Would Changes in the Rules for Director Selection and Liability Help Public Companies Gain Some of Private Equity's Advantages?

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It is widely believed that companies owned by private-equity sponsors have significant advantages over public companies. Among the advantages of private equity cited by commentators are: (1) better governance and a greater willingness to take risks, (2) the ability to focus on long-term issues and a more stable shareholder base, (3) the ability to attract better management talent, (4) creating a sense of urgency, (5) the ability to use leverage more effectively, (6) avoiding the costs imposed by the Sarbanes-Oxley Act, and (7) freedom from shareholder suits. It would be helpful if public companies could gain some of these advantages. This Article examines whether changes in existing legal rules governing how public company directors are chosen and the extent to which public company directors can be held liable for damages if they do not have a conflict of interest would be likely to increase the ability of public companies to obtain some of the benefits that companies owned by private-equity sponsors appear to have. My conclusion is that, while changing the rules for selecting directors would not be worthwhile, a reduction in the potential liability of directors for damages in situations in which they do not have a conflict of interest would be likely to increase the ability of public companies to mirror the effectiveness of private-equity portfolio companies without creating other problems that would be unacceptable.

INTRODUCTION

It is widely perceived that companies owned by private-equity sponsors or their affiliates ("PE Portfolio Companies") have significant advantages over public companies.[1] These advantages are thought to be

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1 See Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J Fin Econ 217, 218–19 (1989) (showing through statistical analyses that firms that change from public to private ownership have higher average returns, including a 20 percent increase in operating income relative to assets and 50 percent higher net cash flows when compared to the industry in general); Donald J. Gogel, *What's So Great about Private Equity*, Wall St J A13 (Nov 27, 2006) (explaining that PE firms, unlike public companies, are not bound by multiple-owner constituencies and regulations); Bill George, *Private Equity, Public Gain*, Bus Wk Online (Aug 21, 2007), online at http://www.businessweek.com/careers/content/aug2007/ca20070821_995464.htm (visited Jan 11, 2009) (arguing that PE companies have more dynamic management with a longer-term outlook); Jack Welch and Suzy Welch, *Private Equity Redux*, Bus Wk 126 (July 9, 2007) (explaining why PE companies are more competitive than public companies).

the key to why private-equity buyers frequently can pay more than strategic buyers for target companies and produce superior returns.[2] Although some commentators have questioned whether private-equity investments in fact produce higher net returns than the stock market,[3] it seems likely that, at a minimum, the best private-equity-owned firms are able to produce superior returns.[4] That private equity has invented a better mousetrap certainly appears to be the conclusion of institutional investors that have poured a torrent of money into private equity, a trend that may have slowed during the 2008 financial crisis but that appears likely to continue over the medium and long term.[5] While conceding that future research may undermine the conclusion that PE Portfolio Companies have significant advantages over public companies, I will assume that it is true. This Article will examine whether public companies could import some of private equity's advantages through changes in existing legal rules regarding the selection and liability of directors of public companies.

I. THE ADVANTAGES OF GOING PRIVATE

Although almost everybody agrees that private equity has advantages over public companies, different commentators see different factors as being important. With that caveat, the list of private equity's advantages includes: (1) better governance and a greater willingness to take risks, (2) the ability to focus on long-term issues and a more stable shareholder base, (3) the ability to attract better management talent,

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2 See Robert Weisman, *Raid Corporate Pirates' Arsenal: Public Firms Urged to Borrow Buyout Tactics*, Boston Globe C1 (Nov 11, 2007); Geoffrey Colvin and Ram Charan, *Private Lives*, Fortune 190 (Nov 27, 2006).

3 See Steven N. Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J Fin 1791, 1792 (2005).

4 See id; Paul A. Gompers and Josh Lerner, *Risk and Reward in Private Equity Investments: The Challenge of Performance Assessment*, 1 J Private Equity 5, 9 (Winter 1997).

5 See Mark O'Hare, *Cautious Optimism amid the Turmoil*, 9 Private Equity Rep 5 (Debevoise & Plimpton Fall 2008), online at http://www.debevoise.com/files/Publication/dce46cb2-b93c-4d49-9dc0-77ddd792912d/Presentation/PublicationAttachment/1d4c1b6b-b379-49b1-833e-a74282a4b89/pe%20report%20fall%202008.pdf (visited Jan 11, 2009) (citing a survey of one hundred institutional investors that concluded that, while fundraising would be depressed in 2008–2009, it would recover thereafter and that 54 percent of the institutions surveyed believed that the trend of institutions increasing their allocations to private equity would continue); Lauren Silva, *Smart Crowd, Harsh Reality* NY Times B2 (Dec 8, 2008) (reporting that some endowments and pension funds are selling investments in private equity at a discount); Raquel Pichardo, *CalPERS to Shift $44 Billion: Fund Moving 18% of Assets to International, Alternative Strategies*, Pensions & Investments 1 (Dec 24, 2007), online at http://www.pionline.com/apps/pbcs.dll/article?AID=/20071224/PRINTSUB/166724513/1031/TOC (visited Jan 11, 2009) (reporting that CalPERS, the California pension investment fund, will be shifting more money into private equity); Grace Wong, *Private Equity Still Drawing Big Investors*, (CNN Aug 15, 2007), online at http://money.cnn.com/2007/08/15/markets/pe_investors/index.htm?postversion=2007081510 (visited Jan 11, 2009) (reporting that PE firms are continuing to raise money for buyouts despite the credit crunch).

(4) creating a sense of urgency, (5) better use of leverage, (6) avoiding the costs imposed by the Sarbanes-Oxley Act of 2002,[6] and (7) avoiding shareholder suits.

A. Better Governance and a Greater Willingness to Take Risks

In PE Portfolio Companies, there is much greater contact between equity owners and management than there is in public companies.[7] This helps PE Portfolio Companies solve one of the central problems of public corporations: the inability of widely dispersed equity owners to adequately ensure that management is competent, is not running the company for its own benefit, and is not committing fraud.[8] Beginning with Adolph Berle and Gardiner Means, critics have noted the agency problem for public companies and have suggested ways of dealing with it.[9]

Public companies have attempted to alleviate the agency problem by adding outside directors who are both independent of management and likely to be disinterested in transactions that present conflicts of interest for management.[10] The New York Stock Exchange (NYSE) and

6 Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745, codified in relevant part at 15 USC § 7201 et seq.

7 See Gogel, *What's So Great about Private Equity*, Wall St J at A13 (cited in note 1) (describing a number of the other advantages of going private).

8 See generally Edward Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Georgetown L J 445, 453 (1991) (describing and analyzing classic agency and collective action problems in the corporate context).

9 See Adolph A. Berle, Jr and Gardiner C. Means, *The Modern Corporation and Private Property* 69 (Harcourt, Brace 1932) (discussing the separation of ownership of wealth and control of wealth in the corporate structure). See also William T. Allen, *Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law* *4–10 (Comparative Research in Law & Political Economy Research Paper No 06/2008, June 2008), online at http://ssrn.com/abstract=1105591 (visited Jan 11, 2009) (providing an overview of the changing relationship between corporate ownership and management over the course of the twentieth century); Lawrence A. Hamermesh, *Twenty Years after* Smith v. Van Gorkom*: An Essay on the Limits of Civil Liability of Corporate Directors and the Role of Shareholder Inspection Rights*, 45 Washburn L J 283, 284 (2006) (discussing the ongoing impact of the *Van Gorkom* decision on shareholder actions alleging directors' violations of their duty of care); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv L Rev 833, 836 (2005) (arguing for a reallocation of power among shareholders and owners by allowing shareholders to initiate changes to a company's basic corporate governance arrangement); Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 Harv L Rev 1735, 1736 (2005) (arguing that Bebchuk's shareholder empowerment idea is inefficient and that a corporate director primacy model is best).

10 "Disinterested" directors are those who "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Williams v Geier*, 671 A2d 1368, 1377 n 19 (Del 1996). In addition to determining whether a director is "disinterested," it is also important to determine whether a director is "independent." A director is not independent if he is "dominated or otherwise controlled by an individual or entity interested in the transaction." *Grobow v Perot*, 539 A2d 180, 189 (Del 1988). Compare also Peter J. Wallison, *All the Rage: Will Independent Directors Produce Good Corporate Governance?* (American Enterprise

Nasdaq Stock Market rules now require that a majority of the directors of listed companies be independent of management.[11] The Sarbanes-Oxley Act created a number of rules that audit committees, which must be entirely composed of independent directors, must follow in keeping watch on management.[12] These self-regulatory organization and statutory rules are designed to prevent more scandals involving fraud like the ones that brought down Enron and WorldCom.

There appears to be general agreement that these rules have helped curtail fraud. However, a number of observers have asserted that a consequence of these rules has been that public company boards focus on process-directed methods of preventing fraud or other misconduct rather than focusing on adding value to the company's business and taking appropriate risks.[13] This exacerbates another problem that many public company boards face—that directors own only a nominal amount of the company's stock and therefore have little "skin in the game."[14] A director with little direct financial interest has an incentive to worry more about preventing misconduct—for which he can be held liable—than in taking risks that might (but of course also might

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Institute for Public Policy Research, Jan 2006), online at http://www.aei.org/publications/pubID.23648/pub_detail.asp (visited Jan 11, 2009) (examining the effects of outside directors on corporate performance and suggesting that independent directors' lack of incentives may lead to higher rates of fraud and ineffective corporate governance), with Business Roundtable, *Corporate Governance and American Competitiveness*, 46 Bus Law 241, 249–50 (Nov 1990) (suggesting that effective boards of directors should possess independent directors with varying backgrounds and no management responsibility within the corporation).

11 See SEC, *NASD and NYSE Rulemaking: Relating to Corporate Governance*, Release No 34-48745, B(1) (Nov 4, 2003), online at http://www.sec.gov/rules/sro/34-48745.htm (visited Jan 11, 2009).

12 See SEC, *Standards Related to Listed Company Audit Committees*, Release No 34-47654 (Apr 9, 2003), online at http://www.sec.gov/rules/final/33-8220.htm (visited Jan 11, 2009), codified at 17 CFR § 228 et seq; SEC, *NASD and NYSE Rulemaking* (cited in note 11).

13 See Tom Perkins, *The "Compliance" Board*, Wall St J A11 (Mar 2, 2007) (observing that, as boards go public and become subject to Sarbanes-Oxley, they become more concerned with regulatory compliance and less concerned with growing the firm and making tough decisions); Symposium Transcript, *Director Liability*, 31 Del J Corp L 1011, 1025 (2006) ("Symposium Transcript") (Robert Mendelsohn) (suggesting that new corporate governance rules promulgated after the collapse of Enron and WorldCom are making directors more risk averse due to the specter of lawsuits).

14 See, for example, Welch and Welch, *Private Equity Redux*, Bus Wk at 126 (cited in note 1); Elizabeth Cosenza, *The Holy Grail of Corporate Governance Reform: Independence or Democracy?*, 2007 BYU L Rev 1, 25 (describing the majority view that equity ownership enhances directors' incentives to actively monitor management); Charles M. Elson and Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 Wake Forest L Rev 855, 881 (2003) ("Independence gives a director objectivity but it is equity ownership that provides the incentive to exercise that objectivity"); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Del J Corp L 540, 555–56 (1985) (arguing that while outside directors may serve as effective evaluators of management conflicts of interest, their distance from the company and lack of interest can create problems).

not) lead to future gains. He will be blamed if taking the risks does not pan out but will not receive a significant reward if the gains materialize.[15]

Tom Perkins, a leading Silicon Valley venture capitalist who has served on a number of public company boards,[16] has pointedly expressed this view. Perkins asserts that most public companies have "Compliance Boards" that are overly concerned with following the right process in adhering strictly to the applicable rules. They do not have "Guidance Boards," typical of venture capital portfolio companies, that attempt to be a sounding board for management in helping the company compete in the marketplace.[17] In Perkins's view:

> The Guidance Board is typically very involved: Strategy, tactics, hiring, firing, technology and engineering reviews are normal. The board may meet monthly and the chairman may visit the company on a weekly basis. Normally the board is small. Directors tend to be no-nonsense people who expect to be listened to and who take responsibility for their decisions—and sometimes this intense involvement is annoying to the management. But the results can be more than gratifying.
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> But once the startup becomes a public company, a strange metamorphosis commences. It begins to be assumed that the public investors have different goals than the original backers. The continuing creation of shareholder value—the primary goal of the venture capitalist—while not forgotten, must take its place along side a host of other considerations.
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> Above all, when the venture goes public, the emphasis shifts, with the inevitability of the tide, to obeying the laws pertaining to

15 See Bernard Black, Brian Cheffins, and Michael Klausner, *Outside Director Liability*, 58 Stan L Rev 1055, 1059 (2006) ("Too much fear of liability, therefore, may reduce rather than enhance the quality of board decisions."); Anne Fisher, *Board Seats Are Going Begging*, Fortune 242 (May 16, 2005), online at http://money.cnn.com/magazines/fortune/fortune_archive/2005/05/16/8260173/index.htm (visited Jan 11, 2009) (noting that the average pay for a Fortune 1000 director is $57,000 per year and the potential personal liability is unlimited); Laura Lin, *The Effectiveness of Outside Directors As a Corporate Governance Mechanism: Theories and Evidence*, 90 Nw U L Rev 898, 916–17 (1996).

16 Tom Perkins served on the boards of Hewlett-Packard, Applied Materials, Corning, Genentech, News Corporation, Philips, and Tandem Computers, among others. See Kleiner, Perkins, Caufield & Byers, *Tom Perkins*, online at http://www.kpcb.com/team/index.php?Tom%20Perkins (visited Jan 11, 2009).

17 See Perkins, *The "Compliance" Board*, Wall St J at A11 (cited in note 13).

> traded companies. The SEC, the stock exchange rules and most recently the Sarbanes-Oxley act, come into play.[18]

Similar criticisms of public company boards have been expressed by Jack Welch, the former CEO of General Electric,[19] and by Robert Mendelsohn, the former CEO of Royal & Sun Alliance Insurance Group.[20]

PE Portfolio Companies tend to have the Guidance Boards that are favored by Perkins. The directors are deeply engaged and come to know a great deal about the business. As representatives of the PE sponsor or its affiliate that controls the company, the directors have an enormous financial incentive to promote the economic success of the enterprise. They are right on the scene, and therefore have less need than public directors to worry that management will stray from its appointed tasks. In addition, they do not need to concern themselves with stock exchange rules or the Sarbanes-Oxley Act, which generally will not be applicable to PE Portfolio Companies.

B. The Ability to Focus on Long-term Issues and a More Stable Shareholder Base

The funds organized by private-equity sponsors tend to have equity holders who have committed to long-term ownership. This is partly a function of requirements imposed at the time these funds are structured and partly a reflection of the willingness of the investors in these funds to commit funds for a long time. The result is that PE Portfolio Companies do not need to "meet their numbers" on a quarterly basis[21] and otherwise focus on short-term goals at the expense of long-term goals.[22] The

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18 Id.

19 Welch and Welch, *Private Equity Redux*, Bus Wk at 126 (cited in note 1) ("In private equity, board meetings center not on questions like, 'Has anything happened to embarrass us lately?' but on comments such as 'Forget the quarter. Make the investment.'").

20 See Symposium Transcript, 31 Del J Corp L at 1025 (cited in note 13) (Robert Mendelsohn) (describing directors' reluctance to serve on public boards because of the risk of liability).

21 See Greg Myers, *Look Past Private Equity's Bad Rap*, Plastics News 6 (July 16, 2007) (noting that "[p]rivate equity allows for steadier, longer-term growth" and that "[p]ublicly traded companies are held to quarterly goals, whereas private equity allows flexibility to make strategic decisions that can pay off in the long run"). See also Josh Lerner and Anuradha Gurung, eds, *Globalization of Alternative Investments Working Papers Volume 1: The Global Economic Impact of Private Equity Report 2008* viii (World Economic Forum 2008), online at http://www.weforum.org/pdf/cgi/pe/Full_Report.pdf (visited Jan 11, 2009) (noting that "[p]rivate equity investors have a long-term ownership bias" and that the "private status, according to some, enables managers to proceed with challenging restructurings without the pressure of catering to the market's demands for steadily growing quarterly profits, which can lead to firms focusing on short-run investments").

22 See Congressional Quarterly, *Tax Breaks on Compensation for Equity-fund Managers: Statement of Bruce Rosenblum, Chairman of the Private Equity Council*, CQ Congressional Testimony (July 31, 2007) ("Without the pressures from public shareholders looking for short term gains, [private-equity shareholders] can focus on what is required to improve the medium to long-term performance of the company.").

inability of public company boards to take the same approach has been cited as one of the disadvantages of being public.[23]

Recently, a number of PE Portfolio Companies have been quickly resold or have conducted initial public offerings (IPOs) shortly after going private. These transactions, which have been widely criticized,[24] demonstrate that, despite the ability of private-equity sponsors to take a long-term view, they will not always do so.

C. Ability to Attract Better Management Talent

PE Portfolio Companies appear able to pay more and offer better working conditions to talented managers than public companies can.[25] The inability of public companies to compete on compensation is partly because of their inability to offer as much equity as PE Portfolio Companies can provide and partly because of the need to make management compensation public, which creates an effective ceiling on what public company boards can realistically pay management. There is a widespread view that public company managers are overpaid, both relative to other employees and to the rest of society, and that managers continue receiving high pay even when their performance is poor.[26] This has given rise to the "Say on Pay" movement in which shareholders are seeking

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23 See id.

24 See *Is Private Equity Working in the Public Interest?*, Caterer and Hotelkeeper 1 (Aug 2, 2007) (noting that "private equity companies have been slammed by trade unions as amoral asset strippers" and "criticized by [managing partners] and others for tax avoidance (which, unlike tax evasion, is legal)"); Richard Reeves, *The Storm over 'Locusts*,' Mgmt Today 25 (May 1, 2007) ("These companies are dubbed 'barbarians', 'asset-strippers' and 'locusts' by trade unions."); Danielle Fugazy, *Private Equity Lobbying Group Gives the Market a Voice: Representation Could Have Its Advantages, but Small and Mid-size Players Hope They Won't Start Feeling the Heat from Regulators*, M&A J 2 (Mar 1, 2007) (noting that private equity has been criticized for doing high-profile buyouts like the Hertz deal that was "simply buy, strip and flip, and the fact that Hertz was taken public so soon after the [leveraged buyout] has sent the wrong message to the world about what private equity is about"); Bertrand Benoit, *German Deputy Still Targets 'Locusts*,' FT.com (Fin Times Feb 14, 2007), online at http://www.ft.com/cms/s/55437712-bc4e-11db-9cbc-0000779e2340.html (visited Jan 11, 2009) (discussing the push by German politicians to increase regulation and transparency of hedge funds based on their concerns about the increased market power these investors possess).

25 See Colvin and Charan, *Private Lives* at 190 (cited in note 2) (noting that private-equity firms focus management "extraordinarily well, provide strong incentives, free them from distractions, give them all the help they can use, and let them do what they can do"). See also *Practitioner Note: Current Issues in Executive Compensation*, 3 NYU J L & Bus 519, 548–49 (2007); Andrew Ross Sorkin and Eric Dash, *Private Firms Lure C.E.O.'s with Top Pay*, NY Times A1 (Jan 8, 2007) (reporting that CEOs of public companies have opportunities to double or triple their compensation at private-equity firms).

26 See, for example, Colvin and Charan, *Private Lives* at 190 (cited in note 2) ("[A]ny public company that paid, say, a $20 million signing bonus or offered a package with a potential nine-figure payout would be pilloried by governance activists and the press."). See also *Practitioner Note*, 3 NYU J L & Bus at 548 (cited in note 25) (noting that the popular media portrays executive compensation as broken and executives as overly greedy).

the right to cast a nonbinding vote on managers' pay each year.[27] The perception that managers' compensation is immune to poor performance may have been more true a few years ago than it is now, given the substantial number of public company CEOs who have recently been terminated.[28] However, it remains the case that public company directors face effective constraints in paying for talent, even if making that payment would be the best thing for shareholders.

D. Creating a Sense of Urgency

Boards of public companies are often perceived to be in a rut, unwilling or unable to make dramatic changes even if they would be beneficial. Part of the explanation for this phenomenon, when it applies, may be the directors' reluctance to make changes that would benefit shareholders in the long run but would have adverse short-term effects.[29] The directors of PE Portfolio Companies are often more willing than public company directors to break the hold of inertia and impel management to make changes that will substantially increase the company's profitability. Some commentators have argued that these changes are made on the backs of the employees,[30] although the

27 See Phred Dvorak, *Theory & Practice: More Holders Want Say on Executive Pay*, Wall St J B8 (Apr 28, 2008) (reporting that "Say on Pay" votes are becoming more popular and discussing the potential downsides to shareholder input on executive compensation); Claudia H. Deutsch, *Say on Pay: A Whisper or a Shout for Shareholders?*, NY Times BU9 (Apr 6, 2008) (noting that the movement calling for a retrospective thumbs-up or thumbs-down on historic pay to management has its first victory this year with Aflac giving its shareholders a nonbinding vote on executive compensation).

28 For example, Wachovia terminated CEO G. Kennedy Thompson in June 2008; JetBlue's board of directors terminated David Neeleman in May 2007; and Bear Stearns terminated James Cayne in January 2008. See Tomoeh Murakami Tse, *Wachovia Ousts Top Executive*, Wash Post D1 (June 3, 2008); Dan Schlossberg, *Thin Ice Cracks for JetBlue's Founder*, ConsumerAffairs.com (May 10, 2007), online at http://www.consumeraffairs.com/news04/2007/05/jetblue_ceo.html (visited Jan 11, 2009); Landon Thomas Jr, *Extrication Time*, NY Times C1 (Jan 9, 2008).

29 See Colvin and Charan, *Private Lives* at 190 (cited in note 2) ("Making a big new investment or taking a write-off for a plant closing may be the best thing for the business, but many public companies hesitate because such actions could cause the stock to tank.").

30 See Steven J. Davis, et al, *Private Equity and Employment*, in Lerner and Gurung, eds, *Globalization of Alternative Investments*, 43, 45–54 (cited in note 21) (noting that employment falls more rapidly at companies which have been bought by private-equity firms than at comparable public companies and asserting that private-equity firms "act as catalysts for creative destruction" by "shed[ding] presumably unprofitable segments" of the target companies). See also Walter Kiechel III, *Private Equity's Long View*, 85 Harv Bus Rev 18, 19 (July/Aug 2007) (noting that private-equity firms reduce costs relentlessly, sell off ancillary businesses, and are known among strategy consultants as "the most economically rational of owners"). Other industry officials have noted that once a private-equity firm makes the initial employment cuts, "[e]mployees left behind are doing more work, looking over their shoulders, [and] feeling stressed." Ianthe Jeanne Dugan, *In the Trenches: How a Blackstone Deal Shook Up a Work Force—Layoffs at Travelport, Dividend for Investors; 'On Pins and Needles,'* Wall St J A1 (July 27, 2007). These post-transaction layoffs also cause remaining employees to feel they "are all on pins and needles. . . . Everybody here feels it's only a matter of time." Id.

overall effect on employees of private-equity ownership does not appear to be settled.[31]

E. Better Use of Leverage

PE Portfolio Companies tend to be substantially more leveraged than public companies.[32] If the business is successful and the loan is repaid, the additional use of leverage will frequently yield higher returns to the investors in PE Portfolio Companies than those to public company shareholders.[33] Obviously, increased borrowing also increases the risk of insolvency if the business is not successful. However, while some PE Portfolio Companies, including a number acquired in recent buyouts, have filed for bankruptcy or are struggling,[34] in the aggregate and over time the use of additional leverage by PE Portfolio Companies appears to have been a successful strategy.[35]

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31 See Davis, et al, *Private Equity and Employment* at 44 (cited in note 30). Andy Stern, President of the Services Employees International Union, has also "found he had leverage with the buyout firms, in part because so much of their funding comes from union-dominated public pension funds . . . [which] makes the [private] firms more open to union arguments than most public companies." Alan Murray, *Labor Leader, Buyout Kings Speak Same Language*, Wall St J A2 (May 30, 2007) (reporting on an interview with Andy Stern).

32 See Kiechel, 85 Harv Bus Rev at 19 (cited in note 30). See also *Why the Credit Crunch Should Help Corporate M&A*, Knowledge@Wharton (May 28, 2008), online at http://knowledge.wharton.upenn.edu/article.cfm?articleid=1969 (visited Jan 11, 2009) (noting that "[e]xtensive use of leverage has long been a distinguishing characteristic of the LBO firms, whose equity typically comprises just 20% to 30% of total capital," while for public corporations "equity is more likely to comprise 70% to 89% of the total").

33 See Colvin and Charan, *Private Lives* at 190 (cited in note 2) ("In the 12 months through [June 2005], PE firms returned 22.5%, vs. 6.6% for the S&P 500, says Thomson Financial. Over the past ten years, the score is 11.4% a year vs. 6.6%; over the past 20 years, 14.2% vs. 9.8%."); Alan Shipman, *Private Equity: Return of the Prodigal Sum?*, FinanceWeek (Feb 25, 2008), online at http://www.financeweek.co.uk/item/5943 (visited Jan 11, 2009). But see *Private Equity May Not Be As Lucrative As It Seems*, 1 Capital Matters 1, 1 (Oct 2007), online at http://www.law.harvard.edu/programs/lwp/pensionsletter_new_Oct5_FINAL.pdf (visited Jan 11, 2009) (noting that private equity "looks less glamorous over the longer term, besting the S&P by 1.8% [ ] over the past ten years and by 3.7% over the past twenty"); Kaplan and Schoar, 60 J Fin at 1792 (cited in note 3) (finding that increasing levels of risk were correlated with increased returns for equity funds).

34 See Lauren Silva, *Red Flags Fly after Big Buyouts* NY Times B2 (Nov 24, 2008) (noting that a number of large companies recently acquired by private equity funds are struggling); Carolyn Murphy, *Dealwatch: PE-backed Bankruptcies*, The Deal.com (June 9, 2008), online at http://www.thedeal.com/dealscape/2008/06/dealwatch_pebacked_bankruptcie.php (visited Jan 11, 2009) (noting that many private-equity portfolio firms are filing for bankruptcy).

35 One study has noted that "6% of buyout transactions end in bankruptcy or financial restructuring" and that

> while this number implies a lower success rate compared to bankruptcy rates among US publicly traded firms, it also suggests that buyouts have a lower average default rate than US corporate bond issuers, and substantially lower than the default rates among average junk bond issuers. Hence, given the high leverage in these transactions, bankruptcy rates of LBOs seem relatively modest.

It is not entirely clear why public companies generally use less leverage than PE Portfolio Companies, but the best explanation appears to be that it is personally less risky for public company directors to rely on equity rather than debt capital. If the company is forced into bankruptcy, the directors may be exposed to liability on a number of theories[36] and would at a minimum suffer a blow to their reputations. Since the upside from borrowing is limited for the majority of directors that own only a small number of shares, they have an incentive to avoid the risks that borrowing creates.

F. Avoiding the Costs Imposed by the Sarbanes-Oxley Act

Public companies must bear the costs of complying with the Sarbanes-Oxley Act. These costs can be substantial, in terms of both out-of-pocket expenditures and the time that must be spent by employees.[37] Private companies are not subject to Sarbanes-Oxley, and a number of commentators and persons connected with public companies have observed that the ability to become free from the statute's constraints is a significant advantage of going private.[38] The benefit of avoiding the cost of compliance with Sarbanes-Oxley is greater for smaller companies because that cost is greater relative to their revenue stream.[39]

Public companies must also bear substantial costs in complying with securities laws other than the Sarbanes-Oxley Act. However, the advantage of going private in eliminating these costs will be reduced if

Per Strömberg, *The New Demography of Private Equity*, in Lerner and Gurung, eds, *Globalization of Alternative Investments* 3, 4–5 (cited in note 21).

36 See Henry T.C. Hu and Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 Colum L Rev 1321, 1336 n 49 (2007).

37 See Joseph A. Grundfest and Steven E. Bochner, *Fixing 404*, 105 Mich L Rev 1643, 1646–47 (2007) (noting that first-year implementation costs of § 404 of the Sarbanes-Oxley Act, which authorizes the regulation of companies' internal controls, were eighty times greater for larger companies than what the SEC had estimated, and sixteen times greater for smaller companies); Deborah Solomon, *Corporate Governance (A Special Report)—At What Price? Critics Say the Cost of Complying with Sarbanes-Oxley Is a Lot Higher Than It Should Be*, Wall St J R3 (Oct 19, 2005) (discussing the costs of compliance, including the need to commit staff to run various tasks to ensure compliance with internal controls requirements); John Thain, *Sarbanes-Oxley: Is the Price Too High?*, Wall St J A20 (May 27, 2004) (arguing that one factor driving foreigners away from the US capital markets is the need for Sarbanes-Oxley compliance).

38 See Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of Sox 404*, 29 Cardozo L Rev 703, 734 (2007) (noting the decrease in IPOs due to costs of Sarbanes-Oxley compliance); Maurice R. Greenberg, *Regulation, Yes; Strangulation, No*, Wall St J A10 (Aug 21, 2006) (giving examples of companies being pushed back from public listing because of the costs of Sarbanes-Oxley compliance).

39 See Grundfest and Bochner, 105 Mich L Rev at 1646–47 (cited in note 37); Alan Murray, *Fees May Be Costing Wall Street Its Edge in Global IPO Market*, Wall St J A2 (Aug 2, 2006); Neal L. Wolkoff, *Sarbanes-Oxley Is a Curse for Small-cap Companies*, Wall St J A13 (Aug 15, 2005).

a PE Portfolio Company retains public debt, which many do, and must comply with the securities laws in connection with that debt.[40]

G. Avoiding Shareholder Suits

Public companies are subject to shareholder suits, especially federal securities law claims based on alleged misstatements or omissions in public statements or documents.[41] PE Portfolio Companies do not face these risks.

The directors of public companies are also subject to being sued by shareholders under the federal securities laws and to derivative and class action shareholder suits under state law.[42] Because their upside from share ownership tends to be limited, the prospect of damages liability that is out of proportion to their potential gain is thought to possibly discourage well-qualified persons from becoming directors of public companies and to discourage persons who serve from taking on risks that would be beneficial to the company. This problem is eliminated with PE Portfolio Companies, both because shareholder suits would be unusual and because, in any event, directors tend to also be the owners or their representatives.

II. Should the Selection Process for Public Company Directors Be Modified?

Would changing the existing legal rules governing the selection process for public company directors help public companies gain some of the advantages of PE Portfolio Companies? If those rules encouraged significant shareholders with skin in the game, or their designees, to serve as directors, it arguably might change some of the incentives that directors now have to avoid risk and focus on process, and it might do so without sacrificing the protection against fraud that the Sarbanes-Oxley Act and the stock exchange rules have added. Significant shareholders have a built-in interest in maximizing the value of the shares they hold by attracting and working with the best managers.

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40 See generally Gerald Nowak, Andrew Terry, and William Chou, *In the Twilight Zone: The Unique Status of High Yield-only Issuers*, Insights 1–2 (Aug 2004); Robert P. Bartlett III, *Going Private but Staying Public: Reexamining the Effect of Sarbanes-Oxley on Firms' Going-private Decisions*, 76 U Chi L Rev 7 (2009).

41 See, for example, *APA Excelsior III LP v Premiere Technologies, Inc*, 476 F3d 1261 (11th Cir 2007) (adjudicating a case involving shareholder action against an acquiring company for securities fraud, specifically misrepresentations in registration statements).

42 See generally, for example, *In re Merck & Co, Inc Securities, Derivative and ERISA Litigation*, 493 F3d 393 (3d Cir 2007); *In re Crown Castle International Corp*, 247 SW3d 349 (Tex App 2008). See also Bernard Black, et al, *Legal Liability of Directors and Company Officials Part 2: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability*, 2008 Colum Bus L Rev 1, 29–47.

It also might arguably be easier to persuade directors affiliated with significant shareholders to spend more time on the affairs of the company because they have so much at stake. Directors have devoted more time to the job since the Enron and WorldCom scandals, but on the whole they would need to increase their commitment to implement the Guidance Board model envisioned by Tom Perkins.

In examining whether changing the applicable rules would cause more representatives of significant shareholders to serve on public company boards and whether that in turn would help public companies gain some of the advantages that PE Portfolio Companies have, it is helpful to divide significant shareholders into three groups. The first group is mutual funds, insurance companies, pension funds for private-company employees, and other traditional institutional investors (collectively, TIIs). The second group is pension funds for public employees ("Public Pension Funds"), and the third group is hedge funds.

Persuading TIIs to place their designees on the boards of the public companies in which these TIIs own shares might well help those boards move toward the private-equity model. TIIs often have very substantial investments that ought to create an incentive to take reasonable risks, including using leverage, and they should be concerned with growth as well as compliance with the law and the stock exchange rules. TIIs have the resources to hire representatives who would be sophisticated and diligent directors. Moreover, TIIs often have the same willingness to take the long-term view that many investors in private-equity funds have.

However, while the designees of TIIs might improve the quality of public company boards and in theory should be willing to serve as directors to increase the value of their investments, in practice most TIIs are unwilling to place designees on those boards. As a number of commentators have noted, it is generally not the business model of mutual funds, private pension funds, insurance companies, or similar institutions to serve on the boards of companies in which they have investments.[43] Rather, they want to be passive investors. They are sufficiently diversified that, in light of free-rider and other incentive problems,[44] they be-

43 See Iman Anabtawi and Lynn A. Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan L Rev 1255, 1276 (2008); Symposium Transcript, 31 Del J Corp L at 1015–28 (cited in note 13) (discussing potential liability issues for board members of public companies). See also Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U Pa L Rev 1021, 1049 (2007) (discussing how laws that require mutual funds and other institutional investors to have minimum levels of diversification discourage active participation by the institutional investors).

44 See Kahan and Rock, 155 U Pa L Rev at 1049–57 (cited in note 43) (noting that, in addition to the regulatory constraints, inadequate incentives, and conflicts of interests that impede mutual funds, costs arising from governance activities can be too large for mutual funds, who have a greater number of shares in a larger number of companies than do individual investors).

lieve that they cannot economically spend the time needed to be directors of the companies whose stock they hold.[45] A mutual fund might also fear the possibility that its affiliates would lose investment banking or retirement-management business from corporate clients if the funds' designees served on the corporation's board, either because the corporation might view the situation as presenting a conflict of interest or because management or the rest of the board might view an active role on its board by the mutual fund with disfavor.[46]

There does not appear to be any change in the method of selecting directors that would increase the likelihood of TIIs having their designees serve as directors of public companies. One controversial change would be Lucian Bebchuk's proposal that shareholders have the right to place their nominees for the board on the company's proxy statement and be reimbursed for the cost of a proxy fight if they receive a substantial number of the votes (which he suggests might be one-third or more).[47] It seems unlikely that adoption of Bebchuk's proposal would materially change the analysis for TIIs. Although it is difficult to be sure, my perception is that TIIs could place their designees on many public boards today just by asking. They generally do not ask, and they generally do not engage in proxy fights,[48] regardless of whether the proxy fight could be facilitated by the adoption of Bebchuk's proposal.

Public Pension Funds face the same free-rider problems as TIIs and have not tended to have their designees serve on public company boards. In addition, the designees of Public Pension Funds might not be good choices for public company directors in most circumstances because these pension funds are subject to political influences that frequently would cause them to pursue an agenda that is contrary to the interests of the corporation or its other shareholders.[49] For example, they may be opposed to high pay for the company's managers because it is politically correct to do so rather than because they are trying to maximize the corporation's returns.[50] Also, they do not have the same incentive to maximize their own returns that other institutions have because the leadership

45 See Anabtawi and Stout, 60 Stan L Rev at 1278 (cited in note 43).

46 See Gerald F. Davis and E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J Fin Econ 552, 553–54 (2007).

47 See Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va L Rev 675, 697–700 (2007).

48 Id at 717–18. See also Kahan and Rock, 155 U Pa L Rev at 1056 (cited in note 43); Davis and Kim, 85 J Fin Econ at 564 (cited in note 46).

49 Consider Anabtawi and Stout, 60 Stan L Rev at 1280 (cited in note 43) (noting that hedge funds can take a negative position in a company "by shorting its stock and then seek to profit from using its power as a formal shareholder to push for business policies that drive stock price *down*"); Kahan and Rock, 155 U Pa L Rev at 1058 (cited in note 43).

50 See Kahan and Rock, 155 U Pa L Rev at 1058 (cited in note 43).

of Public Pension Funds is decided by politics and may therefore be immune or less sensitive to market forces.[51]

In contrast, hedge funds are willing to have their designees serve on the boards of public companies and have on a number of occasions threatened or mounted proxy fights to obtain board seats.[52] Shareholder activism by hedge funds has become a significant feature of the American corporate landscape.[53] The presence of hedge fund designees on the board of a public company in which the hedge fund has a significant investment arguably would help that board obtain some of the advantages of PE Portfolio Companies, such as creating a sense of urgency and a willingness to take on additional risks. Proponents of hedge funds argue that their activism has recently had a salutary effect on US public boards and the US economy generally.[54] There is a good deal of support for this argument.[55]

However, the presence of hedge fund designees on public boards will sometimes create serious problems. Hedge funds tend to have a short-term focus and push for strategies, such as the sale of the company or a division,[56] an extraordinary dividend,[57] or a repurchase of shares at a premium,[58] that are inconsistent with the interests of shareholders

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51 See id at 1057.

52 See id at 1029–34.

53 See, for example, Emily Williams, *Institutional Activism Positive for Shareholders, Panelists Say*, Virginia Law News & Events (Feb 21, 2007), online at http://www.law.virginia.edu/html/news/2007_spr/institutional_investors.htm (visited Jan 11, 2009).

54 See Brody Mullins and Sarah Lueck, *Democrats Lose Zeal for Raising Hedge-fund Tax*, Wall St J A1 (July 31, 2007) (noting that executives from private-equity firms and hedge funds, and certain elected officials, argue that their activity benefits the US economy in that their activities earn returns for public employee pension plans and university endowments, which are increasingly reliant on healthy returns).

55 See Anabtawi and Stout, 60 Stan L Rev at 1267–68 (cited in note 43); Kahan and Rock, 155 U Pa L Rev at 1028–47 (cited in note 43).

56 See Anabtawi and Stout, 60 Stan L Rev at 1287 (cited in note 43) (citing marketplace examples in which hedge funds have pushed through the sale of Company A in order to profit from their ownership position in Company B, rather than to maximize the share price of Company A); id at 1288–90 (citing marketplace examples in which hedge funds take two positions within the company and use one holding (for example, equity) to increase the value of their other holding (for example, debt), including via approval of sales); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 Va L Rev 789, 794 (2007); Kahan and Rock, 155 U Pa L Rev at 1087 (cited in note 43) (noting that "[w]hen the company is diversified, [the hedge fund investors] push for the sale of the company or a change in management" and "[w]hen the company has assets on its balance sheet that can be monetized (for example, real estate), [hedge fund investors] push to monetize those assets").

57 See Kahan and Rock, 155 U Pa L Rev at 1087 (cited in note 43) (explaining that "[w]hen the company has excess cash on hand, [the hedge fund investors] push for stock repurchases or dividends," and "[w]hen companies are pursuing capital-intensive investment plans, hedge funds sometimes oppose the plans and push for the cash to be returned to shareholders."). See also Anabtawi and Stout, 60 Stan L Rev at 1290–92 (cited in note 43).

58 See Anabtawi and Stout, *Fiduciary Duties for Activist Shareholders* at 1290–92 (cited in note 43); Kahan and Rock, 155 U Pa L Rev at 1087 (cited in note 43).

who have a longer-term investment horizon.[59] This focus is also inconsistent with the emphasis on long-term issues that is supposed to be one of the hallmarks of what private equity brings when it acquires a company. Promoting a sale or getting cash to shareholders may be the right thing to do in many circumstances, but it seems unlikely to be a strategy that will make public companies operate better in the long term.

There are other problems with hedge fund activism that, in some circumstances, may militate against putting their designees on public company boards. First, hedge funds sometimes vote for a transaction between the company and another entity not because they think the transaction is in the best interests of the corporation but because they believe that the transaction will increase the value of their investment in the other entity.[60] Obviously, this situation creates a conflict of interest between the hedge fund and the other shareholders. Second, the marked increase in derivatives transactions has led to examples in which a hedge fund has cast votes when it no longer has an economic interest in the underlying shares.[61] Depending on the circumstances, these potential problems may outweigh the advantages that a hedge fund would bring.

Marcel Kahan and Edward Rock have compared the advantages and disadvantages of having hedge funds involved in issues of corporate governance.[62] They conclude that, despite a number of "happy stories" in which hedge funds have caused public company boards to do the best thing for shareholders, the problems enumerated above, especially what they term the problem of "pervasive short termism," are serious enough to give them pause about whether the increased role of hedge

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59 See Anabtawi and Stout, 60 Stan L Rev at 1291 (cited in note 43):

> [Hedge funds'] short-term focus stands in stark contrast to the investing styles of index funds, pension funds, insurance companies, and many individual investors, who often hold shares for years. The result, it has been suggested, is short-term activists pressuring managers to pursue policies that raise share price in the short term but fail to help the company, and even harm it, in the long term.

See also Kahan and Rock, 155 U Pa L Rev at 1083–91 (cited in note 43).

60 For example, in the proposed acquisition of King Pharmaceuticals by Mylan Laboratories, the hedge fund Perry Capital, which had recently purchased nearly 10 percent of Mylan's common stock, supported the acquisition although industry observers perceived the deal as overpriced—because Perry was also a large shareholder in King. Perry had entered into a derivatives contract to hedge away its economic interest in the Mylan shares it held, and therefore Perry stood to make money if the deal went through even if Mylan's shares declined. See Anabtawi and Stout, 60 Stan L Rev at 1287 (cited in note 43); Kahan and Rock, 155 U Pa L Rev at 1072 (cited in note 43).

61 See Kahan and Rock, 155 U Pa L Rev at 1075–77 (cited in note 43) (discussing "empty voting"). See also generally Shaun Martin and Frank Partnoy, *Encumbered Shares*, 2005 U Ill L Rev 775, 778–79 (describing combinations of derivative holdings that effectively result in a shareholder being able to hold stock and vote without risk).

62 See generally Kahan and Rock, 155 U Pa L Rev 1021 (cited in note 43).

funds in corporate governance is salutary.[63] They further argue that the law should not intervene to alleviate these problems with hedge funds because of the ability of companies and the market to adopt adaptive devices in response.[64]

Kahan and Rock do not say whether they would intervene the other way by making it easier for hedge funds to gain entry onto corporate boards. My conclusion is that the law should not be changed to do so at this time. There is too much evidence of the potential for hedge fund conflicts or misconduct to warrant modifying the present rules in their favor. Moreover, it seems unlikely that adoption of Bebchuk's proposal or other similar measures is necessary to cause hedge funds to seek board seats. They do not hesitate to mount or threaten proxy fights, and it is far from clear that allowing them access to the company's proxy statement or lowering the vote threshold for recovery of costs would make much difference in their aggressiveness.

Margaret Blair, Lynn Stout, and Stephen Bainbridge, while noting the problems associated with hedge fund activism, have argued that Bebchuk's proposal should be rejected also because it would give too much power to shareholders at the expense of other corporate constituencies such as employees, customers, suppliers, and the community.[65] They argue that the proper role of a corporation's board is to promote a team enterprise in which all of these constituencies have a role and to mediate conflicts between these constituencies.[66] Hedge fund activism, in their view, threatens to disturb the board's ability to be such a mediator.[67]

I find these arguments to be problematic. Many states have "constituency" statutes that permit, but do not compel, directors to take into account the interests of other constituencies as well as those of shareholders.[68] In advising boards, practitioners have never known what to

63 Id at 1083–91

64 Id at 1091–93.

65 See Stout, 93 Va L Rev at 795 (cited in note 56); Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 Harv L Rev 1735, 1749 (2006); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L Rev 601, 607 (2006); Margaret M. Blair and Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va L Rev 247, 276–77 (1999).

66 See generally Stout, 93 Va L Rev at 792 (cited in note 56). See also Margaret M. Blair and Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 Wash U L Q 403 (2001); Blair and Stout, 85 Va L Rev at 319 (cited in note 65).

67 See Stout, 93 Va L Rev at 794–95 (cited in note 56). See also generally Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L Rev 561 (2006) (arguing that giving more power to shareholders will not necessarily improve corporate performance and will most likely only lead to private benefits for the largest shareholders).

68 See Anabtawi and Stout, 60 Stan L Rev at 1284 (cited in note 43), citing Lynn A. Stout, *Bad and Not-so-bad Arguments for Shareholder Primacy*, 75 S Cal L Rev 1189, 1204–07 (2002); Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board's Decision to Engage in Social Entrepreneurship*, 29 Cardozo L Rev 623, 637–38 (2007).

make of these statutes because the statutes are so open-ended. However, they are at least clearly permissive and do not expose the directors to any liability if they choose not to take account of nonshareholder interests. The arguments of Blair, Stout, and Bainbridge suggest that a board must, or at least should, take nonshareholder interests into account. Adopting this suggestion would be a dramatic change from present law,[69] absent circumstances in which the corporation is insolvent or in the vicinity of insolvency.[70] It would also call into question many actions that benefit the shareholders at the expense of employees, such as a decision to sell the company or close plants. Directors would be left with no basis except their own sense of propriety for resolving conflicts between the constituencies. Consequently, my view that Bebchuk's proposal should be rejected at this time is based on the problems that hedge fund activism poses for other shareholders rather than on the premise that the board should have a duty to promote a team concept among various corporate constituencies.

III. Should the Rules Governing Directors' Liability for Damages Be Changed?

The possibility of being held liable for damages has the potential to discourage persons who would bring some of the virtues associated with PE Portfolio Company boards from serving on public boards and to encourage existing public company directors to focus excessively on process. Directors can be held liable under state law for damages even if they do not have a conflict of interest and under the federal securities laws for the inaccuracy of the company's disclosures. I examine each topic very briefly. I do not examine directors' liability for damages when they do have a conflict of interest because it is beyond the scope of this Article.

A. State Law

The issue of whether directors can be liable for damages for paying insufficient attention to process has been contentious since the Delaware

69 See Andrew G.T. Moore II, *The Birth of* Unocal*—A Brief History*, 31 Del J Corp L 865, 886 (2006) ("[D]irectors may take into account the interests of other constituencies but only as and to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation."); Bebchuk, 118 Harv L Rev at 911 (cited in note 9); Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 Yale L & Policy Rev 381, 390–91 (2005).

70 I do not intend to comment on when directors' duties shift from shareholders to creditors. For a discussion of that topic, see generally Douglas G. Baird and M. Todd Henderson, *Other People's Money*, 60 Stan L Rev 1309 (2008).

Supreme Court's celebrated 1985 decision in *Smith v Van Gorkom*,[71] in which the court held the directors of TransUnion personally liable for failing to satisfy their duty of care in connection with the sale of the company, despite the fact that the sale price represented a 50 percent premium to the market price of TransUnion.[72] The Delaware General Assembly reacted to the widely held view that *Van Gorkom* would discourage many persons from serving as directors by enacting § 102(b)(7) of the Delaware General Corporation Law.[73] Section 102(b)(7) permits corporations to adopt charter provisions exculpating directors from liability for damages arising from breaches of the duty of care, while not permitting such exculpation for breaches of the duty of loyalty, actions taken not in good faith, intentional misconduct, deliberate violations of the law, unlawful dividends, and transactions from which directors derive an improper personal benefit.[74] Most state legislatures soon followed Delaware's example, and today virtually every public company has a charter provision exculpating directors from liability to the full extent permitted by § 102(b)(7) and similar provisions.[75]

Shareholders seeking a way around the exculpatory provision in their company's charter focused on the exception in § 102(b)(7) for acts taken not in good faith and on the possibility that the board's failure to appropriately exercise oversight could fit within that exception. In the case of *In re Caremark International Inc Derivative Litigation*,[76] the Delaware Chancery Court acknowledged the possibility that directors could be liable under the good faith exception for being asleep at the switch by holding that

> it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.[77]

71 488 A2d 858 (Del 1985).

72 Id at 864.

73 See Sarah Helene Duggin and Stephen M. Goldman, *Restoring Trust in Corporate Directors: The* Disney *Standard and the "New" Good Faith*, 56 Am U L Rev 211, 231–32 (2006) (describing the Delaware legislature's quick negative reaction to *Van Gorkom*); Hamermesh, 45 Washburn L J at 286–87 (cited in note 9) (describing the legislation passed by the Delaware legislature in response to *Van Gorkom* as setting limits to director liability in the face of claims by shareholders alleging breach of fiduciary duty).

74 8 Del Code Ann § 102(b)(7) (Michie).

75 See Duggin and Goldman, 56 Am U L Rev at 233 (cited in note 73) ("In the course of the succeeding year, more than thirty states enacted similar provisions, and all fifty states eventually did so.").

76 698 A2d 959 (Del Ch 1996).

77 Id at 970.

The court then attempted to limit the potential that this exception could be interpreted to sweep in a broad range of cases, holding:

> Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.[78]

The question the *In re Caremark* court left open is what it takes to have "a sustained or systematic failure of the board to exercise oversight."[79] The defendants obtained a favorable opinion approving a settlement in *In re Caremark* itself, but the Sixth Circuit, in *McCall v Scott*,[80] and the Seventh Circuit, in *In re Abbott Laboratories Derivative Shareholders Litigation*,[81] relied on *In re Caremark* in concluding that derivative cases seeking damages based on a failure of board oversight and a breach of the duty of good faith could proceed because the allegations of the complaint excused the need for a demand on the directors.[82] These decisions suggest that failure-of-oversight cases are worth bringing, especially in courts outside Delaware. Derivative cases frequently settle once they get beyond a motion to dismiss for failure to make a demand (or, if a demand was made, because the demand was refused).[83] Under state law, directors cannot be indemnified (absent court approval) if a judgment is entered against them in a derivative case,[84] and many "directors and officers" (D&O) insurance policies contain exceptions that arguably might prevent coverage if a court found that the directors had acted in bad faith.[85] Both of these factors create a substantial incentive for directors to settle to avoid a possible adverse judgment.

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78 Id at 971.

79 Id.

80 239 F3d 808 (6th Cir 2001).

81 325 F3d 795 (7th Cir 2003).

82 See *McCall*, 239 F3d at 817 (holding that a director is not required to have intentionally acted to harm the corporation in order to be liable for breach of fiduciary duty under Delaware law); *In re Abbott Laboratories*, 325 F3d at 805 (holding that a shareholder suit alleging breach of fiduciary duty by directors for entering into a consent agreement with the FDA was a valid complaint that would be allowed to go to trial).

83 See Christine Hurt, *The Undercivilization of Corporate Law*, 33 J Corp L 361, 363–66, 383–86 (2008) (describing the demand process and the requirements of a board demand in a derivative action); Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U Kan L Rev 83, 116–17 (2007) (describing the incentives that lead most derivative suits to settle).

84 See 8 Del Code Ann § 145(b); Nishchay H. Maskay, *The Constitutionality of Federal Restrictions on the Indemnification of Attorneys' Fees*, 156 U Pa L Rev 491, 498–501 (2007); Alces, 56 U Kan L Rev at 116–17 (cited in note 83).

85 Maskay, 156 U Pa L Rev at 501 (cited in note 84).

The scope of the bad faith exception to exculpatory charter provisions when the board did make a decision (as opposed to failing to exercise oversight) was addressed by the Delaware courts in the *In re Walt Disney Co Derivative Litigation* cases.[86] The Disney board was worried about identifying a successor to Michael Eisner as CEO. Eisner recommended Michael Ovitz, one of the most prominent agents in show business, whose access to major stars had the potential to alleviate one of Disney's major strategic problems. Ovitz's yearly compensation as an agent was $20 to $25 million per year. To induce him to give up that compensation and the ownership of his agency, Disney provided him with a large salary and, if he was terminated without cause, a severance package valued at approximately $130 million.[87] Shortly after Ovitz began, Eisner changed his mind about the wisdom of bringing Ovitz into Disney. Ovitz was terminated without cause after about one year and received the severance package called for under his agreement. Shareholders then brought a derivative suit, alleging that Disney's directors had breached their duty of good faith both in hiring Ovitz with such a lucrative contract and then firing him, triggering his entitlement to the severance package.[88]

The Delaware Chancery Court, in a decision that generated a great deal of publicity, initially held, in denying a motion to dismiss, that the directors could be found to have acted in bad faith if they "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks attitude'" and that they would be liable for damages under that standard if the facts alleged in the complaint were proven.[89] After a trial, however, the Chancery Court found that, while the directors had failed to employ best practices in a number of ways, they had breached neither their duty of care nor their duty of good faith.[90] The Delaware Supreme Court affirmed, agreeing with the Chancery Court that the standard for bad faith was "intentional dereliction of duty, a conscious disregard for one's responsibilities."[91]

86 See *In re Walt Disney Co Derivative Litigation*, 906 A2d 27 (Del 2006) ("*Disney III*") (holding that the company's president was not negligent nor did he voluntarily leave Disney and therefore was not liable to shareholders, and that the Disney directors also did not breach their fiduciary duty of care to shareholders); *In re Walt Disney Co Derivative Litigation*, 907 A2d 693 (Del Ch 2005) ("*Disney II*") (finding that Disney's executive officers and directors acted in good faith and did not act negligently when they terminated the company's president); *In re Walt Disney Co Derivative Litigation*, 825 A2d 275 (Del Ch 2003) ("*Disney I*") (denying Disney's motion to dismiss a shareholder's suit due to sufficiency of the allegations of misconduct included in the plaintiff's complaint).

87 *Disney III*, 906 A2d at 37, 43.

88 Id at 46.

89 *Disney I*, 825 A2d at 289.

90 *Disney II*, 907 A2d at 760–77.

91 *Disney III*, 906 A2d at 62.

In *In re Emerging Communications Inc Shareholders Litigation*,[92] the Delaware Chancery Court held a member of a special committee of outside directors considering a merger with the company's controlling shareholder personally liable for the difference between the $10.25 per share merger price the director approved and $38.05 per share, which the court found to be the fair value of the minority shareholders' stock.[93] The court concluded that the director had a special obligation because he had experience in financial matters and that he had consciously disregarded his duties. The court held that he had therefore acted in bad faith in voting to approve the merger.[94]

Most recently, in *Stone v Ritter*,[95] the Delaware Supreme Court applied the *Disney* standard for good faith in upholding the grant of a motion to dismiss in a directorial oversight case.[96] The court also concluded that there was no separate duty of good faith; instead, a failure to act in good faith was evidence of a breach of the duty of loyalty.[97]

Summarizing the results in these cases, a director sued for misconduct in a Delaware court appears to have a good chance of escaping the case on a motion, though obviously further proceedings (as in *Disney*) or liability are possible if the facts warrant. Outside of Delaware, courts interpreting Delaware law seem more open to finding the bad faith exception to be applicable in oversight cases than the Delaware courts. And while many derivative cases that get beyond the motion stage settle, with payment on behalf of the directors coming from their D&O insurer,[98] there is always the possibility that insurance coverage will be unavailable because the insurer declines coverage or the insurance is used up in related matters.[99] So directors need to be concerned that they could be required to pay damages, albeit in a rare case, if they fail to be careful in making decisions or fail to establish adequate oversight mechanisms for management and the company.

92 2004 WL 1305745 (Del Ch).

93 Id at *39–42.

94 Id at *42–43. The court also found that this director might have breached his duty of loyalty by approving the merger partly because he hoped to obtain future business from the controlling shareholder.

95 911 A2d 362 (Del 2006).

96 See id at 365 (upholding dismissal of a derivative suit alleging a breach of the duty of care where directors did not establish a system to gather information about possible illegal activity and wrongdoing in the corporation and did not comply with antifraud and anti-money-laundering statutes after a fraud took place).

97 Id at 369–70.

98 Maskay, 156 U Pa L Rev at 494–501 (cited in note 84).

99 See Black, Cheffins, and Klausner, 58 Stan L Rev at 1060–61 (cited in at note 15); Rebecca Smith and Jonathan Weil, *Ex-Enron Directors Reach Settlement*, Wall St J C3 (Jan 10, 2005) (reporting that some of the Enron and WorldCom directors had to pay out of pocket, but that most of the settlement was covered by insurers).

B. Federal Securities Laws

The most common vehicle for obtaining damages liability under the federal securities laws is a class action alleging "fraud on the market" in violation of SEC Rule 10b-5.[100] The crux of a fraud on the market claim is that the company misspoke in a filed report or other communication, or failed to speak when it had a duty to do so.[101] Liability under the fraud-on-the-market theory requires scienter—deliberate fraud or recklessness.[102] The exposure of outside directors in fraud-on-the-market cases is limited. Unless they played a direct role in the misstatement or omission, which is rare, they are unlikely to be subject to primary liability.[103] Moreover, it is frequently difficult to hold them liable as a "control person" because of their limited involvement.[104] They often are not named as defendants. Even when they are named, generally in order to bring pressure on the company to settle, virtually all such cases are resolved on a motion or in a settlement that is funded by the company or a D&O insurer.[105]

Section 11 of the Securities Act of 1933[106] provides another vehicle for seeking damages when a company is selling securities. Section 11 prohibits misstatements or omissions in a registration statement and provides a damages remedy against the company. The statute also pro-

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100 17 CFR § 240.10b-5 (forbidding fraud, misstatement, and deceit in relation to the purchase and sale of any security).

101 See *Basic Inc v Levinson*, 485 US 224, 241–43 (1988). Prior to *Basic*, several circuit courts had supported the theory that plaintiffs who had not directly relied on the defendant's misstatements or omissions could recover under Rule 10b-5. See, for example, *Blackie v Barrack*, 524 F2d 891, 905 (9th Cir 1975) ("[P]ositive proof of reliance is not a prerequisite to recovery."); *Schlick v Penn-Dixie Cement Corp*, 507 F2d 374, 380–81 (2d Cir 1974). See also generally *Shores v Sklar*, 647 F2d 462 (5th Cir 1981) (stating that plaintiff's reliance is a rebuttable presumption that can be overcome by defendant's evidence that there was no actual reliance).

102 See *Ernst & Ernst v Hochfelder*, 425 US 185, 192 & n 12 (1976) (defining scienter as intent to "deceive, manipulate, or defraud"). In addition, the Private Securities Litigation Reform Act established a uniform scienter pleading standard for securities fraud cases. See Pub L No 104-67, 109 Stat 737 (1997), codified as amended in various sections of Title 15.

103 In *Central Bank, NA v First Interstate Bank, NA*, 511 US 164, 191 (1994), the Court held that a plaintiff cannot state a cause of action for aiding and abetting a Rule 10b-5 violation. The Court reaffirmed this position recently in *Stoneridge Investment Partners, LLC v Scientific-Atlanta, Inc*, 128 S Ct 761, 769 (2008).

104 See Sandra P. Wysocki, *Controlling Personal Liability of Directors under Section 20(a) of the Securities Exchange Act of 1934*, 31 Suffolk U L Rev 695, 719 (1998) (noting that the potential for secondary liability under Rule 10b-5 is diminished following *Central Bank*).

105 See Black, Cheffins, and Klausner, 58 Stan L Rev at 1059–60 (cited in note 15) (noting that since 1980, outside directors have only once made personal payments after a trial, in the *Van Gorkom* case, and that there have been twelve instances of directors making out-of-pocket settlement payments or payments for their own legal expenses); Smith and Weil, *Ex-Enron Directors Reach Settlement*, Wall St J at C3 (cited in note 99).

106 Securities Act of 1933, Pub L No 73-22, 48 Stat 74, codified as amended at 15 USC § 77a et seq.

vides a damages remedy against the company's directors, officers, and underwriters for any such inaccuracies, without the need to show scienter, unless the defendants can show that they exercised due diligence in investigating the accuracy of the registration statement.[107] With the advent of shelf registration statements allowing companies to very quickly sell securities in the public markets, however, it is often impracticable to conduct extended due diligence.[108]

Section 11 claims were an important part of two of the most prominent examples of outside directors paying damages out of their own pockets. In the *WorldCom* case, twelve former directors contributed an aggregate of $24.75 million of their own money to supplement about $35 million to be supplied by their D&O insurance carriers to settle § 11 and other claims.[109] In the *Enron* case, ten former directors agreed to a settlement of § 11 and other claims requiring them to pay an aggregate of $13 million of their personal funds.[110] In both cases, the lack of a scienter standard under § 11, and the possibility of bankrupting damages (because more insurance was not available and the total losses to shareholders were so high), were thought to be factors contributing to the directors' willingness to pay millions of dollars.[111]

C. Should These Rules Be Modified?

The availability of damage awards against outside directors for the failure to be sufficiently conscientious plainly deters some candidates who would bring with them some of the virtues of PE Portfolio Companies from serving on public boards. It also seems likely to motivate existing directors to be more process driven and less interested in creating an atmosphere of urgency in which risk taking is encouraged. The question is whether the benefits of potential damages liability for directors outweigh these and other costs.

The wisdom of permitting damage awards against outside directors when they do not have a conflict of interest has been a hot topic since *Van Gorkom* and became the subject of renewed interest after the *WorldCom* and *Enron* settlements made the possibility seem real for many boards. Many observers believe that it is a very good thing that directors pay damages when they are insufficiently careful, because

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107 15 USC § 77k.

108 See Jeremy W. Dickens, Paul Dutka, and Joshua S. Amsel, *Underwriter Due Diligence: WorldCom and Beyond*, Insights: The Corporate and Securities Law Advisor (Apr 2005) (discussing how shelf takedowns can occur in days, or even in hours, materially limiting the ability of underwriters to discharge their due diligence obligations).

109 See Black, Cheffins, and Klausner, 58 Stan L Rev at 1057, 1118 (cited in note 15).

110 Id.

111 Id at 1078.

that vulnerability creates a powerful incentive for directors to be more careful.[112] As Adam Hevesi, the Comptroller of New York and a trustee of the New York State Common Retirement Fund that sued the WorldCom directors, put it:

> The fact that we have achieved a settlement in which these former outside directors have agreed to pay 20 percent of their cumulative personal net worth sends a strong message to the directors of every publicly traded company that they must be vigilant guardians for the shareholders they represent. We will hold them personally liable if they allow management of the companies on whose boards they sit to commit fraud.[113]

Other observers, however, have expressed concern that subjecting outside directors to the risk of damages for lack of care could have serious adverse effects. John Olson, a prominent corporate governance practitioner, has put it this way:

> What all of these cases have done is cause directors to focus a lot more on process. I don't think that's all bad. . . . But there is a cost. . . . For example, one thing I'm seeing is—and I've talked to directors every week really—directors are pruning the boards they are willing to serve on. So they will go on the board of a well-established, cautiously managed, establishment company that's not doing anything very exciting—what we call a cash cow. But, they're much more reluctant to go on the board of a high-tech, high-flyer with the entrepreneur.[114]

Robert Mendelsohn has focused on the effect potential liability has on the willingness of existing directors to take risks:

> There is an increasingly risk-averse climate, and we see that not just in the United States but around the world. Let's say directors are confronted with two strategies, one of which is a very, very high risk strategy, but may pay off in a huge way ten years down the road. The other is a very low risk strategy with a safe but low-return probability. There is an increasing bias toward the low risk strategy rather than the high risk but potentially high-reward strategy. Directors now must think about the personal consequences for them if hindsight shows they made a seriously flawed decision (or the rules of the game are different in the future), and

112 See Symposium Transcript, 31 Del J Corp L at 1018 (cited in note 13).

113 See Office of the New York State Comptroller, *Hevesi Announces Historic Settlement, Former Worldcom Directors to Pay from Own Pockets* (Jan 7, 2005), online at http://www.osc.state.ny.us/press/releases/jan05/010705.htm (visited Jan 11, 2009).

114 See Symposium Transcript, 31 Del J Corp L at 1017 (cited in note 13).

> it's far easier to do due diligence on the short term, low risk alternative than on the high-risk one. I worry about the impact of that trend both on our global competitiveness and on the long-term health of our economy.[115]

Even William Allen, who decided *Caremark* when he was the Chancellor of the Delaware Chancery Court, has recently expressed serious concerns about the effect on risk taking of potential damage awards against directors in the absence of a conflict of interest.[116] Allen argues that the threat of damages may not be needed given the change in the dominant board ideology over the last twenty years from collegiality to being independent monitors, increased economic incentives for directors, and heightened director attentiveness because of successful efforts to make shareholder voting more effective.[117] Allen concluded:

> Once you take notice of the myriad ways in which modern corporate governance constrains and incents corporate directors, and you acknowledge both the protections available to investors through diversification of their investments and their need to encourage risk taking activity, and finally once we recognize the deleterious effects on risk taking that a liability rule creates, you may begin to believe, as I do believe, that the systematic risks to investors interests from possible director liability for breach of the duty of care, uncomplicated by financial conflict or improper motivation, likely far outweighs the systematic benefits that may accrue from deploying a liability rule, even if quite rarely.[118]

What does the desire to import some of the advantages of PE Portfolio Companies to public companies add to the analysis? Because the directors of PE Portfolio Companies are not materially exposed to the risk of damage awards, the success of PE Portfolio Companies relative to public companies strengthens the arguments of the opponents of damage awards against directors. That success suggests (though does not prove) that the potential for damages is helping to create a climate in which public companies are unable to match the ability of PE Portfolio Companies to take intelligent risks, be open to change, and avoid an excessive focus on process—and that the difference in the way public boards and PE Portfolio Company boards are

115 Id at 1025.

116 See Allen, *Modern Corporate Governance* at *11–12 (cited in note 9) (describing how shareholders try to shift risk to directors by accusing them in derivative suits of negligence and breaches of fiduciary duty whenever things go wrong, which subsequently discourages appropriate risk taking).

117 Id at *14–15.

118 Id at *16.

composed and function makes a difference in the returns each kind of company is able to generate.

The argument that the possibility of being held liable for damages induces a number of excellent candidates not to serve on public boards is hard to challenge. As noted above, the financial upside for most public company directors is quite limited. Given the inherent uncertainty of litigation, many individuals conclude that the risk of paying damages, even though it is relatively low, is too great to justify board service.[119]

On the other hand, the argument that being exposed to damage awards leads public boards to be too process-oriented and make excessively conservative decisions needs to be broken down into parts. The argument seems correct as applied to vulnerability under state law for actual decisions that a reviewing court later determines were made in bad faith. When directors without a conflict of interest consciously make a decision, subjecting them to the possibility of damages if that decision goes wrong will inevitably drive them to be more conservative and process-oriented.

But the strength of the argument is less clear in the cases of vulnerability for damages under state law for failing to apply appropriate oversight or under the federal securities laws for inaccurate disclosure. Being exposed to damages for something they failed to do under *Caremark* does not seem likely to make directors act more conservatively. It might lead directors to be concerned about process but not in a way that would reduce sensible risk taking. Being exposed to damages for inaccurate disclosure would not appear to have much effect at all on the board's decisionmaking. It is possible to contend that public company directors who, like PE Portfolio Company directors, are more involved in the company's business would have weaker defenses based on the lack of scienter or lack of being a control person, but it is unlikely that most public company directors would modify their behavior on the basis of this fairly obscure point.

My overall conclusion is that public companies would be able to gain some of the advantages of PE Portfolio Companies without excessive cost, and would be better off generally, if the potential for damage awards against directors without a conflict of interest were reduced. Specifically, I would eliminate monetary liability for directors for bad faith that is tantamount to egregious lack of care and limit those awards to cases of bad faith in which directors had actual bad intent. In cases in which the board made an actual decision, subsequent findings that the board made the decision using an inadequate process or with inadequate information have all of the problems that led to

119 See text accompanying notes 109–11.

the enactment of § 102(b)(7) and are likely to discourage both qualified board candidates and aggressive board action. In cases in which the board is faulted for inadequate oversight, my experience is that it is always possible to make such a claim after something has gone wrong, that the cost of permitting these claims is too high, and that the charge of bad faith is generally just a way around the rule that directors should not have to pay potentially bankrupting damages on the theory that they were not careful enough. The gain in deterrence from imposing damages when directors are not careful, even if an effort is made to limit that exposure to egregious cases, is, in my judgment, not worth the cost.

On the disclosure side, I agree with Donald Langevoort that § 11 should be modified to require scienter on the part of outside directors.[120] I would go further and modify the definition of scienter, in both § 11 and Rule 10b-5 cases, to require actual bad intent, rather than simply recklessness, on the part of outside directors in order to establish liability in cases in which the company's statements or omissions are at issue. It realistically is not possible in most cases for outside directors to control a company's disclosure, and they should not have derivative liability for that disclosure except in circumstances in which it can be shown that they intended to deceive.

CONCLUSION

For a number of reasons, PE Portfolio Companies have advantages over public companies. In this Article I have examined whether changing the governing rules for the selection and liability of public company directors would help public companies gain some of those advantages. My conclusion is that, while changing the rules for the selection of public company directors would not be worthwhile, it would be desirable to reduce the liability of directors who do not have a conflict of interest for damages for claims of bad faith under state law or inaccurate disclosure under the federal securities laws.

120 See Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 L & Contemp Probs 45, 61 (Summer 2000).