heterogeneous assets and reputations at stake; fees set to compensate modal directors would fail to attract the wealthiest or most illustrious candidates. The concern that expanding liability would discourage the most qualified candidates from joining boards appears to have a strong influence on lawmakers, motivating them to insulate directors from liability.[36]

Finally, of course, there would be an enormous political cost to any effort to impose negligence-based liability on directors, particularly if such a reform also sought to restrict indemnification, insurance, the business judgment rule, exculpatory charter provisions, and the board's power to fund settlements with the plaintiffs' bar—in short, the entire arsenal of risk-shifting devices that are an accepted part shareholder litigation today. There is no organized group to bear this cost, least of all corporate shareholders, who have consistently voted to eliminate directors' monetary liability for breach of the duty of care whenever the matter has been put to a shareholder vote.[37]

III. THE PROMISE OF REWARDS

[34] *See, for example,* Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1, 1-2 (1989) (noting "reports of directors resigning because their firms had lost insurance coverage and of individuals declining invitations to serve on boards in increasing numbers"); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation,* 69 U. CHI. L. REV. 1233, 1244 (2002) (measures to enhance director liability for breaching the duty of care "may have the perverse effect of discouraging board service by the well-qualified, especially for corporations facing significant business challenges.")

[35] *See* Bernard Black et al., *supra* note 32, at 14.

[36] *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1162 (1990) (states that allow corporations to indemnify directors "hope to prevent an exodus of qualified directors from boards"); Gregory S. Rowland, *Earning Management, the SEC, and Corporate Governance: Director Liability Arising from the Audit Committee Report*, 102 COLUM. L. REV. 168, 201-202 (2002) (reviewing pressures on the SEC to protect audit committee members from liability under the concern that liability would reduce ability to find qualified members).

[37] *See* Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477, 490 (2000) ("[O]ut of one hundred 'Fortune 500' companies, ninety-eight of the stock corporations that incorporated in jurisdictions allowing for exculpatory charter provisions have adopted such provisions.")

If negligence-based liability for directors is a dead end, might lawmakers construct a rewards regime of roughly the same incentive power, but with significantly lower costs and more political appeal? A well-funded reward regime could certainly match the behavioral incentives offered by negligence-based liability regime. [38] The threshold question is whether it could do so at a significantly lower economic and political cost.

To investigate this question, we must start by temporarily putting aside skepticism to assume a functioning reward regime with two characteristics. First, the availability of rewards would be tied to a triggering event, such as the discovery a financial scandal at the company, material corporate misconduct of some other sort, or even a material restatement of financial reports. After such an event became public, directors (or recent retirees from the board) would become eligible for rewards upon demonstrating that they had diligently performed their monitoring duties and could not have been expected to do more than they had to prevent the company's crisis. Second, directors who persuaded an independent fact finder—let us say a court—that they had met this standard would receive a large reward, equal perhaps to the CEO's compensation during the preceding year.[39] For present purposes we need not specify who would pay the reward. It is enough to suppose that the regime exists to ask how it would compare to a negligence regime with similar incentive properties?

The answer, we believe, is that it compares quite well. A reward regime would enjoy at least four significant advantages over its liability counterpart: a lower error rate, lower agency and recruitment costs, lower political costs, and the positive externality of facilitating the development of an informed market for directors.

[38]To illustrate, assume that it is socially desirable for directors to make an investment valued at $50 in reviewing the company's financial statements, and compare a liability regime under which directors must pay a penalty of $100 if they fail to make this investment to a rewards regime under which directors are paid $100 if they do make this investment. Under the liability regime, directors will weigh the cost of $50 against their expected liability for failure to monitor—$100. Under the rewards regime, directors will weigh the cost of $50 against their expected payment for adequate monitoring--$100. Both regimes, therefore, provide comparable incentives under these circumstances.

[39] Rewards would have to be considerably higher if one believed—as we do not—that the optimal incentive amount for directors should approximate the potential harm to the company associated with management misconduct. We consider the optimal magnitude of rewards in Part V.A.4., *infra*.

A. Error Rates Under a Reward Regime

Error rates are likely to be lower under a reward regime than under a comparable liability regime, even though fact finders undertake similar assessments of director conduct in both regimes. There are two reasons for this. First, a rewards regime would encourage eligible directors (who had voiced suspicions or helped to uncover company misconduct) to produce information that, even if sometimes self-serving, would go well beyond what fact finders would receive under a liability regime in which boards could be expected to close ranks to fend off accusations of negligence. As the quality of information increases, fact finders are more likely to make more accurate decisions. Second, eligible directors themselves would bring actions under a reward regime, not the plaintiffs bar. An important shortcoming of liability regimes in the corporate area is that enforcement generally depends on plaintiff lawyers to bring class actions or derivative suits. These shareholder suits are not only inherently costly,[40] but also susceptible to abuse by attorneys who file dubious suits merely to extract settlements.[41] We expect the directors who initiate reward procedures, in contrast, to be much less likely to behave strategically than the plaintiffs' bar, partly because of reputational constraints and partly because other company insiders are likely to be willing and able to verify or dispute their accounts. Moreover, rewards procedures would lack the elements—such as asymmetric stakes, cost differentials, and the prospect of significant fees—that provide the plaintiff bar with the leverage to extract settlements even for lawsuits with questionable merits.[42] Rewards regimes would therefore be both administratively cheaper and more accurate than comparable liability regimes. [43]

B. Decisionmaking and Recruitment Under a Reward Regime

Even if comparable reward and liability regimes had identical error rates, however, reward regimes would be less costly for corporations. Using rewards to

[40] *See, e.g.,* Roberta Romano, *The Shareholder Suit: Litigation without Foundation?,* 7 J. LAW ECON. & ORG. 55 (1991).
[41] *See, e.g.,* Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 535-536 (1997) (describing the concern that class attorneys file frivolous claims solely for their settlement value).
[42] *See* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 153-154 (2004)
[43] Furthermore, risk averse directors have far less incentive to sell their contingent claims on rewards than they do to protect themselves against the risk of catastrophic liability

motivate directors mitigates the liability-induced problem of distorted decisionmaking and virtually eliminates the perverse effect of liability on director recruitment.

Consider first director recruitment. A reward regime would have a benign or even positive effect on the recruitment of qualified directors for two reasons. First, a reward regime substitutes the prospect of a benefit at a fixed amount that is identical for all directors for the threat of a variable downside risk. Reward and negligence regimes with similar error rates might impose similar risk-bearing costs on *identical* directors, but real directors have starkly heterogeneous assets, reputations, and personal characteristics. Under a negligence regime, candidates for the board would face financial risks that varied with their personal assets,[44] and reputational risks that varied with positions. This means that negligence-based liability regime would inevitably deter some candidates from serving on boards (again, assuming that insurance is limited or proscribed), unless compensation were set high enough to offset the risk-bearing costs of the wealthiest, most reputable, and most sensitive candidates—which would be very costly. By contrast, under a reward regime all directors who fully discharged their fiduciary duties during a triggering crisis would earn the same monetary rewards. A reward regime, it goes without saying, would not put directors' personal wealth at risk.[45]

Second, reward regimes are unlikely to put directors' reputation at significant risk. In fact, rewards may allow directors to establish reputation for quality of oversight. Directors who qualified for rewards would undoubtedly earn recognition and prestige. But we conjecture that directors who neither qualified nor applied for rewards would not suffer reputational harm.[46] Thus, even when fact finders make errors, a rewards regime should not discourage qualified candidates from joining

[44] Directors would be liable to the full extent of their personal assets unless liability was capped.

[45] Reward regimes will likely reduce other components of director pay. Moreover, this decrease would likely not equal the expected reward amount, since companies would offer their risk-averse director fixed pay amounts to offset the additional risk associated with contingent rewards. **Compare this impact to parallel impact under liability under loss aversion and other behavioral phenomena?**

[46] Those who cannot demonstrate by a preponderance of the evidence that they fully performed their fiduciary duties and did all that was possible to avert a crisis need not fear stigma. All the market learns is that that the evidence to support a reward was missing or that the director in question did not apply for a reward. Limiting rewards to a minority of directors further mitigates directors' concern for their reputation, since all the market would learn then is that other directors exercised exceptional effort,

boards. Moreover, the prospect of earning recognition and rewards might in fact encourage qualified candidates to join even boards of relatively risky companies.

A reward regime is also less likely than negligence-based liability to induce risk-averse board decisions. Two aspects of negligence-based regimes combine to encourage directors to be overly cautious. First, liability typically follows some harmful event for the company, such as a disastrous business failure or a major financial restatement. The threat of liability thus discourages directors from making decisions that would increase the company's risk profile.[47] Second, the negligence standard allows directors to protect themselves from the risk of liability—which might jeopardize their entire wealth and tarnish their reputation—by demonstrating that they acted diligently. Directors thus have an incentive to invest more resources than would otherwise be optimal in order to ensure that they meet the applicable due care standard.

Rewards mitigate the incentives for excessive caution with respect to both aspects of negligence regimes. First, as we explain in detail below,[48] directors would receive rewards can be paid out only upon the occurrence of certain "harmful" triggering events. Thus, reward regimes will not induce directors to disfavor measures solely because they increase the risk to the company. Second, rewards put neither directors' personal wealth nor their reputation at risk. Instead, they offer diligent directors the prospect of receiving a fixed amount contingent on the occurrence of certain events. Since the potential benefits from caretaking are limited, directors would have a weaker incentive than under a negligence regime to exercise excessive precaution. To emphasize, the latter advantage of rewards applies even in comparison to negligence-based liability with a cap on the amount of out-of-pocket damages.[49] Capping liability would mitigate—but not eliminate—the recruitment and decisionmaking costs, especially since legal measures cannot effectively cap the damage to directors' reputation.[50]

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[47] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 98-99 (1991).

[48] *See* Part V.A.1. *infra*.

[49] We discuss the optimal magnitude of rewards (and penalties) for negligent oversight in Part V.A.4., *infra*.

[50] On the other hand, rewards might have a stronger effect than liability on directors' incentives when the amount at stake far exceeds directors' wealth. This is because the incentive effect of rewards

Of course, one might ask whether rewards could have the opposite effect. Specifically, since they will be paid only upon the occurrence of certain "harmful" triggering events, rewards might induce directors to make risky decisions opportunistically in order to become eligible for windfall gains.[51] But this prospect seems farfetched. Directors are unlikely to hope for financial scandal or criminal prosecution on their watch under any circumstances. Crises of these proportions are bad news for top managers and board members regardless of the legal regime in place. Still more to the point, any director who appeared to have contributed to such a crisis would be unlikely to receive a reward for the performance of her duties after a careful ex post review.[52] Finally, even if they did have an incentive to act opportunistically, the practical implications of such incentive are likely to be rather limited given directors' limited influence. Unlike senior officers, directors cannot initiate new projects. At most, directors who were eager to increase the company's risk profile could refuse to veto overly-risky management proposals.

C. Private Risk-Shifting and the Political Costs of Implementation

In addition to protecting boards from the corrosive effects of liability risks, reward regimes share another advantage over liability regimes that, while not fundamental as a conceptual matter, is very important as a practical one: rewards are unlikely to trigger contractual risk-shifting devices such as liability insurance and indemnification. The usual justification for these devices—that they are necessary to recruit risk-averse directors—simply does not apply to rewards because companies and their directors lack an obvious reason to contract out of a rewards regime. Indeed, attempting to do so by entering into a “reverse indemnification” contract[53] might appear suspicious, given that a rewards regime does not put directors’ personal

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applies to all directors—even those with limited assets, whereas the impact of liability on directors is subject to directors' wealth constraint. To illustrate, consider a director with assets worth $200,000. For this director, the effect of a threat of damages in the amount of $500,000 would likely be smaller than the effect of a $500,000 award.

[51] *Cf.* Saul Levmore, *Waiting for Rescue: An Essay on the Evolution and Incentive Structure of the Law of the Law of Affirmative Obligations,* 72 VA. L. REV. 879, 886 (1986) (providing rescuers with large rewards might induce potential rescuers to create a demand for their services by putting others at risk).

[52] We elaborate on legal measures to alleviate this moral hazard problem in Part IV.A.2 *infra*.

[53] Under a reverse indemnification agreement, a director would waive rights to petition for a reward in exchange for higher fixed compensation.

wealth at risk. The upshot is that reward incentives are likely to remain undiluted when liability incentives are not unless risk-shifting devices are banned or regulated.

How far liability insurance and indemnification undermine deterrence is a complicated question with no clear answer as a matter of theory or empirics.[54] However, for those who believe that these arrangements improperly dilute director oversight incentives, a regime that can incentivize directors without triggering insurance and indemnification agreements should be a welcome development. Indeed, reward regimes should appeal even for those who believe that pervasive risk is currently necessary in order to achieve the right balance of directorial liability and insulation,[55] since reward regimes reduce the need to rely on risk-shifting—and hence the transactions costs associated with their negotiation and subsequent triggering.[56]

D. Developing the Market for Directors

A final institutional advantage of a rewards regime over a comparable liability regime arises from its influence on a developing the market for corporate directors. It is commonly assumed that the market for directorial positions produces perhaps the strongest incentives for director oversight, and that directors are typically influenced more by the concern for their reputation than by monetary incentives.[57] There is some evidence that directors at failing companies suffer reputational penalties. Yet, under existing conditions, the market has little opportunity to evaluate the quality of individual directors, especially when it comes to directors who exercise exceptional vigilance. If, for example, a board terminates the employment of the

[54] For a comprehensive analysis of the impact of liability insurance on deterrence, see generally Steven Shavell, *On the Social Function and the Regulation of Liability Insurance,*25 GENEVA PAPERS ON RISK AND INSURANCE 166 (2000).
[55] *See*, for example, Black et. al., *supra* note XX, at XX (explaining why a tiny risk of out-of-pocket liability might be desirable); Ehud Kamar, *Shareholder Litigation under Indeterminate Corporate Law,* 66 U. CHI. L. REV. 887 (1999).
[56] Some argue that the decoupling of nominal from actual liability is designed to provide the plaintiff bar with sufficient incentives to bring suits. *See* Kamar, *id*; Maria Gutiérrez, *An Economic Analysis of Corporate Directors' Fiduciary Duties,* 34 RAND J. ECON. 516 (2003). Under a reward regime, directors will initiate reward claims and capture the entire amount of the reward.
[57] *See, e.g.,* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997);Black et al, *supra* note XX, at XX. *But see* Renée B. Adams & Daniel Ferreira, *Do Directors Perform for Pay*?, (April 6, 2004); *available at* www.ssrn.com (finding a positive link between attendance-based director fees and director attendance behavior).

CEO of an under-performing company behind the scenes, the public is unlikely to discover which directors took the initiative in orchestrating a change of leadership.

An enhanced liability regime might produce more information, particularly when entire boards behaved poorly.[58] But a well-functioning reward regime would celebrate the achievements of individual directors. It would single out and compensate directors who demonstrated exemplary performance or who assumed a leadership role during a time of crisis for the company. In this way, a reward regime would offset the collective action problem that is inherent in a collective decisionmaking body such as a corporate board. Equally important, publication of the basis for making a monitoring award to a director would give institutional investors and other corporate outsiders information about the quality of individual directors, who might then be nominated to other boards.

IV. EQUITY COMPENSATION AS A REWARD MECHANISM

The hypothetical rewards regime sketched in Part III is a "reverse negligence" regime in which directors are rewarded for doing the right thing when their companies do wrong. But it might be objected that many firms have already voluntarily adopted another, far simpler "reward" regime in the form of equity compensation for their directors. The intuition is straightforward:[59] aligning the interests of directors with those of shareholders through share ownership will motivate directors to overcome their passivity and monitor management effectively. Better still, equity pay is self-executing; no costly judicial or administrative procedure is required to determine a director's eligibility for a reward. This reasoning may partly explain the increasing popularity of equity pay for directors,[60] and why share ownership by directors has found favor with a broad spectrum of

[58] However, reputational concerns also provide directors with incentives to settle, thereby preventing courts from scrutinizing the conduct of individual directors. *See* Black. et. al., *supra* note 6, at 147.

[59] At the same time, one could question the wisdom of rewarding directors with equity based on the following logic: Directors' role is to monitor CEOs who are entitled to hefty stock-based compensation. If equity-based compensation worked for outside directors, it would be expected to work also in the case of CEOs. *But see* our discussion of plausible differences between CEOs and outside directors in note 77, *infra.*

[60] *See* Ivan E. Brick et al., *Board Compensation Structure and Firm Performance,* (January 15, 2003 David Yermack, *Remuneratioion, Retention, and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281 (2004).

observers, ranging from institutional investors[61] to economists,[62] lawyers,[63] and even the Delaware Supreme Court.[64]

We take no position in this paper on the merits of equity pay for directors in general. We are convinced, however, that equity pay *alone* cannot substitute for a reward regime of the sort sketched in Part III—and that, in fact, equity compensation *in isolation* is more likely to retard effective monitoring than to motivate it. Our contrarian position rests on the observation that directors in Anglo-Saxon companies have two roles which sometimes conflict.[65] On the one hand, they are part of the management team with responsibility for advising the CEO and shaping firm strategy. For this managerial role equity pay may indeed be an efficient compensation device.[66] On the other hand, directors are gatekeepers with a monitoring duty to ensure that management is not pursuing its own self interest – *inter alia*, by manipulating share price—at the expense of shareholders and company

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[61] *See, e.g.,* Yermack, *id.,* at 2282 (observing that tying directors' pay to stock performance through the use of options and other equity awards is a frequent goal of corporate governance initiatives undertaken by institutional investors).

[62] For empirical research finding that equity pay enhances firm value, see Sanjai Baghat et. al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999) (finding some correlation between the dollar value of director equity-holdings and CEO turnover); R. Tod Perry, *Incentive Compensation for Outside Directors and CEO Turnover* (July 1999), *available at* www.ssrn.com (finding that equity-based director compensation is associated with better director monitoring and CEO turnover following poor performance); David A. Becher et al., *Incentive Compensation of Bank Directors: The Impact of Deregulation,* 78 J. BUS. 1753 (2005) (banks utilizing a high degree equity-based director compensation exhibit higher performance and growth) For articles that cast doubt on the value of equity pay for directors, see Nikos Vafeas, *Operating Performance around the Adoption of Director Incentive Plans,* 68 ECON. LETTERS 185 (2000) (finding that the adoption of director incentive plan does not affect firms' operating performance); Mason Gerety et. al., *Do Shareholders Benefit from the Adoption of Incentive Pay for Directors?,* 30 FIN. MGMT. 45 (2001) (finding that the adoption of incentive pay for directors does not impact share price).

[63] *See* Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives,* 96 NW. U. L. REV. 579, 577-89 (2002) (arguing that the judicial application of the duty of care should be tailored to the level of equity ownership by outside directors).

[64] *See* Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1380-81 (Del. 1995) (holding that directors who hold substantial equity stakes in a target corporation may not be subject to "strict scrutiny"). For an analysis, see J. Travis Laster, *Exorcizing the Omnipresent Specter: the Impact of Substantial Equity Ownership by Outside Directors on Unocal Analysis,* 55 BUS. LAW. 109 (1999).

[65] *See generally* Donald Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability,* 89 GEO. L.J. 797, 797 (2001).

[66] Indeed, most studies that found correlation between incentive director pay and corporate performance have focused on the business role of directors. *See* Stephen E. Bryan & April Klein, *Non-Management Director Options, Board Characteristics, and Future Firm Investments and Performance*, (May 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=550506; Yermack, *supra* note 60. *But see* Baghat, *supra* note 62 (finding some correlation between the dollar value of director equity-holdings and CEO turnover).

value.[67] For purposes of motivating this monitoring role, equity pay is a poor incentive device for two reasons: first, it may give directors an affirmative incentive to overlook wrongdoing (a failing we term "incentive reversal"); and, second, it may fail to offset incentives to overlook wrongdoing that originate from structural features of the outside director's position on the board (a failing we term "incentive insufficiency").[68]

A. Equity Pay and Incentive Reversal

Equity compensation can reverse the monitoring incentives of directors (and other market gatekeepers[69]) in several ways. To begin, equity holdings reduce a director's incentive to uncover and disclose wrongdoing because doing so will normally depress share price. Companies that restate their financial statements, for example, lose on average roughly 10% of their market value.[70] Directors with significant shareholdings will thus have a perverse incentive to ignore bad news or withhold it from investors.[71] In addition, this perverse incentive can also operate

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[67] Michael Jensen argues that that one of the principal agency problems characterizing public companies is that markets overvalue their shares, perhaps as a result of inaccurate disclosure. *See generally* Michael C. Jensen, *Agency Costs of Overvalued Equity,* FIN. MANG. 5 (2005).

[68] Our analysis should be distinguished from the ongoing scholarly debate over whether some forms of incentive pay are superior to others in aligning management incentives with those of shareholders. For example, some economists argue that CEO stock options—but not restricted stock or bonuses—are likely to encourage misreporting. *See generally* Natasha Burns & Simi Kedia, *The Impact of Performance-based Compensation on Misreporting*, J. FIN. ECON. (forthcoming 2005). Others posit that restricted stocks are more likely than stock options to encourage earning management. *See* Ohad Kadan & Jun Yang, *Executive Stock Options and Earning Management: A Theoretical and Empirical Analysis,* (January 5, 2005), *available at* www.ssrn.com. Still others believe that restricted stocks are superior to stock options in rectifying management's short-term focus. *See, e.g.,* Black et al., (2004), at 42 (noting that a large up-front grant of restricted stock or options to be held until the director leaves the board may be a "promising structure"). Our claim is more ambitious in scope. We argue that *all* forms of equity pay are likely to fail in providing directors with adequate monitoring incentives.

[69] Here we include auditors and attorneys. *See, e.g.,* Ronald A. Dye et. al., *Contingent Fees for Audit Firms,* 28 J. ACCT. RESEARCH 239 (1990); Sankar De & Pradyot K. Sen, *Is Auditor Moral Hazard the Only Reason to Ban Contingent Fees for Audit Services?,* 1 INT. J. AUDIT. 175 (1997).

[70] *See* U.S. GEN. ACCT. OFF., FINANCIAL STATEMENT RESTATEMENTS, 76 GAO-03-138, at 5 (July 2002) (finding an average decline of 10%); Zoe-Vonna Palmrose et al., *Determinants of Market Reactions to Restatement Announcements,* 37 J. ACCT. & ECON. 59 (2004) (finding an average decline of 9.2%).

[71] *See* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation,* 69 U. CHI. L. REV. 1233, 1242 (2002) ("stock-based director compensation may… increase … ambivalence about uncovering embarrassing facts that will reduce the share price."); Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 577 (2003) (equity-based compensation cannot provide incentives for directors to identify and disclose evidence of misconduct).

before misconduct occurs by discouraging measures that prevent some misconduct while increasing the probability that residual misconduct is detected or reported ex post.[72] Thus, a board preoccupied with share price might eschew a particular control on accounting fraud if it appeared that fraud might occur nonetheless and, as a result of the control, fraud would almost certainly be detected if it did occur.[73]

As the example of accounting controls suggests, moreover, equity pay is particularly likely to reverse the incentives of gatekeepers whose role it is to ensure accurate disclosure. Recent corporate debacles typically involved fraudulent financial reporting and other major violations of securities laws.[74] Directors—and especially members of the audit committee—are expected to prevent management from misleading investors and take corrective measures upon discovering problems of inaccurate disclosure.[75] This makes the link between the market price of the company's stock and director wealth especially problematic. As a recent paper notes: "a compensation structure in which the payout is contingent on reported earnings cannot simultaneously incentivize the managers to maximize profits and to report those profits honestly."[76] This intuition is supported by a large empirical literature documenting correlations between equity pay and several measures of accounting fraud and earning management practices.[77]

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[72] *See* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994).

[73] On plausible solutions to the problem on the liability side, see generally Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: an Analysis of Corporate Liability Regimes,* 72 N.Y.U. L. REV. 687 (1997).

[74] *See* John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*, (Working Paper, 2005), *available at* www.ssrn.com.

[75] *See generally* Sale, *supra* note 19.

[76] Keith J. Crocker & Joel Slemrod, *The Economics of Earning Manipulation and Managerial Compensation*, 22, *available at* www.ssrn.com. *See also* Susan R. Curtis, *Incentive Pay, Fraud, and Self-Reported Performance Measures, (*March 8, 2005), *available at* www.ssrn.com; Jensen, *supra* note 67, at 14-15 ((equity-based compensation cannot solve the agency problems arising from overvalued equity).

[77] For recent examples, see Shane A. Johnson et al., *Executive Compensation and Corporate Fraud*, (April 16, 2003), *available at* http://ssrn.com/abstract=395960; Merle Erickson et. al., *Is There a Link Between Executive Equity Incentives and Accounting Fraud?*, J. ACCT. RES. (forthcoming 2006), *available at* http://ssrn.com/abstract=509505; Qiang Cheng & Terry D. Warfield, *Equity Incentives and Earning Management,* 80 ACCT. REV. 441 (2005) (finding correlation between high-powered equity incentives and various measures of earning management practices); Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statement? The Role of In-the-Money Options and Other Incentives,* (September 4, 2005), *available at* www.ssrn.com (finding correlation between in-the-money stock options held by CEOs and accounting restatements). There is some disagreement over

To be sure, requiring directors to hold stock for lengthy periods can mitigate the problem by tying compensation to a company's long-term performance. Often, however, we wish to motivate actions that will lead to decreases in share price *without* offering any prospect of an offsetting future increases. One example is the restatement of financial results. When directors (and other market gatekeepers such as accountants) uncover accounting irregularities, they have a duty to disclose restated financial results to the market. Yet research shows that significant restatements of financial results are often followed by bankruptcy.[78] Thus, although we undoubtedly wish to motivate restatements of financial results when these are necessary, equity compensation does precisely the reverse—particularly when the firm is likely to enter bankruptcy after the extent of its difficulties are revealed. The problem here is *not* that directors have a short-term focus that can be ameliorated by extending their holding period; it is that performing their gatekeeping duties will automatically—and permanently—punish them by wiping out the value of their shareholdings.

B. Board Compensation and Incentive Insufficiency

Unlike incentive reversal, incentive insufficiency characterizes not just equity pay but all conventional forms of director compensation, including flat fees for board meetings and committee service. Two features of board service combine to discourage individual directors from taking the lead in aggressively monitoring management: the risk of being isolated and forced off the board, and the collective action problem endemic to multi-member groups. Conventional forms of compensation have no power to offset these deterrents to energetic monitoring.

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whether some forms of equity pay—especially stock options—are more likely than others to encourage earning manipulation. *See* sources cited in note 68, *supra*.

Although research has thus far focused on incentive pay for executives, the insights seem to extend to directors as well. One plausible difference is that equity pay is substantially higher for senior executives than for directors, thereby making it less likely for directors to sell stock for risk-diversification purposes. *See* Eli Ofek & David Yermack, *Taking Stock: Equity-based Compensation and the Evolution of Managerial Ownership,* 55 J. FIN. 1367 (2000)(equity-based compensation encourages fraud since it makes executives sell stock to diversify risk)

[78] *See* Zoe-Vonna Palmrose & Susan W. Scholz, *The Circumstances and Legal Consequences of Non-GAAP Reporting: Evidence from Restatements,* 21 CONT. ACCT. RES. 139, 145 (2004) (companies with substantial restatements have higher frequencies of a subsequent bankruptcy or delisting).

Consider first the risk that a director might be "fired." Conventional wisdom has it that directors who openly spar with CEOs will often find themselves eased off the board—unless, of course, they persuade the majority of the board.[79] A director who expects to serve multiple terms (as most presumably do) will therefore hesitate to rock the boat, and any compensation regime that pays by the term—be it in the currency of equity, flat fees, or the social and networking benefits of serving on a board¯will encourage directors to refrain from challenging management.[80] Thus, even if a director has accumulated significant shareholdings and believes that an aggressive challenge to management might raise share prices, she must weigh this increase against the risk that she will lose the compensation and social prestige that she might otherwise receive during future years of complacent service on the board. Moreover, directors with a reputation for vigilance are unlikely to be viewed as attractive candidates for service on other boards.[81] To be sure, the pressure on deviant directors is likely more nuanced today than in the past as a result of the new exchange listing requirements that assign nomination responsibilities to a nominating committee consisting of independent directors.[82] Yet, these new requirements are unlikely to eliminate management influence altogether.[83] Thus, as long as CEOs exert influence over the appointment and tenure of "their" directors, conventional forms of compensation will provide insufficient oversight incentives.[84]

Finally, the collective action problem endemic to multi-member boards compounds the disincentives arising from market pressures, and further discourages

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[79] *See* Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 293 (2004), ("a board member who takes the initiative to seek change but fails to gain a consensus will lose power and probably not last long on the board").

[80] This problem is generic to gatekeeper schemes, which often rely on gatekeepers who are hired by those they are under an obligation to monitor. *See*, *e.g.,* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid*," 57 BUS. LAW. 1403 (2002)(auditors); Poonam Puri, *Taking Stock of Taking Stock,* 87 CORNELL L. REV. 99, 152-153 (2001)(attorneys) .

[81]But see Srinivasan, *supra* note 20 (finding significant labor market penalties for outside director following accounting restatements).

[82] **Provide reference for applicable exchange rules. XX**.

[83] *See also* Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot,* 59 BUS. LAW. 43 (2003).

[84] See also LUCIAN A.BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION XX (2004) (positing that compensation is a limited solution as long as nomination is not determined by shareholders).

individual directors from taking leading roles in monitoring management.[85] Equity pay—like other forms of compensation—is granted to all directors alike, regardless of their individual contributions to the board's oversight efforts. By contrast, the cost of vigilance is visited principally on individual directors, especially when vigilance requires that directors take leading roles in confronting CEOs. This personal cost consists not only of the effort required to evaluate management's performance, but also of the threat of retaliation by management and its supporters, i.e., the risk of losing a board seat, suffering reputational damage in the labor market, or incurring the severe informal sanctions that working groups often impose on their deviant members.[86] Moreover, while these costs of aggressive monitoring are often significant for individual board members, the entire board shares in the benefits of close monitoring and good corporate governance through increased compensation, enhanced reputations, and increases in company share values.[87] This asymmetry creates a powerful incentive for directors to free-ride, which can only be offset by a mechanism that provides for the individualized assessment of the efforts of leading directors—most particularly when the going gets tough because there is reason to suspect that management is cutting corners.

V. THREE ALTERNATIVE REWARD REGIMES

In the preceding Parts of this paper, we have demonstrated that a reward regime for corporate directors can replicate the monitoring incentives of negligence-based liability at a lower social and political cost. We have also shown that the market itself cannot implement such a regime in the form of equity compensation for directors. Yet it remains to be shown that legal intervention could translate the

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[85] Empirical studies show that the number of directors on a firm's board is negatively related to the firm's financial performance. *See* Benjamin E. Hermalin & Michael E. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature,* 9 ECON. POL'Y REV. 7, 8 (2003).

[86] *See generally* James D. Westphal & Poonam Khanna, *Keeping Directors in Line: Social Distancing as a Control Mechanism in the Corporate Elite,* 48 ADMIN. SCI. Q. 361 (2003) (exploring the various informal social sanctions suffered by directors who participate in corporate governance changes that reflect greater board control over management).

[87] *See, e.g.,* Lynn A. Stout, *On the Proper Motives of Corporate Directors (or, Why You Don't Want to Invite Homo Economicus to Join Your Board),* 28 D. J. CORP. L. 1,4 (2003) (arguing that equity-based compensation for directors is unlikely to be effective since each director will attempt to free ride on the oversight effort of her peers).

potential benefits of rewards into an administrable regime with the features that we assumed in Part II. Needless to say, we cannot demonstrate this point conclusively, any more than we can conclusively show that any effort to bolster directorial monitoring incentives is worth the candle, given the inevitable tradeoffs we expect between the managerial and monitoring functions of corporate boards.[88] What we can do, however, is to provide preliminary sketches of three alternative reward regimes. Given the potential advantages of rewards over director liability, it is our hope that a least one of these regimes will seem sufficiently plausible to lawmakers or the investment community to merit further study and development, or that our analysis here will encourage future attempts to devise new proposals for director reward regimes. Put differently, the purpose of this Part of our paper is less to prescribe policy than to open up avenues of investigation.

The three reward regimes that we consider below range from a formal, judicially-administered analogue to negligence liability (which we term "reverse negligence") to a voluntary, board-administered regime that is encouraged rather than mandated by law and rules of best practice for corporate governance. All three regimes share important similarities: they dispense generous, high-impact rewards for exemplary behavior after an ex post review of director conduct that follows the occurrence of certain "triggering events"—events that generally indicate harm to the company and are often associated with managerial misconduct. Nevertheless, these regimes differ in important respects as well. With respect to each regime, we identify the main challenges—such as ensuring accuracy, funding the awards, and obtaining political support—that must be met if directors are to face a workable structure of monitoring incentives.

A. The Reverse Negligence Regime

The first reward regime we consider is the mirror image of negligence-based liability, and closely resembles the model regime discussed in Part III of this paper. Like negligence-based liability, reverse negligence builds on a civil lawsuit that turns on the reasonableness of a director's conduct. And like the monetary liability for

[88] As we explained at the outset, our project is to demonstrate the superiority of rewards over liability, contingent on a prior decision to embark on a course of legal intervention.

breach of the duty of care under Delaware law, reverse negligence could be introduced as a default regime that companies could opt out of by amending the corporate charter. Unlike negligence-based liability, however, directors would file lawsuits demanding rewards for conduct that met or exceeded a legal standard. Directors who were successful in their suits could claim substantial awards, which we discuss in detail below.[89] However, directors could sue for a reward only in the aftermath of certain observable triggering events that caused—or were associated with—substantial harm to the company. These events might include a major restatement of financial results,[90] a settlement of a shareholder lawsuit resulting in a monetary payment above a threshold amount, or the opening of an investigation by the SEC.

1. Triggering Events and Standards of Review

Restricting a director's standing to seek a reward to the aftermath of a major financial restatement or similar event has several functions. To begin, it economizes on investigation costs, since events of this magnitude ordinarily spark inquiries into management behavior in any case. In addition, it limits judicial review to precisely those circumstances in which vigilance is most valuable because managerial misconduct is most likely, and in which vigilance is least comfortable because it is likely to lead to bad news and lower share prices. Conversely, evaluating directorial conduct without a prior triggering event—say, at random intervals even in well-managed companies—would fail to assess directorial vigilance effectively, since vigilance is most easily observed when directors react to hints of misconduct or incipient crises in ways that reveal a growing awareness of the problem and a desire to respond appropriately.[91] Put differently, focusing on the aftermath of corporate wrongdoing or mismanagement allows courts to tailor their scrutiny to a specific

[89] *See* text accompanying notes 101-**Error! Bookmark not defined.**, *infra.*

[90] Not all financial restatements are the result of management wrongdoing. *See generally* Jeffrey L. Callen et. al., *Accounting Restatements: Are They Always Bad News for Investors?*, J. INVESTING (forthcoming 2006). The import of financial restatements has already received legal recognition in Section 304 of the Sarbanes-Oxley Act, (**cite formally**) XX, which forces executive compensation give-backs after financial restatements under certain circumstances.

[91] Directors are thus different from auditors whose work is governed by well-established standards. Indeed, Section 104 of the Sarbanes-Oxley Act, **(formal cite)** XX, requires the Public Company Accounting Oversight Board to conduct routine inspections to assess the degree of compliance of accounting firms with the requirements relating to their auditing work,

company and its circumstances, and to evaluate directorial conduct with respect to specific concrete harm.

Finally, allowing directors to claim rewards only in the aftermath of certain triggering events tackles two concerns that might prevent the use of rewards as motivators in other contexts. First, it makes it more difficult for directors to act strategically in order to receive windfall. Second, compared to a scheme of routine evaluations of director conduct, it requires companies to set aside smaller amounts to fund reward payments.

Closely related to the issue of when to evaluate directorial conduct is the question of what standard of review a court should employ. A natural answer is a "reverse negligence" standard: if a negligence regime imposes liability for failing to exercise due care, a reverse negligence regime ought to reward the director who *does* take due care in monitoring management. Note that this standard does *not* imply its converse. Not every director who might have escaped liability under a negligence regime would be eligible for a reward under a reward regime. Instead, a director seeking a reward under this regime carries the burden of affirmatively proving that her conduct met or exceeded a standard of reasonable vigilance. Of course, variations are possible as well. For example, one could imagine a "reverse *gross negligence* rule," under which a director would be required to prove that her conduct was not merely reasonable, but exceeded the level of vigilance normally expected of outside directors. This modification would ensure that only those directors who demonstrated exemplary vigilance would qualify for a reward. In addition, this rule would enhance the reputational benefits associated with the reward while mitigating any plausible adverse effect on the reputation of directors who failed to qualify for a reward.[92]

2. The Moral Hazard Problem

An important concern arises in evaluating conduct of directors over multiple time periods, including an *ex ante* period when misconduct might have been prevented, and an *ex post* period when it can be detected if it is not prevented. In this case, the dilemma is how to treat the director who failed to press for preventive

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[92] We consider an example of such standard in section C below.

measures *ex ante* but nonetheless displayed exemplary vigilance *ex post*. For example, she might have neglected to press for internal accounting controls early on while being the first to follow up on hints of fraudulent reporting afterwards. Rewarding this director for her *ex post* response creates a moral hazard problem insofar as the prospect of reward for discovering misconduct after the fact might discourage its prevention in the first place. As we explained above,[93] directors have considerable market incentives that discourage them from deliberately leading the company to one of the events triggering the reward procedure. At the legal design level, this problem (which might also afflicts negligence-based liability regimes[94]) can be further mitigated in at least two ways: by making rewards contingent upon a showing of appropriate conduct in *all* relevant time periods,[95] or by adjusting the size of rewards downward to reflect a mixed record of performance across the relevant time periods. Finally, it should be noted that personal liability would continue to be a deterrent of self-conscious efforts to induce misconduct: a director who intentionally allowed misconduct to occur would surely risk heavy civil and criminal liability as a result.[96]

3. Funding

Reward regimes must fund rewards as well as the cost of administering them. At first glance the corporation itself would seem to be the most attractive source of funding. Following the procedure of derivative actions, a director—or a former director—might demand a reward and, if it were not forthcoming, sue and either prevail or not, as the court or the parties decided. But even apart from the awkwardness of inviting directors to sue their own companies, direct corporate funding of rewards would create two major problems. First, there is a risk of collusion. Supposedly disinterested directors and managers might fail to contest reward claims in court, especially claims brought by continuing directors who

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[93] *See* Part III.B., *supra*.

[94] *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW XX (2004) (noting the potentially perverse incentives to take precaution associated with the narrow time frame of negligence rules).

[95] *See* Arlen & Kraakman, *supra* note XX, at XX.

[96] *Cf.* Levmore, *supra* note 51, at 886 (moral hazard problem associated with rewarding rescuers might be avoided when rewards are accompanied by liability for creating risk).

remained on the board.[97] If this practice became entrenched, a reward regime might soon degenerate into its opposite, namely, a kind of payoff for directors who turned a blind eye to signs of misconduct. Second, many corporations might lack the resources to pay rewards, especially since reward payouts would occur only in the aftermath of triggering events that are often associated with financial distress. Relying exclusively on corporate funding, then, might cripple a reward regime in just those circumstances in which its incentives were most needed.

If direct corporate funding is unsuitable for a reverse negligence regime, what alternatives remain? Government funding is a possibility, but we have little faith in the government's ability to administer a rewards regime. In addition, national public funding would raise issues of federalism and provoke objections to highly visible public subsidies of the costs of corporate governance. A market solution to the funding problem is preferable to a governmental one, then, particularly if a third party, rather than the corporation itself, is responsible for screening directors' claims for rewards. One possibility is to require companies to purchase "reward insurance" from third parties who would also undertake the tasks of screening and litigating reward claims.[98] These insurers would have no reason to collude with (or retaliate against) petitioning directors, and they would have every incentive to process claims on the merits.[99] Directors would be saved the embarrassment of litigating against their own companies. And finally, turning to solvent insurers would guarantee that meritorious reward claims would always be paid, even if corporations that gave rise to them subsequently went bankrupt.[100]

4. Assessment and Optimal Rewards

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[97] This problem is the mirror image of the failure to sue that underlies the derivative action device. One could thus think of parallel solutions, such as authorizing shareholders or an independent committee of the board to handle the rewards dispute. We assume that limits on out-of-court settlements would be both ineffective and undesirable.

[98] Given that reward amounts are capped and involve far smaller sums than most shareholder suits, we would expect reward insurance to be a small fraction of the price of a standard D&O insurance policy that firms virtually always purchase on behalf of themselves and their directors today.

[99] *Cf.* Robert Cooter & Ariel Porat, *Anti-Insurance,* 31 J. LEGAL STUD. 203, 218-221 (2002) (proposing an arrangement of anti-insurance for gains to cases in which the joint effort of multiple parties can produce gain).

[100] **Confirm whether legislation is required to ensure that this funding source will not be available to creditors.** *See also* Nan Roberts Eitel, *Now You Have It, Now You Don't: Directors' and Officers' Insurance after a Corporate Bankruptcy*, 46 LOY. L. REV. 585 (2000) (reviewing case law on whether D&O insurance coverage is considered bankruptcy estate property).

As a technical matter, reverse negligence appears to be workable and, on balance, superior to negligence-based liability for directors. It would be no more costly to administer than a negligence regime and far less likely to distort board decisionmaking or recruitment practices. In addition, reverse negligence would not disrupt established bodies of law and practice, such as the business judgment rule, the permissive conventions governing director indemnification and insurance, and the director exculpation provisions common in corporate charters. Relative to the status quo, the principal technical objection to a reward regime based on reverse negligence is also the principal objection to a negligence regime: the concern that courts won't get it right in evaluating director conduct in hindsight. But even if error rates were similar across the two reforms, the cost of errors would be much lower under a reward-based regime.

Relative to negligence-based liability, the principal drawback of reverse negligence is the possible misalignment of incentives that follows from the difficulty of picking optimal *levels* of rewards. Negligence regimes conventionally set damages equal to the harm resulting from misconduct, which is optimal assuming that all concerned have perfect information.[101] An analogous calculation for reverse negligence would set rewards equal to the expected value of the harm that a director prevents by meeting her monitoring obligations. We suspect, however, that fact finders operating with imperfect information can rarely get damages right under an ordinary negligence rule, much less divine optimal rewards under a reverse negligence regime.

Rather than setting rewards on a case-by-case basis, then, we suggest a fixed formula for rewards, such as a multiple of board fees or a fraction of annual CEO compensation. The resulting payouts need only be large enough to motivate even wealthy directors (after discounting for the likelihood of the occurrence of a triggering event) to monitor diligently and then initiate reward claims (taking into account litigation costs).[102] Payouts also ought to be small enough to temper public outrage. Any qualifying figure (between, say, $5 and $10 million for S&P 500 firms)

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[101] *See* generally Steven Shavell, *Strict Liability v. Negligence,* 9 J. LEGAL STUD. 1 (1980).

[102] Directors would presumably have their litigation costs reimbursed if the prevailed in earning a reward, but not if the failed to establish their claim.

will do as well as any other. After all, our objective with reverse negligence is not to produce optimal incentives, which very likely can't be done, but to establish a regime that outperforms negligence liability on the dimension of social cost and outperforms the status quo mix of weak liability and skewed market incentives on the dimension of quality—in this case, the quality of the monitoring incentives offered to outside directors.

Moreover, notwithstanding their failure to reflect precisely the social value of directors' oversight, payouts under the reverse negligence rule might produce sufficient oversight incentives. Many believe that optimal sanctions for directors' negligent oversight are far smaller than the harm associated with corporate failure.[103] Although a full analysis is beyond the scope of this paper, we suspect this intuition to be correct. Apart from the well-known result that negligence-based rules can produce optimal incentives even when sanctions differ from social harm,[104] the reason might be that the cost of optimal monitoring by directors is normally far smaller than the expected harm to the company associated with oversight failure. Beyond a certain threshold, therefore, enhancing liability exposure would produce substantial costs, but insignificant deterrence benefits[105] Finally, with respect to liability for securities fraud, it is unclear whether the existing measures of damages—loosely based on investors' out of pocket losses—accurately reflect social harm produced by a misleading disclosure.[106]

Apart from issues of accuracy in evaluating conduct and setting rewards, we expect political acceptability to be the principal obstacle to reverse negligence for directors. Adopting this regime would present significant issues of legal design. To

[103] *See, for example,* Black et. al., *supra* note 32 .

[104] Setting sanctions higher than harm will not induce directors to exercise over-caution since exercising the "due" level of care shields directors from liability. *See* Robert Cooter, *Prices and Sanctions,* 84 COLUM. L. REV. 1583 (1984); SHAVELL*, supra* note 94, at 251-252. When sanctions are lower than harm, a negligence standard would have a stronger incentive effect than strict liability. *See* Steven Shavell, *The Judgment-Proof Problem*, 6 INT. REV. LAW & ECON. 45, 48-49 (1986).

[105] More generally, one argue that there are rapidly diminishing marginal returns to increasing gatekeepers' sanctions (or rewards) beyond a certain threshold. Indeed, some believe that sanctions for other gatekeepers' oversight failures need not reflect social harm. *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: the Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (making this point with respect to auditors).

[106] *See, e.g.,* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639 (1996).

illustrate, lawmakers would have to determine whether this rule will be part of federal securities laws or state corporate law. Further, the rewards regime would have to be synchronized with the existing regime of director liability under both securities and corporate laws. This, in turn, would require answers to thorny procedural questions, such as whether a single court should handle both liability and reward disputes, and what the impact of settlements in shareholder lawsuits should be on a director's reward eligibility. Resolving these issues would require legislation and thus political support. The open question is whether a rule that invites courts to evaluate director conduct could possibly garner business support, and whether a regime that promises to reward (some) directors in the aftermath of corporate crises could win the understanding of the investment community the public at large.

B. Resignation under Protest

Although reverse negligence is sufficiently flexible to address all scenarios requiring director oversight, it is not precisely targeted. It does not specify precisely what a director must do to earn a reward, nor does it specifically target any of the key institutional disincentives to vigorous directorial monitoring. The second regime we propose—which we term the "resignation rule"—addresses both of these points. It specifies the behavior that directors need to follow to be eligible for rewards, and hence is more akin to a regulatory regime than a liability regime. [107] It also targets an important institutional disincentive to vigorous monitoring, namely, the risk that an active and concerned director might be sidelined on the board and hounded into resigning.

1. Nature of the Rule

The resignation rule would reward directors who lose their board seats in the line of duty. Under it, a director would become eligible for a reward when she filed a letter with the board (1) announcing her immediate resignation; (2) detailing her suspicions about an incipient crisis or hidden company misconduct; (3) identifying facts that gave rise to her suspicions; and (4) describing her efforts to prompt action

[107] For a comprehensive review of the relevant considerations for choosing between liability and regulation, see generally Steven Shavell, *Liability for Harm versus Regulation of Safety,* 13 J. LEGAL STUD. 357 (1984).

or investigation, which had either failed to move the board's majority or excited management's antagonism. If subsequent events vindicated the withdrawing director's suspicions, she would become eligible to receive a generous fixed reward large enough to cover her pain and suffering, several years of lost board fees, and application costs. To collect, the resigning director would merely submit her application and "exit letter" to the administrating authority, which might be a court (as was discussed in Part IV.A. above) or the board itself (as is discussed in Part IV.C. below). If the director's suspicions prove to have been well-founded, the company or its insurer would be forced to pay the reward unless it could be shown that the claimant had failed to communicate her suspicions before resigning, or that the board had immediately initiated action that should have made her resignation unnecessary. It may seem paradoxical that only failed gatekeeping efforts would be rewarded under this proposal, but in fact it is not. Directors will presumably monitor more vigorously if they are protected from the financial and reputational costs of retaliation by a recalcitrant management.

A difficult point in the application of the resignation rule, however, concerns the director who does not resign but is forced to depart because the company drops her name from the proxy as a candidate for reelection. A director might be excluded from the proxy for two reasons. On the one hand, management's allies on the board's nominating committee might be retaliating against an aggressive monitor, in which case she should be eligible for a reward. On the other hand, a director might be dropped for incompetence or disruptiveness, in which case she should not be encouraged to file an exit letter in the hope of receiving a reward. Ideally, directors who were excluded for the former reason should be eligible for rewards under the resignation rule. However, given the practical difficulty of distinguishing between the two reasons for exclusion, our tentative inclination is to exclude "non-nominations" from the resignation rule, and limit rewards to directors who in fact resign. Doing this ensures that a director pays for the option of seeking a reward

with her board seat, which makes the claim that she had fruitlessly sought to perform her monitoring duties more credible.[108]

2. Assessment

In comparison to the reverse negligence regime, the resignation rule offers both weaknesses and strengths. Its principal strength is that it clearly marks the path that directors must follow in order to earn rewards. The rule thus reduces uncertainty for directors *ex ante* and imposes few burdens *ex post* on reward administrators, who need only examine exit letters in light of subsequent events. Error rates are therefore likely to be low. Nevertheless, predictability comes at a cost. The resignation rule is unhelpful when, for example, a director discovers misconduct and remains on the board to participate in its rectification. Indeed, this rule is likely to encourage outside directors on the margin to resign prematurely. But we should not expect too much from the resignation rule. This rule does not seek to provide a comprehensive device for motivating director oversight. Rather, it is designed to rectify a single failing of the existing market for directors: management's de facto influence over the tenure of directors. Moreover, if its objectives are limited, so are its likely political costs. Finally, it should be noted that the resignation rule offers an ancillary enforcement benefit: an exit letter puts the board on notice of possible wrongdoing, and thus makes it more likely that directors who do not resign will face personal liability for neglecting their gatekeeping duties, even under the weak, knowledge-based liability regime that prevails today.

C. A Board-Administered Regime: Rewarding Leadership

Our third proposal combines elements of the previous two regimes, although its most distinctive feature is that it requires very little legal intervention. This proposal, which we term a "leadership regime," would authorize boards themselves to reward directors who exercised extraordinary initiative in times of company crisis. The justification for this would be similar to the rationale for rewarding departing

[108] The resignation requirement mitigates the collective action problem characterizing boards. Without the resignation requirement, directors who happen to leave the board for whatever reasons could deposit confidential letters without taking any further action. Under the proposed rule, only the director who resigns (or is being let go) will be entitled to a reward. Directors thus cannot free-ride the vigilance efforts of their colleagues without personally incurring the cost of leaving the board.

directors under the resignation rule: pursuing difficult issues and persistently asking tough questions in the face of management indifference or hostility goes well beyond what most directors expect to do when they join their boards.[109] Directors who make this extra effort and who spark major corporate changes as a result deserve the special recognition of shareholders.

Companies would opt into the leadership regime by means of a charter provision requiring boards to consider whether to reward directors who had exercised exemplary initiative. As with reverse negligence, the board's duty—and authority—to make leadership awards would arise after the occurrence of a triggering event, such as the involuntary departure of the company's CEO,[110] a major financial restatement, or an SEC investigation. The precise set of triggering events would be identified in each company's charter. In the best of worlds, moreover, the law would expressly provide for company charters to authorize leadership awards, much as Delaware law now blesses charters provisions that relieve directors of monetary liability for breach of the duty of care.[111] But the law's imprimatur would not be essential; inclusion of this regime in a respected code of best practices might be enough.[112] Even without legislative change, state law presently allows corporations to adopt the charter provisions necessary for establishing the leadership regime.

Because the board would make leadership awards, it would be important to limit the number of eligible directors to one or two per triggering event. The award, after all, is meant to recognize *individual* initiative relative to the behavior of other board members; it is not intended to allow the entire board to give itself a bonus for a job well done, which would undercut the function of the award as well as its political credibility. The number of recipients per period should limited explicitly, in the company's charter, and also implicitly, by setting a high threshold for eligibility. In

[109] *See, e.g.,* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 103-04 (1985); Donald Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability,* 89 GEO. L.J. 797, 797 (2001) ("the work of the board prizes consensus, not conflict").

[110] The company can define in advance the circumstances under which the resignation of a CEO would qualify as a forced resignation for our purposes. For example, the company can determine that a resignation in conjunction with events such as a restatement or the opening of an SEC investigation would be considered forced resignation.

[111] DGCL §102(b)7.

[112] **Address failure of market to offer such reward arrangements without legal intervention.**

particular, leadership awards should not be granted to directors who were merely non-negligent in supervising management, but to only to those who took the initiative and performed a leading role in sparking corporate change.

How big should a leadership award be? The considerations bearing on magnitude would be similar to those we reviewed in the discussion of the reverse negligence regime. The principal difference is that if boards rather than courts administered leadership awards, there would be more room to adjust their magnitude to the particular characteristics of a director's actions. For example, awards might be sums keyed to the CEO's total annual compensation, prorated for the duration of the crisis or recipient director's role in managing it. Thus, a director whose line of inquiry extended over a year and eventually resulted in the displacement of the CEO might merit a payment equal to the CEO's annual compensation, or several millions of dollars for an S&P 500 company.[113] Whatever the size of a leadership award, moreover, the corporation itself would presumably have to pay it, since the board could not both select the recipients and expect an insurer to foot the bill. For small firms, this might mean that the board should make provision ex ante to assure the availability of funds for a reward even if the company were to become insolvent.

1. Collusion and Retaliation

The real question with respect to the leadership regime is: why should it work at all? Why should the same institution that initially greets the prodding of an activist director with indifference or worse later become able to competently assess her eligibility for an award? Or, since we talk of incentives here, why would an activist director who faces initial resistance later expect the board to gratefully recognize her efforts to the tune of a million dollars or more?

The answer has several parts. First, boards are better positioned than courts to acquire the information necessary for evaluating director conduct, especially when the inquiry focuses on quite elusive actions, such as sparking a change.[114] If one or two directors mobilize their colleagues by in exposing wrongdoing that results in a material change in corporate governance—say, the displacement of the CEO or a restatement of the financials—the importance of the contribution that these directors

[113] **Reference recent figures** XX.
[114] **Reference recent board action to displace CEOs.**

make to the firm's governance will be obvious to everyone on the board, including the remaining directors and the new CEO.

The question, however, is whether boards could be relied upon to deny payments to those who do not deserve them (the collusion problem) and to make payments to those who do (the retaliation problem)? One important check on the quality of the board's decisionmaking is the fact that the corporate crises we suggest as triggering events – major financial restatements or involuntary terminations of CEOs—are typically accompanied by a change in the management team and major turnover on the board. The board after a crisis is unlikely to be the same as the board that presided before it.[115] In addition, a special committee of new or independent directors might be charged with making awards. Alternatively, the board could commit to obtaining shareholder approval of its awards. Finally, press coverage and intra-board rivalries would make it difficult to reward a single continuing director without good reason to do so.

The need for a fresh start in the wake of a regime change or major financial restatement is also the best guarantee that continuing directors will not retaliate against the activist director who uncovered wrongdoing or pressed for new management. Under the leadership regime, we would not permit law suits to compel boards to pay out awards, as this would implicate judicial participation and legislation that are contrary to the self-help character of this regime. Instead we would rely on the reputational value to the company of celebrating its honest and persistent directors, particularly when these directors continue on the board. In addition, if a new management team assumes control of the company in the wake of a crisis, as frequently happens, it will have every reason to feel grateful toward the directors sparked the fall of the old regime.

2. Assessment

Like the resignation rule considered in the previous section, the leadership regime is underinclusive. It is unlikely, for example, to provide incentives for

[115] *See, e.g.,* Kathleen A. Farrell & David E. Whidbee, *The Consequences of Forced CEO Succession for Outside Directors*, 73 J. BUS. 597 (2001) (finding increased likelihood of outside director turnover following forced CEO succession). *But see* Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, (October 19, 2005), *available at* www.ssrn.com (finding no evidence of abnormal turnover of outside directors on the boards of firms facing shareholder lawsuits).

directors to perform routine oversight tasks such as the hard work of the audit committee and particularly of its chair. The leadership regime is also the least precise of our three proposals in terms of the conduct it reaches. Directors would have a difficult time predicting ex ante just what to do to qualify for this reward. On the other hand, that fact that a company recognizes the possibility that individual initiative on the board may pay large dividends to the company and its shareholders will have an important incentive effect. On the other hand, the fact that the leadership is wholly voluntary and involves almost no necessary political involvement increases its political attractiveness. If the costs are low enough, there is every reason to adopt a reward regime even if we believe that its determinations will be noisy and its error rate high. The only reason to pause would be the risk that an inventive regime might cut in the wrong direction on balance – that, for example, promising to reward directors ex post for taking exceptional initiative might induce them to become uncooperative or adversarial ex ante. We judge this risk to be small, given the careful screening of directors for public companies, the powerful norms governing the behavior of individuals within small groups such as corporate boards, and the large ensemble of market and reputational incentives that act on corporate directors.

VI. CONCLUSION AND EXTENSIONS

The preceding Part addressed a family of reward regimes loosely based on the principle of reverse negligence as a means of motivating corporate directors. As we outlined above, regimes of this sort would reward directors for diligent monitoring during certain identifiable periods—generally speaking, periods of harm to the firm or managerial misconduct. At first glance, these regimes might seem to reward directors for bad outcomes. In fact, however, the association of rewards with bad outcomes is merely a matter of administrative economy. The true effect of these regimes is to induce outside directors to monitor most closely in precisely those periods when their vigilance is most needed—that is, when management is misbehaving. The likely result would be the deterrence of some misconduct (as managers desist from misbehaving for fear of being discovered), and the interruption of other wrongdoing midstream (as directors discover ongoing wrongdoing).

To be sure, a negligence-based liability regime could create the same incentives as the reward regimes we describe. But liability would pose obstacles to recruiting top-caliber directors and pressure boards toward risk-averse decisionmaking. Thus, expanding directorial liability would be not only far more costly than rewards, but also infeasible on political grounds. Over the years, the law has woven a cocoon of liability insulation around the director's oversight role, and this is unlikely to change any time soon. It follows that if legal reform is needed, a reward regime (of the reverse negligence type) may be the only practicable alternative.[116]

This paper focuses on outside directors. But would rewards outperform liability with respect to other kinds of gatekeepers as well?[117] A full answer is beyond the scope of this paper. Nevertheless, we would like to generalize about the qualities that might make a gatekeeper's role suitable for a reward regime by briefly returning to the characteristics that make outside directors attractive candidates for rewards. There are, by our count, at least four of these characteristics.

The first is the "lumpiness" of the director's services and the magnitude of the harm that they can prevent relative to the size of their own assets. Directors are individuals—not organizations[118]—who sit on a small numbers of boards for long periods of time. Conventional wisdom suggests that most directors are wealthy executives for whom directors' fees are small relative to personal assets, and therefore not strong motivators. But even if directors expect "large" compensation relative to their assets, the possible liability they would face (relative to their assets) under a negligence regime is larger still. As we have argued, this catastrophic liability risk, which cannot be fully insured if it is to provide monitoring incentives, produces recruitment difficulties and distorted decisionmaking.

Second, as we note above, directors have two functions: they are monitors of managers and advisers of managers in business decisionmaking. Personal liability,

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[116] The other alternative—which lawmakers currently follow—is regulating board functions and structure. *See* sources cited note 23, *supra*.

[117] We assume that rewards lose their appeal with respect to primary wrongdoers, at least with respect to intentional misconduct.

[118] In some jurisdictions, directors are also organizations. The possibility of organizational directors raises additional gatekeeper alternatives that parallel those we discuss below in the context of accountants.

which arguably enhances the director's monitoring performance, simultaneously distorts her performance as an advisor and architect of corporate policy. In theory, paying rewards only in the aftermath of certain harmful events also would distort the director's performance by motivating her to select risky ventures for the company. Rewards, however, are less likely to degrade directorial advice because directors have neither the power—given their limited responsibility for initiating projects—nor the inclination—given the severe market and legal consequences that follow misconduct—to urge overly risky business strategies. Put differently, by virtue of their organizational roles, directors are asymmetrically susceptible to distorted decisionmaking on the side of excess caution rather than risk-taking.

A third characteristics that makes directors well-suited to a reward regime is the fact that they act collectively in a small group, rather than individually. Monitoring by groups is inevitably subject to free riding and other collective action problems. Even if all directors faced equal liability costs for failing to challenge a problematic course of action pressed by the CEO, each director might refrain from making a challenge—assuming a challenge would risk costly retaliation—in the hope that another director would step up to the plate. This problem is exacerbated by the pressure on directors to settle shareholder lawsuits, thereby preventing courts from scrutinizing the performance of individual directors. By contrast, individualized compensation under a reward regime would overcome this collective action problem.

Finally, and perhaps most importantly, the difficulty of describing ex ante precisely what a director must do in fast-moving business circumstances makes directors particularly suitable candidates for a reward regime. Uncertainty as to the precise content of a director's duty under a negligence rule leads to a high risk of error, which in turn aggravates the secondary liability costs of recruitment and distorted decisionmaking. By contrast, even if it left error rates unchanged, a reward regime would eliminate liability costs associated with recruitment and reduce the costs of distorted decisionmaking. Moreover, because the prospect of rewards will motivate directors to reveal rather than conceal information about their own behavior, a reward regime is likely to lead to more informed evaluations of directorial conduct and, therefore, fewer errors.

The importance of these four elements of the outside director's role in favoring reward-based incentives over liability can be gleaned from the fact that at least one class of participants in corporate governance—auditors—have long been held liable under a negligence regime for monitoring failures. Auditors stand at the opposite end of the spectrum from directors on all four characteristics that recommend a reverse negligence regime. The auditors of public companies are large firms rather than individuals, with deep pockets and diversified professional relations that extend to hundreds or even thousands of clients.[119] Outside auditors are gatekeepers pure and simple. Their sole function is to monitor the firm's financial statements; they are not involved in other aspects of the firm's decisionmaking.[120] In addition, auditors qua organizations are unitary entities; they do not face conventional collective action problems, even though—as the fate of Arthur Andersen in the Enron debacle suggests—accounting firms can face severe agency problems.[121] Finally, auditors pursue a highly elaborated methodology that can be described ex ante and evaluated ex post with far more precision than a director's duty of care. On all dimensions, then, liability under a negligence rule makes far more sense for auditors than for outside directors. Correlatively, a reward regime of the reverse negligence variety appears less appealing for auditors. Without auditor liability, the risk of implicit collusion between auditors in search of rewards and managers intent on misrepresentation seems unacceptably large; with auditor liability, there is no need for a parallel reward regime.

This analysis tells us that auditors—in contrast to outside directors—are poor candidates for a reverse negligence regime. It does not imply, however, that the

[119] *But see* Floyd Norris, *Will Big Four Accounting Firm Survive in a World of Unlimited Liability?,* N. Y. TIMES (Sept. 10, 2004) at C1 (reporting concern that auditor liability would cause audit firms to become insolvent).

[120] In fact, lawmakers impose various restrictions on auditors' ability to provide their clients with non-audit services. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* 114 YALE L.J. 1521, 1533-38 (2005). The Sarbanes-Oxely Act introduced a requirement that auditors attest to managerial assessments of internal controls and report their conclusions publicly. *See* SOX, § 404(b) XX. On the implications of this new internal control audit requirement, see Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System*: *Control Disclosure, Auditor Liability and Safe Harbors,* 55 HASTINGS L. J. 1449 (2005).

[121] *See* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry,* 48 VILL. L. REV. 1167 (2003)

existing regime provides auditors with adequate incentives.[122] Nor does it answer the larger question of whether the law might improve auditor incentives with a different sort of reward regime. Here the possibility of "reverse strict liability" comes to mind, or, alternatively, of a regime that allocated rewards on an aggregate basis, according to a normalized measure of financial restatements among all of an auditor's clients. We list these possibilities not because we endorse them, but because they demonstrate that augmenting the traditional liability regimes with a full set of possible legal sanctions, both negative and positive, can provide potentially valuable tools for fixing the incentives of gatekeepers that have not yet been analyzed—or even imagined.

[122] In fact, the proper scope of auditor liability appears to be on of the most controversial issues facing policymakers in the aftermath of recent accounting scandals. *See generally* John C. Coffee, Jr., *supra* note **Error! Bookmark not defined.**; Joshua Ronen*, Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited,* 8 STAN. J. LAW BUS. & FIN. 35 (2002) (advocating a regime of financial statement insurance that would replace the existing audit system)