Director Notes

Corporate Misconduct and the Market for Directorships

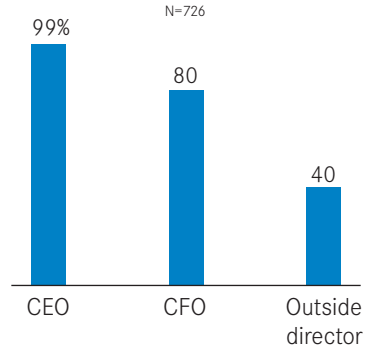
by Jason D Schloetzer

When a public company becomes involved in corporate misconduct, what consequences do its outside directors experience? Research shows that the scope and magnitude of the potential monetary and reputation risks individuals face from board service may vary greatly and include a reduced competitiveness in the market for directorships. Similar consequences are also observed among directors serving on audit committees of companies filing financial restatements. For these reasons, the due diligence performed on current and prospective board positions should extend not only to legal liability exposure but also to the possibility of losing valuable opportunities for board membership at other firms.

The unlimited liability arising from shareholder suits questioning director oversight is typically considered the most significant risk exposure of board service.[1] With 3,059 cases filed against public companies in U.S. federal courts between 1996 and 2009, periodically resulting in multimillion or even billion dollar settlements, the concern is understandable.[2] These cases increasingly entail allegations of financial misrepresentations,[3] and some three out of 10 directors are less than satisfied with their access to the financial information of the companies they serve.[4] Furthermore, outside directors are often implicated in securities class actions: nearly 40 percent of the cases filed between 2000 and 2003 name at least one outside director as a defendant (Chart 1).[5]

Chart 1

Who is named a defendant in securities class action litigation?



Note: Percentages are for cases filed between 2000 and 2003.

Source: Michael Klausner and Jason Hegland, 2010, "How protective is D&O insurance in securities class actions?–Part I," *Professional Liability Underwriting Society (PLUS) Journal*, Vol. 23, No. 2, pp. 1–4.

THE CONFERENCE BOARD
Trusted Insights for Business Worldwide

Clearly, when shareholder suits involve allegations of financial misrepresentation, company management should be held accountable. Consistent with this view, recent research shows that management of companies involved in enforcement actions brought by the U.S. Securities and Exchange Commission (SEC) or Department of Justice (DoJ) ultimately received significant punishments. Specifically, 93 percent of the 2,206 employees identified in SEC and DoJ enforcement actions from 1978 through mid-2006 lost their jobs by the end of the regulatory enforcement period. In addition, nearly 30 percent of employees faced criminal charges resulting in average jail sentences of 4.3 years.[6]

The accounting irregularities at Peregrine Systems (see box below) are a case in point: as of mid-2009, at least 14 Peregrine executives were sent to prison, including the ex-CEO, who was sentenced to over eight years in prison for his role in orchestrating the fraud.[7]

However, to what extent did the directors implicated in the Peregrine Systems litigation face out-of-pocket payments to shareholders and experience tarnished reputations in the market for directorships? More broadly, what significant monetary and nonmonetary penalties do outside directors experience after their company becomes entangled in corporate misconduct?

Several recent law, finance and accounting studies provide some perspective on this timely topic by investigating outside directors' potential legal liability risk and labor market penalties due to securities class actions in which director oversight is questioned.

Evidence from Trials

It is widely known within the legal community that "approximately one-third of securities class action suits are dismissed, two-thirds settle, and hardly any go to trial."[8]

Table 1 (page 3) reports the number of lawsuits filed between 1996 and 2005 that were tried to judgment.[9] The table contains three rows, one for each of the areas of law the cases refer to (in order: securities law, corporate law, and ERISA—the Employee Retirement Income Security Act of 1974—legislation). Data is based on:

1. an extensive analysis of corporate law cases that have gone to trial in which outside directors were sued for damages;
2. a review of SEC litigation releases for payments from directors due to SEC enforcement actions; and
3. telephone surveys of law firms with large securities litigation practices.

The Peregrine Systems case

The Peregrine Systems case should be viewed as an example of the elaborate accounting fraud that can occur without directors' awareness.

From its initial public offering in April 1997 through June 2001, Peregrine Systems, a software developer since acquired by Hewlett-Packard, reported 17 consecutive quarters of revenue growth that met or slightly beat Wall Street expectations. However, in mid-2002, the company announced the departure of its CEO and CFO after a series of accounting irregularities had been discovered.

The ensuing SEC investigation revealed an extensive, coordinated accounting fraud designed to artificially inflate Peregrine's revenue.[a] According to ex-CFO and ex-CEO testimony, executives held monthly meetings to determine the level of revenue Peregrine needed to report in order to meet or slightly beat Wall Street analysts' projections.[b] Executives would then fabricate sales, alter internal documents, and intentionally omit negative information from SEC filings.[c] For example, the company's vice president for Europe, Middle East, and Africa recorded a fictitious £10 million sale to British Telecom.[d]

Ultimately, Peregrine restated its financial results for fiscal years 2000, 2001, and for the first three quarters of 2002, which reduced previously reported revenue of $1.34 billion by $509 million. At least $259 million in revenue was reversed because the underlying transactions lacked substance.

a See *SEC vs. Peregrine Systems, Inc.*, Case No. 03, CV (www.sec.gov/litigation/complaints/comp18205.htm).

b Bruce Bigelow. "11 Indicted for Fraud at Peregrine," *San Diego Union-Tribune*, October 7, 2004, p. A1.

c Jonathan Sidener. "Peregrine Ex-CEO Sentenced to Prison," *San Diego Union-Tribune*, December 12, 2008, p. C1.

d Jonathan Sidener, "Peregrine Vice President Sentenced to 27 Months," *San Diego Union-Tribune*, May 5, 2009, p. C1.

Table 1

Securities and corporate law trials against public companies and their directors for damages: 1996-2005

Area of law	Total cases tried to judgment	Trial includes outside director	Plaintiff win against outside directors	Damages paid by outside directors
Securities federal and state court	18	3	0*	0
Corporate (fiduciary duty) – derivative and direct	n.a.	8	3	0
ERISA (fiduciary duty; losses on company shares)	0	0	0	0

n.a.=Data not available.

* One case named nine outside directors as defendants. Three directors had the claims against them dismissed prior to trial. The remaining six directors who went to trial settled prior to the end of the proceedings, with damages paid by the D&O insurer.

Source: Bernard Black, Brian Cheffins, and Michael Klausner, "Outside Director Liability," *Stanford Law Review*, 58, pp. 1055–1160; modified to summarize cases filed between 1996 and 2005 based on information in Table B1, pp. 1147-1151.

Securities law cases As the first row of Table 1 indicates, 18 securities law cases seeking damages were tried to judgment against companies, their directors and executive officers, or both. In only three of these trials were outside directors named as defendants when the trial began; in all three instances the suit against the directors failed. Hence, of the roughly 2,300 securities class action cases filed between 1996 and 2005, only three went to trial and involved outside directors, with the plaintiff winning none of these suits. During this period, public companies filed more than 120,000 annual reports (10-Ks) with the SEC, voluntarily disclosed a vast array of earnings and forecast information to investors, and provided additional mandatory filings to regulators and shareholders (e.g., quarterly reports (10-Qs), Form 8-Ks, etc.)[10]

Corporate law cases The second row of Table 1 reports the number of trials involving state corporate law fiduciary duty claims for damages against outside directors. This separate analysis revealed eight lawsuits brought between 1996 and 2005, with the plaintiff ultimately prevailing in three cases. In particular:

- In 1996, Tad's Enterprises Inc. sold its primary business in an asset sale. In turn, the two controlling shareholders then completed a freeze-out merger. The three directors implicated in the litigation were the two controlling shareholders and their personal legal counsel, Richard Bressler, who was considered an outside director for the purposes of litigation. The court awarded $754,000 in damages, which was likely paid by a combination of the two controlling shareholders and Tad's.[11]
- In 1997, MAXXAM Inc. was involved in a derivative trial against outside directors for self-dealing by the controlling shareholder, Charles Hurwitz, who allegedly diverted company funds toward at least two real estate development projects.[12] The case was ultimately settled after the trial was completed and D&O insurers paid $7.5 million on behalf of the directors.[13]
- In 2004, Emerging Communications Inc. completed a freeze-out merger with a company wholly owned by Jeffrey Prosser, CEO of Emerging Communications, as part of a going private transaction. The single outside director included in the litigation, Salvatore Muoio, was appointed by Mr. Prosser and was judged to have "disabling conflicts" because Mr. Muoio was "economically beholden" to Mr. Prosser.[14] As of mid-1997, Mr. Muoio received an annual $200,000 retainer for providing financial advisory services, and he viewed Mr. Prosser as a source of additional consulting fees. For example, in March 1998, Mr. Muoio reportedly sought up to $2 million for serving as an adviser on a potential Emerging Communications acquisition. That effort was unsuccessful only because the acquisition never took place.[15] Given these relationships, the court found that Mr. Muoio was not independent of Mr. Prosser and was judged to have breached his duty of loyalty (which requires fairness in self-interested transactions).[16] The controlling shareholder and the D&O insurer paid the damage award on behalf of Mr. Muoio.

ERISA litigation The third row of Table 1 reports the number of ERISA fiduciary duty cases involving losses on employee-held company shares.[17] Under the statute, directors are fiduciaries if they exercise authority over the management, investment, or administration of ERISA plans. There appears to be a growing trend to award large ERISA settlements in recent times; such settlement amounts include $85 million (Enron), $79 million (Global Crossing Ltd.), and $69 million (Lucent Technologies).[18] However, there were no trials involving ERISA claims between 1996 and 2005.

Evidence from Settlements

While the likelihood of outside director involvement in a securities class action trial is remote, a significant percentage of such cases are settled. Specifically, an analysis of 726 class actions filed between 2000 and 2003 concluded that 443 cases (61 percent) had settled by 2009.[19] In particular, settlements occur relatively quickly—and for significantly larger combined officer and director payments—in cases involving an accounting restatement and a corresponding SEC action, whereas settlements may take longer in non-restatement cases.[20] Some settlements reach headline-grabbing sums; the top 10 securities class action settlements from 1996 through 2008 total over $27 billion and the top 10 SEC disgorgements represent an additional $4 billion.[21] But almost 60 percent of all settlements from 1996 through 2009 were for less than $10 million.[22]

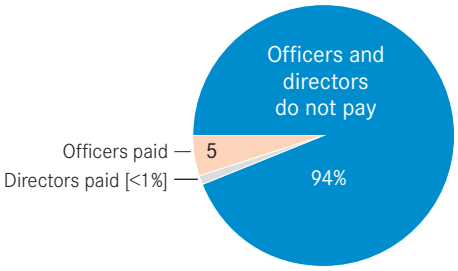
The frequency and magnitude of settlement activity, however, does not shed light on whether directors are responsible for out-of-pocket payments. Research indicates that out-of-pocket payments are rare events; for class actions filed between 2000 and 2003 that settled between 2001 and 2009, outside directors made out-of-pocket payments in less than 1 percent of the cases (see Chart 2).[23] Table 2 reports the seven more widely known cases in which outside directors have made personal payments as part of settlement agreements reached between 1996 and 2005 regarding oversight failures. As Table 2 shows, these settlements have occurred since 2000, which is consistent with the perception of top law firms that director payments—in particular, the WorldCom and Enron settlements—reflect "an almost unprecedented and clearly important development."[24]

At Peregrine Systems, six former outside directors (John Moores, Charles Noell III, Norris van den Berg, Richard Horshey II, Christopher Cole, and Rodney Dammeyer) and a number of executives were implicated in the misconduct. All told, some 20 or more employees, directors, and other interested parties (e.g., an Arthur Andersen audit partner) were named as defendants. Based on publicly-available information, the six outside directors settled the claims against them in mid-2009 for approximately $56 million.[25] The settlement stipulation does not disclose the source of funds for the outside directors' payments.

Chart 2

Officer and Director Payment in Settled Securities Class Action Litigation

N=726



Note: Percentages are for cases filed between 2000 and 2003.

Source: Michael Klausner and Jason Hegland, 2010, "How protective is D&O insurance in securities class actions?–Part I," *Professional Liability Underwriting Society (PLUS) Journal*, Vol. 23, No. 2, pp. 1–4.

Table 2

Out-of-pocket payments by outside directors implicated in oversight failures: 1996-2005

Company	Year of litigation	Number of directors sued	Nature of payment	Total payment by outside directors
WorldCom	2005	12	Settlement	$24.75 million
Peregrine Systems	2002	8	Settlement	$27.5 million to $56 million
Enron #1 (Securities §11)	2005	10	Settlement	$13 million
Enron #2 (ERISA)	2004	11	Settlement	$1.5 million
Independent Energy Holdings	2003	4	Settlement	Portion of $2 million paid by officers and directors
Confidential case #1*	~2000	Several	Settlement	Low $ millions
Confidential case #2*	~2000	Several	Legal Fees	~$50,000
Confidential case #3*	Mid-2000s	Several	Settlement	$300,000 to $400,000

* Nonpublic settlements identified in the study through extensive discussions with private sources.

Source: Bernard Black, Brian Cheffins, and Michael Klausner, "Outside Director Liability," *Stanford Law Review*, 58, Table 2, p. 1070; modified to summarize cases alleging director oversight failure filed between 1996 and 2005 and updated to reflect the status of the Peregrine Systems case using publically available sources.

Importantly, there are some indications in the stipulation that suggest at least part of the outside directors' settlement will be funded by Mr. Moores. Specifically, Mr. Moores—founder of Peregrine Systems, board chairman from 1990 through July 2000 and May 2002 through March 2003, who reportedly realized $611 million in gains from shares sold during the fraudulent period[26]—is to pay $27.5 million via a promissory note from the John J. Moores and Rebecca Ann Moores Family Trust.[27] Insurers likely paid at least a portion of the outside directors' settlement.[28] Similar to the Emerging Communications case, a controlling shareholder (Mr. Moores) and one or more insurers may have paid the damage award on behalf of the remaining outside directors.

Additional shareholder litigation alleging that three outside directors (John Moores, Charles Noell III, and Christopher Cole) were aware of the Peregrine misconduct appears to have been dismissed, with the judge stating that shareholders failed to show that the directors "were involved in the day-to-day control of Peregrine or that they had a 'special relationship' with Peregrine such that they are presumed to have knowledge of the falsity of Peregrine's public statements."[29]

The Effects on Competitiveness in the Directorship Market

The prior discussion focused on the potential legal liability risks for outside directors involved in shareholder class action lawsuits for corporate misconduct. For comparison purposes, Table 3 reports empirical evidence regarding the consequences outside directors' experience in the market for directorships following instances of corporate misconduct.[30]

In particular, Table 3 illustrates the changes in directorships held by outside directors of 113 companies involved in a shareholder class action lawsuit between 1998 and 2000. This period is a subset of the prior out-of-pocket liability discussion, which covered 1996 through 2005. The study focuses exclusively on class actions arising from Section 10(b)-5 rules violations pertaining to the misrepresentation of financial information to investors. The study tracks directorship changes for three years after the initiation of litigation to account for staggered director elections and uses information from proxy statements to identify director turnover.

Table 3

Directorships held by outside directors of 113 companies facing securities class action lawsuits: 1998-2002

Company	Year of lawsuit	Year relative to lawsuit filing		
		+1	+2	+3
Percentage of original outside directors remaining on board of sued firm	–	94.4%	89.1%	83.2%
Average number of other directorships held by outside directors of sued firms	0.95	0.85	0.54	0.47
Percentage of outside directors of sued firms sitting on other boards	49.6%	46.2%	31.3%	29.1%
Average number of other directorships held by outside directors who hold at least one other board seat in addition to seat on sued firm's board	1.9	1.8	1.7	1.6
Percentage of original outside directors who hold at least one other board seat in addition to seat on sued firm's board and lose at least one directorship	–	84.2%	89.5%	95.7%
Percentage of outside directors of sued firms who lose all other directorships by number of other board seats held when lawsuit is filed:				
1 seat	–	83.8%	88.9%	96.3%
2 seats	–	55.6	63.4	79.2
3 seats	–	31.9	47.7	48.6

Source: Eliezer Fich and Anil Shivdasani, "Financial Fraud, Director Reputation, and Shareholder Wealth," *Journal of Financial Economics*, 86, no. 2, Table 2, p. 317.

The first row of Table 3 highlights that within three years of litigation, 83.2 percent of outside directors remain on the board of the firm involved in the lawsuit. Given that related research documents a departure rate among outside directors of between 5 percent and 7 percent per annum, it appears that outside directors do not experience an abnormal turnover rate in firms involved in litigation. Outside directors who become involved in litigation are likely to remain in their role for some time.

The second row of Table 3 highlights the potential for losing board seats due to corporate misconduct. These results are associated with the director reputation, board adjustment, and personal liability risk hypotheses. (See box below.)

Three Research Hypotheses

Given the general impression that explicit litigation-related costs borne by outside directors are not significant on average, an important area of recent research focuses on the potential for directors to lose board seats as a reputational penalty for their role in oversight failure.[a]

This research views board service as a valuable asset that provides directors with retainers, insurance coverage, and pension plans, as well as heightened visibility in the business community and important networking opportunities.

There are at least three hypotheses regarding the potential for outside directors to face, as a result of oversight failures, important consequences regarding their participation in the market for corporate directorships. Each hypothesis predicts that outside directors will hold fewer board seats following the disclosure of corporate misconduct:

The director reputation hypothesis Potential punishment in the directorship market can motivate directors to act in the interest of the shareholders of the firms they serve.[b] If the market for directorships provides valuable opportunities for directors and the availability of such opportunities is responsive to on-the-job performance, then the incentives of directors will be at least partially aligned with shareholder interests. If corporate misconduct arises from an outside director's oversight failure, then the director will likely experience damage to his reputation as a valuable monitor of management. An impaired reputation should result in fewer opportunities to serve on other boards and, ultimately, fewer total directorships. On the other hand, if performance as a director is weakly associated with future directorship opportunities, then the incentive effects of the directorship market are muted. Instead, shareholders must rely on other mechanisms to align the incentives of directors with shareholder interests, such as encouraging directors to hold restricted stock or options.[c]

The board-adjustment hypothesis Prior to the revelation of corporate misconduct, corporate boards are composed of outside directors who possess a mix of monitoring and advising skills that fits the firm's current environment. However, after misconduct is revealed, outside directors in these firms could voluntarily reduce the number of board seats held in other firms. Directors would reduce their total directorships in order to increase their monitoring and advising activities in the firm implicated in corporate misconduct. For example, it is possible for directors involved in a firm dealing with misconduct to require more than 500 hours per year in their director role, a more than three-fold increase in time commitment compared with holding a directorship prior to the Sarbanes-Oxley Act.[d] This potential increase in time commitment has triggered some companies to bar their current CEO from serving on outside boards.[e] Thus, corporate misconduct may constrain the number of board seats outside directors can carefully manage.[f]

The personal liability risk hypothesis There is a view among practitioners that serving as an outside director of a public company in the current legal environment constitutes a "high-risk endeavor" that is causing many outside director candidates to decline board positions.[g] If outside directors are already jittery about the legal risks, then serving as director of a firm suddenly involved in corporate misconduct may motivate some directors to voluntarily reduce the number of directorships held at other firms to control their overall legal liability risk.

a Suraj Srinivasan, "Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members," *Journal of Accounting Research*, 2005, 43 (May), p. 330 states: "The settlement amounts are typically paid by the company's D&O insurance and by the company itself. This suggests that although litigation may be costly to the company, explicit litigation related costs borne by outside directors are not significant."; Eliezer Fich and Anil Shivdasani, 2007, "Financial Fraud, Director Reputation, and Shareholder Wealth," *Journal of Financial Economics*, 86, p. 307 states: "Until the recent settlements in which outside directors at Enron and WorldCom personally paid over $10 million, outside directors appear to face few consequences for preventing financial misconduct." Similarly, Bernard Black, Brian Cheffins, and Michael Klausner, "Outside Director Liability," *Stanford Law Review*, 2005-2006, Volume 58, p. 1055-1160 indicate that the time involved dealing with the misconduct is perhaps the largest penalty borne by outside directors.

b See, for example, Eugene Fama and Michael Jensen, "Separation of Ownership and Control," *Journal of Law and Economics*, 26, 1983, p. 301-325.

c For detailed discussions of the reputation hypothesis, see, for example, Jeffrey Coles and Chun-Keung Hoi, "New Evidence on the Market for Directors: Board Membership and Pennsylvania Senate Bill 1310," *Journal of Finance*, 2007, 58 (February), p. 197-230.

d Suzanne McGee, "The Great American Corporate Director Hunt," *Institutional Investor*, 39, no. 4, p. 32-38.

e Ibid. For related analysis, see James Linck, Jeffrey Netter, and Tina Yang, "The Effects and Unintended Consequences of the Sarbanes-Oxley Act on the Supply and Demand for Directors," *The Review of Financial Studies*, Volume 22, Issue 8, 2010, p. 3287-3288.

f For detailed discussions of the board-adjustment hypothesis, see, Eliezer Fich and Anil Shivdasani, 2007, "Financial Fraud, Director Reputation, and Shareholder Wealth," *Journal of Financial Economics*, 86, p. 306-336. On the significant commitment required of directors of companies under investigation, see Robin Bergen, *Overseeing Internal Investigations*, in Matteo Tonello, *The Role of the Board in Turbulent Times: Leading the Public Company to Full Recovery*, The Conference Board, Research Report No. 1452, 2009, p. 69.

g See McGee, "The Great American Corporate Director Hunt."

Specifically, the second row reports that directors experience a reduction in the number of outside directorships; the average number of board seats held at other firms in the year prior to a shareholder lawsuit is 0.95 and declines to 0.47 three years after the suit is filed.

The third and fourth rows of Table 3 show how the reduction in the number of outside board positions is related to two factors. First, the third row highlights how the percentage of directors of companies involved in misconduct and hold at least one other board position declines from 49.6 percent in the year prior to litigation to 29.1 percent within three years. Second, the fourth row shows how the number of other directorships held by directors involved in misconduct declines from 1.9 in the year prior to litigation to 1.6 within three years. Taken together, this descriptive evidence indicates that outside directors hold fewer board seats after litigation.

The final four rows of Table 3 illustrate the frequency with which outside directors lose other directorships held prior to the revelation of corporate misconduct that triggers shareholder class action lawsuits alleging the misrepresentation of financial information to investors. Importantly, there is strong descriptive evidence that outside board members experience a significant decline in the number of outside directorships held three years after lawsuit initiation:

- 95.7 percent of directors who hold *at least one* other board seat (that is, in addition to the seat on the sued firm's board) lose *at least one* directorship;
- 96.3 percent of directors who hold *one* other board position lose this directorship.
- 79.2 percent of directors who hold *two* other board positions lose both of these directorships.
- 48.6 percent of directors who hold *three or more* other board positions lose all three directorships.

Thus, the study reveals a significant reduction in the number of board positions held by outside directors of firms implicated in corporate misconduct via misrepresentation of financial information to shareholders.

Audit committee members The discussion above examines outside director turnover and the decline in the number of directorships held by directors involved in securities class actions. Research also investigates the directorship market penalties for directors serving on the audit committee of companies that are required to file an income-decreasing restatement of its previously reported financial information. Specifically, a recent analysis of 51 companies that between 1997 and 2001 filed an income-decreasing restatement and had CEO turnover showed:[31]

- significantly higher *outside director turnover* (50.0 percent versus 40.0 percent);
- significantly higher *audit committee turnover* (66.6 percent versus 33.3 percent);
- significant *decline in directorships held at other firms* (loss of 1 seat versus loss of 0.5 seats).

These results suggest that directorship market penalties also relate to directors serving on committees with responsibility for monitoring financial reporting. Audit committee members of a company that issues an income-decreasing restatement—such as Peregrine Systems—experience turnover at a greater rate and lose relatively more directorships on other boards than directors of other companies with similar characteristics that did not issue a restatement.

Table 4

Median director turnover comparison

N=51

	Income-decreasing restatements	Comparison sample
Outside director turnover	50.0%	40.0%
Audit committee turnover	66.6%	33.3%
Total loss in other directorships	1	0.5

Source: Suraj Srinivasan, 2005, "Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members," *Journal of Accounting Research*, 43, no. 2, 2005, Panel B of Table 12, p. 325.

This analysis compared 51 companies that between 1997 and 2001 filed an income-decreasing restatement and had CEO turnover with 51 similar companies (based on performance, industry, and size) with CEO turnover but no restatement.

Conclusion

The evidence regarding outside director out-of-pocket liability risk, as summarized in Tables 1 and 2, provides several interesting insights:

- When corporate misconduct triggers shareholder litigation, outside directors are seldom involved in trials to judgment. Furthermore, in the few cases won by plaintiffs in the 1996–2005 period, the combination of D&O insurance, indemnification, controlling shareholders and the company itself are likely to have paid the damage awards on behalf of the outside directors.
- With respect to negotiated settlements, in the years prior to WorldCom and Enron, outside directors have rarely been required to put their personal assets at stake; directors have made out-of-pocket payments to shareholders in less than 1 percent of settled suits.

In contrast, the evidence regarding the reputational consequences, as summarized in Tables 3 and 4, shows an increased likelihood that directors lose other directorships after becoming entangled in corporate misconduct. In particular:

- Shareholder class action lawsuits related to the misrepresentation of financial information are significantly associated with outside directors subsequently holding fewer board positions.
- Nearly 96 percent of directors who hold at least one other board position lose at least one directorship within three years of litigation initiation; nearly 50 percent of directors lose three or more directorships.

Outside directors are already sensitive to the exposure to demands for contribution resulting from the settlement of securities class action litigation in which director oversight is questioned. It is particularly important, in the current litigation environment, that boards possess the ability to demonstrate to shareholders (and to the court system) that any failure to prevent or discover corporate misconduct—such as the pervasive accounting fraud at Peregrine Systems—took place in spite of the rigorous performance by the board of its oversight duties. A demonstrable aspect of board oversight should include directors' efforts to scrutinize key risk areas within the company.

In conclusion, beyond the potential legal liability risks, research suggests that outside directors should include in their due diligence of current and prospective board positions the possibility of losing existing, valuable directorships at other firms if corporate misconduct were to occur.

Endnotes

1 See, for example, Joann Lublin, Theo Francis, and Jonathan Weil, "Directors are getting the Jitters: Recent Settlements Tapping Executives' Personal Assets put Boardrooms on Edge," *Wall Street Journal*, January 13, 2005, p. B1; Kara Scannell, "AIG Considers Cutting Greenberg Ties-After Enron, WorldCom, Directors Display Higher Level of Concern Over Their Own Legal Liabilities," *Wall Street Journal*, March 16, 2005, p. C1; Anne Fisher. "Board Seats Are Going Begging," *Fortune* May 16, 2005, p. 204.

2 See the Stanford Law School Securities Class Action Clearinghouse (securities.stanford.edu). The passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) appears to have had little influence on the rate of class action litigation. For additional descriptive details, see the unpublished paper by Mukesh Bajaj, Sumon Mazumdar and Atulya Sarin, 2000, *Securities Class Action Settlements: An Empirical Analysis,* securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.pdf.

3 See the written testimony of Joseph Grundfest and Michael Perino entitled "Ten Things We Know and Ten Things We Don't Know About the Private Securities Litigation Reform Act of 1995," presented before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, on July 24, 1997, for an early comparison of the characteristics of securities class actions pre- and post-PSLRA.

4 See *The state of the corporate board, 2007: A McKinsey Global Survey* (corporatefinance.mckinsey.com/_downloads/knowledge/mckinsey_on_finance/MoF_Issue_24.pdf).

5 See Michael Klausner and Jason Hegland, 2010, How Protective is D&O Insurance in Securities Class Actions?– Part I, Professional Liability Underwriting Society (PLUS) Journal, Volume 23 (February).

6 See Jonathan Karpoff, D. Scott Lee, and Gerald Marton, "The consequences to managers for financial misrepresentations," *Journal of Financial Economics*, Volume 88, 2008, pp. 193-215.

7 Jonathan Sidener. "Peregrine ex-CEO sentenced to prison," *San Diego Union-Tribune*, December 12, 2008, p. C1.

8 See Michael Klausner and Jason Hegland, "When are securities class actions dismissed when do they settle, and for how much?–Part II," *Professional Liability Underwriting Society (PLUS) Journal*, Volume 23 (March), 2010.

9 Much of the following discussion is based on the admirable paper by Bernard Black, Brian Cheffins, and Michael Klausner, "Outside Director Liability," *Stanford Law Review*, Volume 58, 2005-2006, pp. 1055-1160. The analysis excludes cases involving insider trading. For evidence of director liability in Britain, Germany, Australia, Canada, France, and Japan, see Brian Cheffins and Bernard Black, "Outside Director Liability Across Countries," *Texas Law Review*, Volume 84, 2005-2006, pp. 1385-1480.

10 Annual report estimation based on data for public companies available in Standard & Poor's Compustat database.

11 See Bernard Black, Brian Cheffins, and Michael Klausner, "Outside Director Liability," *Stanford Law Review*, 2005-2006, Volume 58, p. 1158, footnote 367.

12 David Ivanovich. "Maxxam Investors Settle Suit – Stock Buyback Part of $20-Million Deal," *Houston Chronicle*, December 9, 1997, Business, p. 1.

13 Ibid.

14 See In re Emerging Communications, Inc., Consolidated Civil Action No. 16415 (DE 5/3/2004), p. 90.

15 Ibid. p. 93.

16 Ibid. p. 95.

17 See Bernard Black, Brian Cheffins, and Michael Klausner, "Outside Director Liability," *Stanford Law Review*, 2005-2006, Volume 58, p. 1067, footnote 35 for details regarding the case search process.

18 Stephen Weiss and Shannon Knotts. "Look into Fiduciary Liability Insurance." *Directors & Boards*, June 22, 2005, p. 12.

19 See Klausner and Hegland, "When are securities class actions dismissed when do they settle, and for how much?"

20 Ibid. For related analysis, see Ellen Ryan and Laura Simmons, *Securities Class Action Settlements: 2009 Review and Analysis*, (securities.stanford.edu/Settlements/REVIEW_1995-2009/Settlements_Through_12_2009.pdf).

21 See RiskMetrics Group, Securities Class Action Services "Top 100 Settlements Report" for 2008, available at www.riskmetrics.com.

22 See Ellen Ryan and Laura Simmons, Securities Class Action Settlements: 2009 Review and Analysis, available at securities.stanford.edu/Settlements/REVIEW_1995-2009/Settlements_Through_12_2009.pdf.

23 See Michael Klausner and Jason Hegland, "How Protective is D&O Insurance in Securities Class Actions?"

24 See Skadden, Arps, Slate, Meagher & Flom LLP client memo "WorldCom/Enron Settlements – Implications for Directors," January 2005; Ben White, "Former Directors Agree to Settle Class Actions," *The Washington Post*, January 8, 2005, p. E-1; Brooke Mastos and Kathleen Day, "10 Ex-World.Com Directors Agree to Settlement," *The Washington Post*, January 6, 2005, p. E-1.

25 See *In re Peregrine Systems, Inc. Securities Litigation*, Case No. 02-CV-0870-BEN, United States District Court, Southern District of California, July 13, 2009.

26 Bigelow, "11 indicted for fraud at Peregrine."

27 See In re Peregrine Systems, Inc., p. 15.

28 See Andrew Longstreth, 2009, "Settlement with Peregrine Directors Moves Toward Approval", American Lawyer, July 16, 2009.

29 Bruce Bigelow. "Moores Dismissed From Peregrine Suit," *San Diego Union-Tribune*, December 7, 2007, p. A1; Christine Caulfield, "Ex-Peregrine Execs Prevail in Shareholder Appeal," *Securities Law 306*, March 23, 2009, available at (securities.stanford.edu/news-archive/2009/20090323_Dismissal109706_Caulfield.html).

30 See Eliezer Fich and Anil Shivdasani, 2007, "Financial Fraud, Director Reputation, and Shareholder Wealth," *Journal of Financial Economics*, 86, p. 306-336 for additional details, especially pp. 316-318.

31 See Suraj Srinivasan, "Consequences of Financial Reporting Failure for Outside Directors: Evidence from Accounting Restatements and Audit Committee Members," *Journal of Accounting Research*, 2005, 43 (May), p. 291-334 for additional details, in particular Table 12 Panel B, p. 325 and subsequent empirical analysis.

About the Author

Jason D. Schloetzer is an assistant professor of Accounting at the McDonough School of Business, Georgetown University. His research investigates the role of managerial accounting and control practices in the stewardship of the modern organization, with a particular emphasis on incentive and performance measurement/management issues in corporate governance and inter-organizational relationships. He has presented his research at numerous universities and academic conferences in the United States and Europe, and has published his research in the *Journal of Accounting Research*. Dr. Schloetzer received his Ph.D. from the Joseph M. Katz Graduate School of Business, University of Pittsburgh.

About the Series Director

Matteo Tonello is director, corporate governance research, at The Conference Board in New York. For The Conference Board, Tonello has conducted governance and risk management analyses and research in collaboration with leading corporations, institutional investors, and professional firms. Also, he has participated as a speaker and moderator in educational programs on governance best practices. Recently, Tonello served as the co-chair of The Conference Board's Expert Committee on Shareholder Activism and as a member of the Technical Advisory Group to The Conference Board Task Force on Executive Compensation. Before joining The Conference Board, he practiced corporate law at Davis Polk. Tonello is a graduate of Harvard Law School and the University of Bologna.

About Director Notes

Director Notes is a series of online publications in which The Conference Board engages experts from several disciplines of business leadership, including corporate governance, risk oversight, and sustainability, in an open dialogue about topical issues of concern to member companies. The opinions expressed in this report are those of the author(s) only and do not necessarily reflect the views of The Conference Board. The Conference Board makes no representation as to the accuracy and completeness of the content. This report is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

About The Conference Board

The Conference Board is the world's preeminent business membership and research organization. Best known for the Consumer Confidence Index and the Leading Economic Indicators, The Conference Board has, for over 90 years, equipped the world's leading corporations with practical knowledge through issues-oriented research and senior executive peer-to-peer meetings.

www.conferenceboard.org

THE AMERICAS
845 Third Avenue
New York, NY 10022-6600
United States
Tel +1 212 759 0900
Fax +1 212 980 7014

ASIA
China
Beijing Representative Office
7-2-72 Qijiayuan,
9 Jianwai Street
Beijing 100600 P.R. China
Tel +86 10 8532 4688
Fax +86 10 8532 5332
www.conferenceboard.cn

Hong Kong
Suite No. 2-3, 18/F, Queen's Place
74 Queen's Road Central
Hong Kong SAR
Tel + 852 2804 1000
Fax + 852 2869 1403

India
A-701 Mahalaxmi Heights
Keshavrao Khadye Marg
Mahalaxmi (East)
Mumbai 400 011 INDIA
Tel + 91 22 23051402

Singapore
8 Eu Tong Sen Street #22-81
The Central
Singapore 059818

EUROPE
Chaussée de La Hulpe 130, box 11
B-1000 Brussels, Belgium
Tel + 32 2 675 54 05
Fax + 32 2 675 03 95

Copyright © 2010 by The Conference Board, Inc. All rights reserved.
The Conference Board® and the torch logo are registered trademarks of The Conference Board, Inc.