Schoon-er or Later: Legal Change and Corporate Governance Dynamics

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The Delaware case *Schoon v. Troy Corp*. permitted a corporate board to eliminate advancement rights to a former director with whom they had a legal dispute. The decision surprised many practitioners and left directors, especially outside directors, vulnerable. The case provides a unique opportunity to investigate how corporations respond to changes in the corporate governance environment. Using a hand-collected data set of indemnification provisions before and after the *Schoon* case, we investigate how firms responded to the decision. We find that while outside law firms responded swiftly by issuing memos to clients with clear recommendations, companies' responsiveness was less uniform. Regressions show that firms with more outside directors were more likely to respond either by adopting protection or upgrading their protection after Schoon. We find that this result is related to the presence of outside directors who serve on boards of other firms that responded to Schoon by amending corporate governance provisions.

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Indemnification rights, and especially the right for advancement of expenses, are what help corporate directors sleep at night. Typically, when directors are sued their expenses are advanced by the firm under a sole condition: that if later they are found not eligible for indemnification they will pay the money back to the firm. Since most cases settle with no bad faith admission directors rarely have to pay the money back. This protection is essential because expenses for legal advice, depositions, and hearings could easily reach hundreds of thousands of dollars per director.

While directors depend on indemnification and advancement rights to guard against the risk of prohibitive litigation expenses, these rights faced a serious challenge in March 2008 after the Delaware Court of Chancery, in *Schoon v. Troy Corp.*, validated Troy's board of directors' amendment to the bylaws, eliminating advancement rights to a former director, with whom they had a dispute. The amendment eliminated the former director's rights retroactively – exposing him to litigation costs associated with acts that occurred while he was a director and acted under the belief that he was entitled to advancement. As a result of this decision, current and former directors in Delaware firms suddenly had to worry about their advancement and indemnification rights being taken away retroactively by their fellow board members. The decision "took the corporate world by surprise."[1] Practitioners warned that "it will shock many directors that they could be stripped from their indemnification rights after they leave the board.[2]" Delaware eventually amended the DGCL to restore protection, but for more than a year many directors in

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[1] Development in Indemnification and Advancement Rights in Delaware, Hutchinson LLP (October 20, 2009) NCBA's Business Law Section Section; Vol. 31, No. 1; October 2009 [hereinafter: Hutchinson memo], available at http://www.hutchlaw.com/library/developments-in-indemnification-advancement-rights-in-delaware.

[2] *See* Kevin La Croix, Former Directors, Advancement Rights and D&O Insurance, D&O Diary (May 5, 2008) [hereinafter: D&O Diary] available at http://www.dandodiary.com/2008/05/articles/corporate-governance/former-directors-advancement-rights-and-do-insurance/

Delaware were exposed to a significant risk that could be mitigated only through board action to adopt enhanced indemnification.[3]

We use this unexpected change in the legal environment to shed light on the question of how firms' corporate governance evolves in response to a legal change by measuring firms' response to *Schoon*. We approach the subject from several angles: We begin with an analysis of memos issued by prominent corporate law firms describing the decision and advising companies how to respond. We use a hand-collected dataset of changes in corporate indemnification agreements to analyze how firms responded to the case. We corroborate the results with discussions with corporate practitioners regarding the legal profession's response to the *Schoon* decision.

The contractual theory of the firm predicts that firms will adopt corporate governance terms that maximize shareholder value (Easterbrook and Fischel 1992). But changes in governance present a different set of questions: Contracts are notoriously sticky and difficult to change (e.g. Kahan and Klausner 1996, 1997, Klausner 1995). Different factors such as network externalities, cognitive biases, or law firms' organizational constraints may impede changes even in the presence of a shock like *Schoon*. Gulati and Scott (2012) found that sophisticated transactional lawyers failed to adapt to changing interpretations of language in sovereign bond agreements, even though the need to respond should have been evident. Yet, responding to *Schoon* by amending the bylaws or awarding indemnification contracts to directors does not require negotiation with counterparties as changes in transactional contracts would. Indeed, corporations have responded to legal shocks such as the invention of the poison pill (Davis 1991). Furthermore, since the response to *Schoon* would only strengthen an existing right, it triggers only weakly, if at all, typical concerns of uncertainty in interpretation of new rights. Finally, if outside counsels are not responsive in-house counsels have better capacity and incentives to effect a change (Marotta-Wurgler and Taylor 2012).

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[3] Arguably even after the amendment directors would be better protected with enhanced indemnification. See e.g., Hutchinson memo supra note 1 ; but see Not a Moment Too 'Schoon': Delaware Directors may now Rest Easy, As Amendment Overturns Controversial Case, available at http://www.pircher.com/resources/legalupdate.php?i=230 (suggesting that directors now could rely on Delaware new law to protect them from retroactive change to their indemnification rights).

It is essential therefore to look both to the legal profession's response and to the actual changes adopted by companies after *Schoon* to have a complete picture of the effect of the opinion. The legal and corporate responses are separate empirical questions. To address the response of the legal profession, we take a qualitative approach. We characterize memoranda produced by top corporate law firms, and identify three concrete responses to the *Schoon* decision suggested to companies by these firms. We supplement the examination of these memoranda with conversations with practitioners to better understand how firms could be expected to process the *Schoon* decision. We find that the response of the legal profession was swift and concrete. Corporate general counsels would have received a host of memoranda from different firms describing the decision and giving explicit suggestions to enhance indemnification.

We then examine how firms responded to these recommendations. We hand-collect fillings of the 293 Fortune 500 firms that are incorporated in Delaware. Using public documents, we identify indemnification arrangements before and after *Schoon*. We find that the response to *Schoon* varied. Of the 166 firms that did not already have individual indemnification contracts in place (the most effective post-*Schoon* protection), 64 acted to adopt some form of protection, and most firms did so within eight months of the opinion. Firms varied also in the type of response they adopted. Only 21 firms adopted the strongest protection – individual indemnification contracts. Finally while some firms upgraded existing protections, 35 firms remained entirely unprotected.

What explains firms' responsiveness to *Schoon*? Looking at indemnification protection in relation to other governance variables, we find that, prior to *Schoon*, the governance provisions associated with strong indemnification protection are different than the variables that correlated with legal change in response to the *Schoon* decision. Prior to *Schoon* firms with higher values of the E Index, an entrenchment index that is correlated with low firms value (Bebchuk Cohen and Ferrell 2009) were more likely to have strong indemnification agreements. We also find evidence that firms with more inside directors were less likely to have strong indemnification protection. These effects persist post-*Schoon* as well. But the firms that were most likely to *change* their governance in the aftermath of *Schoon* were those with many outside directors.

In light of this result it is possible that outside directors took the initiative to demand enhanced protection, and that this initiative and its implementation depended on the relative share of outside directors. Yet, board composition is endogenous, as it affected by other firms' properties (Hermalin & Weisbach 1998, 2003). Thus, it is also possible, for instance, that firms that are inclined to hire high number of outside directors are also inclined to provide these directors with protection. To help distinguish these possibilities, we measure whether directors on each company's board served on another board of at least one other company that adopted *Schoon* protection.[4] Using a hazard model, we find that companies with director interlocks at adopting firms were more likely to adopt *Schoon* protection themselves, but only if the interlocking directors were outside directors. Interlocking inside directors do not predict adoption. The effect holds when we control for the total number of directors interlocking with *any* firm in our sample. Finally, the results are robust to controlling for the level of protection that firms had in place before *Schoon,* to geographical and industry controls, and to controls for corporate governance indices. We interpret this result as consistent with outside directors providing a catalyst for change.

What could be the explanation for this result? Outside directors are probably most vulnerable to a *Schoon* scenario. Their tenure is limited, if they are not in consensus with the board they have the freedom to resign but they may be worried about what may ensue if they are sued afterwards. Outside directors however rely on the general counsel for routine legal advice (Veasey and DiGuglielmo 2006, 2012). Why weren't general counsels more proactive in response to *Schoon*? Some of our interviewees suggested that management may have been reluctant to respond to *Schoon*. Board insiders may have indemnification rights in their employment contracts. Furthermore, insiders have better control over the company bylaws and therefore view a *Schoon* scenario as unlikely to happen to them.[5] Finally, insiders might have been reluctant to extend indemnification protection that would serve to make outside directors more independent and effective in the event of a board dispute. While the general counsel advises board members he is also a member of the company management and may be influenced

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[4] In making this measurement, we draw on Davis (1991) and Davis and Greve (1997), which study the diffusion of corporate governance change.

[5] One interviewer suggested that insiders even underestimate their exposure to *Schoon* by underestimating the possibility that they will be forced to leave the company.

by management position (Bainbridge 2012, Veasey and DiGuglielmo 2012). If outside directors have to initiate changes in protection on their own behalf, corporate governance changes may be impeded by inefficiencies. Not all outside directors have the knowledge and leverage to initiate a response.

While our results are consistent with an agency costs account, they could also reflect simple disagreement. It is possible that, despite the advice of outside counsel, general counsels systematically thought that additional indemnification protection was unnecessary, or not beneficial for the corporation. Thus, they may have chosen to act only at the request of outside directors, and especially when this request is supported by precedent at other firms. While this explanation is possible it is not convincing for all firms. In some firms, particularly ones with no or less protection, general counsels should have found a response to *Schoon* appropriate. We find however, that our interlock results are robust to controlling for the level of protection that firms had in place before *Schoon* and are not driven by companies that had previous protection and upgraded it.

The remainder of this paper proceeds as follows. Section 1 briefly reviews the prior literature. Section 2 describes the *Schoon* decision. Section 3 discusses the response of the legal profession. Section 4 examines the response of the companies themselves. Section 5 concludes.

Section 1. Prior Literature

This project is related to several lines of literature. The first is the literature on corporate governance terms and their relationship to firms' characteristics and performance. Gompers, Ishii and Metrick (2003) found an association between companies' corporate governance terms and stock returns. Bebchuk, Ferrell, and Cohen (2009) show that a select group of the G components related to entrenchment, especially in the face of takeovers, drive the significance of the results. Bradley and Chen (2011) constructed an L index out of the three G component related to directors' protection - indemnification terms, indemnification contracts and protections from liability. Consistent with the view that indemnification rights are desirable they find that firms with high L exhibit higher credit ratings and lower yield spreads and conclude that overall they benefit shareholders. All of these studies take corporate governance as an independent variable. We study corporate governance, and in particular corporate governance change, as a dependent variable.

Several papers have taken board composition as the dependent variable and tested its relationship to existing governance. Hermalin & Weisbach developed a model in which a CEO negotiates with the board new nominations. A powerful CEO uses his bargaining power to nominate less outside directors (Hermalin & Weisbach 1988). Consistent with Hermalin and Weisbach model Shivdasani and Yermack found that CEO involvement in the nomination process results in a lower number of outside directors on the board (Shivdasani and Yermack 1999).

Two business organization researchers have looked at corporate governance change and its relationship to board connectivity. In a project closely related to ours Davis (1991) found that the adoption of poison pills in response to the takeover wave during the 80's was related to board interlocks. Unlike Davis we find that it is only the outside interlocks that matter. Furthermore, when Davis conducted his study, information about corporate governance was significantly less available than today. We find that network matters even though client memos are available online and general counsels receive them in their mailboxes. In addition, since Davis did not apply controls for legal advice it is possible that his results were driven by the identity of the outside counsel. Finally, as Coates (2000) forcefully argued there was neither urgency nor real legal reason to adopt a poison pill unless the firm faced a hostile takeover. Poison pills could be adopted in less than twenty four hours in a board meeting over the phone. Thus, it might be less surprising if board connectivity rather than legal actors play a role here. In a subsequent paper, Davis and Greve (1997) found that diffusion of golden parachutes was associated with firms geographical proximity but not with board interlocks. The authors suggest that the main beneficiaries, and therefore the initiators of parachutes were management members, who rely on and are affected by their social network. [6]

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[6] While not focusing on corporate governance changes, several studies found relationship between interlocks and other practices. Board interlocks are associated with acquisitions decisions and strategy (Gulati 1998, Gulati and Westphal 1999) and option backdating (Bizjak Lemmon and Whitny 2009). A particular subset of interlocks – between top executives, who sever on each other's board – has attracted special attention. CEO's interlocks are associated with worse performance (Fahlenbrach, Low and Stulz 2008) and less efficient compensation (Hallock 1997) potentially due to a "back scratching" effect. These

Finally, this project is related to the literature regarding the responsiveness of contracting to legal change. Numerous effects such network and learning externalities, cognitive biases, organizational constraints and concerns of negative signaling impede changes to contracts (Ben-Shahar & Pottow 2006, Hill 2001, Kahan and Klausner 1996, 1997, Klausner 1995). Several papers found evidence of stickiness (e.g. Davidoff 2008, Tiechman 2008, Bar-Gill and Bubb 2012). In a recent study Bob Scott and Mitu Gulati (2012) found very weak responsiveness among lawyers to a surprising court interpretation of the Parri Passu clause in sovereign debt contracts. Stickiness, however, does not always persist. Steve Choi and Mitu Gulati (2012) found that sovereign bond contracts evolved in response to exogenous shocks. Some papers identified mechanisms that potentially contributed to a change. Marcel Kahan and Mike Klausner (1997) analyzed how event risk covenants developed in corporate bond indentures in response to RJR Nabisco announcement of a leveraged buyout. Their findings suggest that underwriters promote the diffusion of learning benefits associated with these covenants. Florencia Marotta-Wurgler & Robert Taylor (2012) document innovation in commercial contracts. Their findings suggest that innovation is more likely in firms with in-house counsels.

We contribute to the literature by studying how the legal protection that the company provides to its directors is affected by the number of outside directors that serve on boards of responsive firms. We find that despite the abundance of legal commentary, this response was a function of outside directors and their networks.

Section 2. Indemnification Rights and the Surprising *Schoon* Decision

Under Delaware law, companies may, and under some circumstances have to, indemnify directors for expenses related to lawsuits. While directors rarely have to pay out-of-pocket costs for liability, they must bear the legal costs to defend lawsuit until settlement is reached. DGCL 145(e) allows companies to advance expenses for legal defense as long as the director commits to pay the expenses back to the company if he is found not eligible for indemnification. Since

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interlocks are not randomly created but rather are positively correlated with measurements for CEO power (Fich and White 2005).

cases rarely go to trial and settlements typically do not contain an admission of breach of good faith, directors rarely have to pay back advanced funds. More importantly, the advancement is automatic; no prior determination of good faith is required. Thus, advancement is directors' first line of defense. It is used frequently and for large amounts of money.

Before *Schoon*, it was commonly believed that a director's right to indemnification could not be terminated by the company with respect to actions that the director had already taken. While indemnification arrangements could change, the change would not be retroactive to past events. Indeed in *Salaman* the Delaware chancery court determined that the right of advancement was "a vested contract right which [could not] be unilaterally terminated."[7]

The *Schoon* saga started with a dispute involving Troy Corporation, a closely held company, William Bohnen, a former director, and Richard Schoon, a current director. Both Bohnen and Schoon represented a large minority shareholder, the Steel Corporation. Steel was seeking to sell its minority stake, and Schoon, acting as a director, made a request for the books and records of Troy. Troy refused, arguing that Schoon and Bohnen planned to share this information with a third party, namely Steel, and Schoon sued Troy, seeking to force disclosure of the requested information.

After Schoon initiated litigation under the books and records provision of the DGCL, Troy amended its bylaws to remove indemnification protection for former directors and to refuse indemnification with respect to claims initiated by indemnified individuals. Troy then counterclaimed against Schoon and Bohnen for breach of fiduciary duties, alleging that Bohnen and Schoon had shared confidential information with Steel. Troy asserted that its indemnification obligations were controlled by the amended bylaws eliminating former directors and that Bohnen was therefore not entitled to advancement of expenses.

While in *Salaman* the company first advanced a portion of Salaman's expenses and fees and only then changed the bylaws to deprive him from advancement for the rest of his expenses,

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[7] *Schoon*, 948 A.2d at 1165, quoting *Salaman v. National Media Corp.*, 1992 WL 808095 (Del. Super. Oct. 8, 1992), at 6.

the *Schoon* board first repealed the bylaws to eliminate indemnification to former directors and only then brought a suit against Bohnen and Schoon. Vice Chancellor Lamb distinguished *Salaman*, deciding that a director's right of indemnification vests only when a lawsuit against the director is submitted. Since there was no claim against Bohnen prior to the amendments, Bohnen's indemnification rights had not vested and were subject to change. The court held that Bohnen was not subject to advancement of expenses.

Bohen had argued that he was protected by a bylaw provision that about the survival of the indemnification rights that "shall continue as to a person who has ceased to be a director … and shall inure to the benefit of such person and the heirs … of such person."[8] Yet, the court interpreted the provision to protect only those rights that have vested prior to the change.

The result was a surprise to commentators and directors who assumed that indemnification protection could not be retroactively altered. A memo from Ropes and Gray puts it this way:

> Prior to *Schoon*, many practitioners had presumed that a director's rights to advancement and indemnification vested by virtue of the director's service as a director and at the time of such service. It was commonly understood, therefore, that advancement and indemnification rights could not be eliminated unilaterally by the director's corporation.
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> *Schoon* disrupts that settled expectation. Now, any director of a Delaware corporation, with standard advancement and indemnification protections, is at risk of losing the director's right to advancement or indemnification as a result of a subsequent amendment to the corporation's bylaws. If the director is not a defendant or respondent in an indemnifiable proceeding at the time of such an amendment, the amendment could be upheld by the courts. [9]

[8] *See* Id., at 1166.
[9] http://www.ropesgray.com/newspubs/detail.aspx?publication=919

If companies could strip directors of protection and then initiate litigation, disputes among board members carried considerable danger. To be sure, D&O insurance may offer indemnification. Yet, insurance policies vary in their scope of protection, they are limited in size, and many require significant retention if the company is allowed to indemnify by law – a status that is not affected by the company decision to cancel indemnification.[10] Indeed, none of the client memoranda suggested that insurance alone would solve the *Schoon* problem, though some memos suggested that insurance could provide some protection.[11] Furthermore, we identified memos from insurance brokerages and risk management companies that were issued subsequent to *Schoon*.[12] In addition to encouraging firms to respond to *Schoon* these memos imply that having no *Schoon* protection might result in a higher insurance premium.[13]

The result also carried the risk of altering the dynamics within boardrooms. Directors who know that their indemnification rights could be taken from them by their fellow board members might be less willing to enter disputes with the rest of the board. The results are a particular threat to outside directors. While insiders sometimes have employment contracts with the company that include indemnification rights, many outside directors rely entirely on bylaws for their indemnification and advancement protection. Outside directors are also more vulnerable to retroactive changes, as in *Schoon*, since their service on the board is likely to be shorter and they are therefore vulnerable to changes after the end of their tenure. To be sure, insiders may be vulnerable if they are being fired or if someone is taking over the company. Yet, they typically attach a low probability to the first scenario and as our interviewers suggested merger agreements would almost always include indemnification protection for the former board members.

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[10] See Intergo Insurance brokers Schoon memo, available at http://www.integrogroup.com/data/File/white-papers/DO_Update_Delaware_Case_Nov_2008.pdf; see also Executive Risks, Willis, http://www.willis.com/Documents/Publications/Services/Executive_Risks/2006/June2006_ExecutiveRisks_Alert.pdf

[11] Wachtel memo. Some memos also suggested thatin response to *Schoon* directors (especially former ones) may consider buying an individual insurance. for former directors. *See id.*

[12] see. http://www.willis.com/Documents/Publications/Services/Executive_Risks/2009/QuickTake_-_Issue_8_-_November_2009.pdf

[13] see id.

With these concerns in mind, in April 2009 the Delaware legislature stepped in to protect directors from the *Schoon* decision. Under the new Delaware General Corporation Law § 145(f), directors' indemnification and advancement rights could be eliminated retroactively only if the rights explicitly allow for such modification.[14] This law took effect shortly thereafter, and restored what many had assumed to be the status quo. Practitioners hailed the adoption of the rule but nevertheless some of them continued to suggest that protection through a personal contract provides the best assurance to directors.[15]

Section 3. The Response to *Schoon* in the Legal Community

The response of law firms to *Schoon* was swift and clear. In the weeks after the decision, client memos were issued by top law firms and distributed widely. We found more than 40 memos available online. We also found numerous blog posts, legal commentaries, and insurance brokers' memos that related to *Schoon*.[16] Thus, the information was abundant. While possible, it is highly unlikely, as our interviewers suggested, that there are general counsels in the Fortune

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[14] *See* § 145(f):

> (f) … "A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by an amendment to the certificate of incorporation or the bylaws after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred."

[15] *See e.g.*, Development in Indemnification and Advancement Rights in Delaware, Hutchinson LLP (October 20, 2009), *supra* note 1:

"Despite the apparent victory for protective charter provisions resulting from the Delaware statutory amendment, the Schoon experience has been a valuable wake-up call for companies, directors and officers, and legal practitioners."

available at http://www.hutchlaw.com/library/developments-in-indemnification-advancement-rights-in-delaware; *but see* Not a Moment Too 'Schoon': Delaware Directors may now Rest Easy, As Amendment Overturns Controversial Case, available at http://www.pircher.com/resources/legalupdate.php?i=230 (suggesting that directors now could rely on Delaware new law to protect them from retroactive change to their indemnification rights).

[16] See e.g. The D&O Diary http://www.dandodiary.com/2008/05/articles/corporate-governance/former-directors-advancement-rights-and-do-insurance/index.html; Delaware Business Litigation Report http://www.delawarebusinesslitigation.com/2008/03/articles/case-summaries/court-of-chancery-limits-advancement-rights-upon-bylaw-amendment/; Intergo insurance brokers http://www.integrogroup.com/data/File/white-papers/DO_Update_Delaware_Case_Nov_2008.pdf

500 companies who were not exposed to the case. The memos included recommendations for firms to review their indemnification plans and recommended specific changes to governance documents to avoid the risk created by *Schoon*.

We supplemented the memos with interviews of partners in top law firms. We conducted informal interviews with 7 partners.[17] Some of our partners wrote client memos or other legal commentaries on the *Schoon* case. The interviews took approximately half an hour. We asked them to provide their own view of the appropriate response to the case, as well as their understanding of the factors likely to affect individual firms' responses to the decision. We followed up with some of them for a second interview to get more detail or discuss topics raised by other interviewees.

The memos and our interviewees were all of the opinion that firms should have some protection from *Schoon*. They were also consistent in offering three possible responses. First they suggested that companies could make explicit that indemnification rights vest when the director is appointed or at the time of the challenged act rather than the time the lawsuit is submitted as *Schoon* held. Second, bylaws could also be changed to include a term stating that indemnification rights cannot be changed. Finally, firms could adopt a personal contract with the directors, which would vest immediately as a contract right, thereby providing the strongest protection. Some memos strongly encouraged the use of the latter:

> The only certain way for a director to avoid Bohnen's fate in Schoon is to insist that the corporation provide indemnification rights via a separate agreement which, as a real contract, cannot be amended without the director's consent. Corporations may also consider including in their bylaws a provision intended to override the Schoon principle—such as a clause to the effect that "no amendment to these indemnification provisions shall affect any

[17] Our sample size is comparable to Bebchuk, Cohen and Ferrell (2009), who interviewed 6 partners in top M&A law firms to have their opinions on which terms in the G index matter most for corporate governance.

> right in respect of acts or omissions of any indemnified person occurring prior to such amendment." There is no downside to including such a provision, but there can be no assurance that it cannot be amended away just like Bohnen's right to advancement.[18]

We classify the suggested solutions into three categories.

1) *Indemnification Contracts* are contracts between the corporation and board members implementing indemnification. Since board members' service is part of the consideration for the contract, these protections cannot be removed by the company against the board members' wishes. This protection is the strongest against the risk created by *Schoon*.
2) *Vesting Bylaws* are indemnification bylaws that specifically state that the protection they create vests immediately. These bylaws attempt to avoid the *Schoon* issue through the language of the bylaw itself. While these bylaws should provide adequate protection, many practitioners indicated they would recommend contractual protection to clients. Because many lawyers and directors assumed, prior to *Schoon*, that protection vested immediately upon the commencement of a director's term, these bylaws were not common prior to *Schoon.*
3) *No-change Bylaws* are indemnification bylaws that indicate that they cannot be changed without the assent of both parties. While these bylaws provide some

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[18] Debevoise memo, available at http://www.debevoise.com/files/Publication/d20259be-c604-44ec-a438-8fc74fe3d92a/Presentation/PublicationAttachment/a785aa7b-a040-49a0-ace1-9b61be48c67b/Directors_And_Officers_Do_We_Really_Need_Separate_Indemnification_Agreement.pdf; *See also* Development in Indemnification and Advancement Rights in Delaware, Hutchinson LLP (October 20, 2009), *supra* note 11 ("Because charters and statutes retain the flexibility to be amended and modified, indemnification agreements are an increasingly attractive option for directors and officers, as the bilateral nature of such agreements provides the parties with certainty regarding the company's obligations-without the worries that a company will attempt a Schoon-like maneuver."); see also D&O diary ("At a minimum, this holding strongly reinforces the need for each director to have their own separate indemnification agreement with the company, to reduce the possibility for a later board to eliminate these rights after the director has left board service. Without a separate contractual undertaking, directors may have no assurance that after they leave the board their rights to advancement and indemnification will be preserved.")

protection against the removal of indemnification, and were common prior to *Schoon*, they are not an ideal form of protection. It is not clear that Delaware courts would enforce a provision restricting the capacity of shareholders and directors to change a company's bylaws.[19]

The strong reaction of the legal community stands in contrast to the findings of Gulati and Scott (2012). While lawyers reported the *Elliot* case and analyzed its implications to sovereign debt, not even one memo included a recommendation to change the ambiguous parri passu clause in response to the surprising interpretation given to it in *Elliot*.[20] This experience suggests that corporate governance lawyers have the capacity to be responsive to legal shocks.

The *Schoon* memos, however, are often where outside lawyers' service ends. Law firms send these memos broadly, almost as a marketing device. Each general counsel typically receives 5 to 10 memos from different law firms. If the general counsel decides to act on the advice she may choose a different outside counsel to implement the change. Accordingly, except for a subset of clients to which they provide continuous advice law firms do not necessarily know if the client has responded. Thus, our conversations with lawyers suggested another important difference between the legal innovation process regarding the corporate form and legal innovation among transactional lawyers. While transactional lawyers have a close control on contracts and can effectuate a change themselves, the corporate lawyers send their memos to clients but have little control over what ensues.

Thus, in most companies, the general counsel may choose whether to act on this information. If she decides to do so she would raise it with the board, typically first with the corporate governance committee. Presumably indemnification is important to recruit and retain directors, and firms should have an interest in maintaining it. The result also carried the risk of

[19] *Cf*. Delaware courts' skepticism about "Dead Hand" poison pills in Mentor Graphics Corp. v. Quickturn Design Systems, Inc. 729 A.2d 25 (Del Ch. 1998).
[20] Gulati & Scott, The Three and A Half Minute Contract ("Importantly for purposes of our story, however, there were no explicit proposals from the debtor side on how best to cure the ambiguity in the standard clause.")

altering the dynamics within boardrooms. Directors who know that their indemnification rights could be taken from them by their fellow board members might be less willing to enter disputes with the rest of the board. Thus, protecting directors from the risk created by *Schoon* should be in the interest of firms and ought to be promoted by general counsels. Consistent with the view that *Schoon* protection is warranted for all firms, in our conversations with practitioners, none defended *Schoon* and its implications.

On the other hand, general counsels may believe that while a protection from Schoon is important for the outside directors it is not necessarily in the best interest of their client, the company. Indemnification contract create a stronger obligation from the company to pay directors their legal expenses and thus increases the company's expected costs.

Second and related, while the general counsel advises the board he is also part of the management team and may find it difficult to balance insiders' and the outsiders' interests (Veasey 2012, Bainbridge 2012). As discussed above, the *Schoon* decision poses a more serious threat for outside directors than to inside directors who have more control over the bylaws. Moreover, insiders may benefit from the *Schoon* decision. In times of internal board disputes inside directors may find *Schoon* helpful in weakening outside directors' willingness to disagree with insiders. The *Schoon* case itself arose out of a dispute between insiders and outsider. It is exactly in these cases of dispute when outside directors may prove effective in advancing the interests of shareholders over the interests of insiders. For instance, research has shown that among companies with a high proportion of outside directors management turnover is more sensitive to performance (Weisbach 1988). Increasing the leverage of outside directors through enhanced indemnification protection may therefore disadvantage insiders.

While the outside legal advice was clear, the response of firms to that advice is a separate question to which we now turn.

Section 4. The Response to *Schoon* Among Corporations

Did firms follow the advice of corporate lawyers in the aftermath of *Schoon*? Which firms were likely to respond? Which firms were likely to have sufficient protection in place before the decision? To investigate these questions we use a hand-collected data on firms' response to the *Schoon* decision. We limit our data collection to the 293 Delaware-incorporated firms in the Fortune 500. In order to determine whether a corporation made an amendment to their bylaws or adopted a contract in response to *Schoon*, we search the SEC EDGAR database beginning March 28, 2008, the date of the Court of Chancery decision in the case. We identify 8-K filings with a 5.03 indicator, suggesting a change in the company's bylaws, and inspect these filing for references to indemnification agreements, changes to the bylaws, and changes to the charter. We also examined 10-K filings one year before *Schoon* and in 2009 and 2010 for reference to pre-existing indemnification provisions or agreements and newly adopted provisions or agreements. Whenever reference is made to an indemnification provision, we inspect the original document to classify the provision.

These searches allow us to identify, for each firm, what type of protection the firm had in place pre-*Schoon* and what type of protection the firm adopted in the aftermath of *Schoon*. We divide indemnification protection into three classes corresponding to the categories of response advocated in law firm client memos:

- Indemnification contracts, the strongest form of protection.
- Vesting bylaws, an intermediate form of protection less safe than contracts, but superior to no-change bylaws.
- No-change bylaws, which provide some protection but are, based on our conversations with practitioners, not adequate.

We match the hand-collected data with data on firm size and board characteristics from Corporate Library. We match the E Index using ticker symbols.[21] These matched datasets further limit our sample to firms with coverage in the RiskMetrics and Corporate Libraray databases, a total of 234 firms. Figure 1 shows the number of firms adopting indemnification contracts or bylaws with some form of *Schoon* protection in each month after the decision in *Schoon*. The response started soon after the Court of Chancery decision in the case and most firms that acted did so within the first eight months after the opinion. Activity largely trailed off,

[21] Unfortunately while the response to *Schoon* was typically assisted by an outside counsel firms do not disclose the identity of the outside counsel that implemented the change and thus we do not have this information.

with relatively few firms adopting changes in the days after January 2009. However, activity did not completely stop, even after the Delaware legislature amended the DGCL to effectively overturn *Schoon*. As the figure shows, at least some companies responded swiftly to the risk created by *Schoon*.

To get a more refined picture of the state of corporate governance before and after *Schoon.* Table 1 Panel A shows, for each type of protection, the number of firms that had the protection prior to *Schoon,* the number of firms that adopted each protection in the aftermath of *Schoon*, and how many firms had each type of protection as of the end of our data. Prior to *Schoon* a bylaw without a no-change provision was the most common type of protection. Since the need for a vesting provision was not apparent prior to *Schoon*, only two companies in our sample had such protection. While the need for a contract to ensure vesting was not obvious pre-*Schoon* many companies nevertheless opted for contractual indemnification. Notably, 69 firms had no protection that would have prevented the removal of indemnification protection.

In the aftermath of *Schoon* many firms adopted no-change bylaws, accompanied with either contractual protection or a vesting bylaw provision or both. In total, 64 firms responded to *Schoon* by adopting one or more of these options. Panel B of Table 1 shows the count of firms by the strongest protection they have in place. The table presents the number of firms with contracts, the number of firms with *at least* vesting bylaws (but no contract), and the number of firms with *only* no-change bylaws. This table differs from Panel A in that it does not double count firms with multiple types of protection in place.

Table 2 shows the number of firms adopting each type of protection, sorted by prior protection.[22] Firms with prior contracts were unlikely to adopt further protection. While many firms with bylaws in place did not respond to *Schoon*, firms with bylaws were more likely than firms with contracts to enhance protection with either a contract or vesting bylaw. Interestingly, thirty-five companies that lacked indemnification protection prior to *Schoon* made no changes to their bylaws after the case was decided. Directors of these companies were not protected against loss of their indemnification in the interim between the *Schoon* decision and the changes to

[22] Note that the numbers in Table 2 don't perfectly map to the corresponding counts in Table 1. Some firms had multiple types of protection or adopted multiple types of protection and thus will contribute to multiple columns or rows in Table 2. Table 1 is a raw count of the number of firms in each category.

Delaware law. In light of the widespread publicity surrounding *Schoon*, and the risk to directors of remaining unprotected, it is puzzling that some firms without prior protection would not opt to enhance their protection. Only 21 firms adopted contracts, and more than half of our sample remained without a contract, despite it being the strongest protection and probably the least costly one to adopt.

Table 3 presents basic summary statistics for the primary covariates reported in our regressions.

4.1 Response to *Schoon*: Basic Regressions

How do firms that altered their governance after *Schoon* differ from other firms? To investigate factors that might correlate with the adoption of additional protection post-*Schoon*, we run a series of logit regressions. We begin with a focus on corporate governance provisions that might have some explanatory power. The first set of variables of interest relate to board size and composition. In particular, we focus on the number of inside and outside directors, since concern about the removal of indemnification protections falls most acutely on outside directors. We hypothesize that firms with more outside directors may be more likely to adopt additional indemnification after *Schoon*, since large contingents of outside directors may have more leverage to insist on additional protection. To test this hypothesiswe include both total board size and, separately, the numbers of inside and outside directors.

Also of interest are measures of anti-takeover protection. In particular, we include in our regressions the Entrenchment Index (E Index) of Bebchuck, Cohen and Ferrell (2009), which captures the cumulative presence or absence of important anti-takeover provisions. Whether and how the E-Index would correlate with a post-*Schoon* response is unclear. Firms with high values of this index are well-protected against takeover and are therefore unlikely to be successfully acquired without the assent of the existing board and without indemnification protection. Board members at vulnerable firms might be more likely to demand protection. Alternatively, firms that were more vulnerable to takeovers may have adopted antitakeover protections and indemnification protections. Finally, a high E-index score may reflect a preference for management-favoring governance therefore predict increased adoption of indemnification by-laws and agreements. While we do not view a response to Schoon as necessarily entrenching under this interpretation high E could predict general inclination to amass protections. We opt for the E-Index rather than the G-Index of Gompers, Ishii and Metrick (2003) because the G-Index includes the presence of indemnification contracts as one of its components.

Finally, we include control variable to capture basic firm characteristics and a control for the log of market capitalization. We report all of our results with and without Fama and French (1988) five-industry classification dummies. Due to the relatively small size of our sample, we are not able to use more fine-grained industry codings. Nonetheless, some degree of industry coding is important to control for possible difference in response by industry. In unreported regressions, we also include geographic dummy variables coding firms that are headquartered in New York, California, or elsewhere.

Our first set of regressions examines the state of affairs before the *Schoon* decision. Table 4 presents a set of ordered logit regressions in which the dependent variable takes values indicating the most effective protection the company had in place prior to *Schoon.* Specifically, the variables take the value of three for contract protection, two for vesting bylaws, one for no-change bylaws, and zero if no protection is present. These codings reflect our ordering of the relative strength of each type of protection. We run models including board size, number of inside and outside directors separately, and each model is run with and without industry dummies. In the absence of industry controls, no variables are significant in either models one or three. Models 2 and 4 include industry controls. In these models, the E-Index is significant at the 10% level. Higher values of anti-takeover protection are associated with stronger pre-*Schoon* indemnification. In model 4, more inside directors is associated with weaker indemnification. The primary purpose of these regressions is to provide a basic understanding of the pre-existing relationship between our variables of interest and the type of indemnification protection. The results are consistent with the following story: Firms with high E-Index scores may have a strong preference for legal protection, and firms with a large number of inside directors may resist extending legal protections to outsiders. However, the static, cross sectional regressions presented here are particularly vulnerable to concerns about unobserved differences between firms that give rise to endogeneity problems. Nevertheless, an understanding of the correlations between the variables of interest is helpful in interpreting our findings of companies' responses to *Schoon*.

Table 5 presents logit regressions in which the dependent variable indicates the adoption of indemnification protection post-*Schoon*. This is a measure of legal responsiveness. We add a control for the presence of an indemnification contract pre-*Schoon*. Since such a contract would provide sufficient protection for directors post-*Schoon*, it is highly predictive of firms taking no action. Board size is not significant in models one or two. When board size is disaggregated into inside and outside directors, only the number of outside directors is significant. This suggests that responsiveness to *Schoon* may be associated with the presence of a significant contingent of outside directors, consistent with the hypotheses that outside directors, who are the directors most vulnerable to the removal of indemnification, may initiate the response to *Schoon*. Variation in board size is highly correlated with the number of outside directors. There is considerably less variation in the number of inside directors, and this makes it difficult to distinguish the effect of total board size from the effect of outside directors. We find no statistical relationship between the E-Index and the decision to adopt additional protection, though it is directionally consistent with a higher propensity to adopt. It is notable that outside directors have such strong predictive power here, as the relevance of the same variable in the pre-*Schoon* degree of protection was extremely weak.

The most interesting relationship identified in the Table 5 regressions is the connection between number of outside directors and the adoption of protection post-*Schoon*. The relationship is statistically significant and robust to the inclusion of industry controls. This relationship is consistent with at least two possible claims: It is possible that having many outside directors increases the likelihood that outsiders would have information about the *Schoon* decision, and leverage in the boardroom to encourage a corporate response to the decision. Yet, it may also be that firms that appoint significant numbers of outside directors are firms that are inclined, along some unobservable dimension, to high-quality corporate governance, and therefore act to enhance protection after *Schoon* without prodding from the outside directors.

Because these two interpretations have different implications for the role of outside directors, it is desirable, to the extent possible, to empirically distinguish them. In the next subsection, we attempt to more clearly identify the mechanism through which the number of outside directors is associated with legal responsiveness.

4.2 Director Interlock and Response to *Schoon*

Many outside directors sit on multiple boards, either as outsiders or insiders. Out of the 269 firms with director data, 107 had at least one director who sits on another board. We refer to the presence of a director on another board in our sample as an instance of director interlock.

Director interlock is one mechanism by which information about corporate governance practices could spread from one board to another. That is, a director who sits on a board, whether as insider or outsider, of a company that adopts enhanced indemnification protection in response to *Schoon* may be particularly likely to seek similar protection on another board where they sit as an outsider. Furthermore, having a change initiated in one firm could give the director more credibility and leverage to encourage a change in his own firm. We hypothesize that companies with outside directors who sit on boards of firms that responded to *Schoon* should be more likely to respond to *Schoon* themselves.

To test this hypothesis, we construct an indicator variable, Adoption Interlock Indicator, that takes the value one when a company's board includes at least one director who sits on board of at least one company, other than the company in question, that responded to *Schoon*. We characterize a director as an instance of "adoption interlock" if the director the director sat on the board of another company (as either an insider or an outsider) that we code as having responded to the *Schoon* decision. We then construct two separate versions of this indicator variable separately flagging whether the company's board contains an inside director interlocking with an adopting firm and whether the board contains an outside director similarly interlocking. This disaggregation reflects our understanding from discussions with practitioners that inside directors were less likely to need additional protection from *Schoon* and that adopting such protection would enhance the power of outsiders. Inside directors are therefore unlikely to be the catalysts for enhanced indemnification protection. But outside directors who sit as insiders on another board that adopted protection will nevertheless learn about the *Schoon* decision and the need for protection. If they sit as outsiders on another board, they may request enhanced protection.

Drawing on the literature on director interlock, we test the impact of adoption interlock using a hazard model. This captures the impact of changes in adopting interlock as more firms adopted responses to *Schoon*. If director interlock is important, we expect that firms with directors in common with firms that have already responded would face pressure, particularly from outside directors, to respond by adopting additional indemnification protection. There are limits to our ability to observe this effect. While we can observe changes in governance structure, the timing of deliberations is not observable. Thus Firm A may have changed its governance provisions before Firm B, though deliberations over a change were initiated first at

Firm B. Nevertheless, on the reasonable assumption that the time of adoption is informative about which firms initially took up consideration of changes in response to *Schoon*, the timing of changes may be helpful in identifying the role of outside directors.

We begin by constructing a panel data set in which we compute the degree of Adopting Interlock at each company for each month. That is, for each company, we ask at time *t*, how many outside directors sit on boards that responded to *Schoon* before time *t*. The panel runs from 2008 through 2010, then end of the Corporate Library data. Four firms adopted protection in 2011, and these firms are excluded from this panel.

We use this data to estimate a Cox proportional hazard model with the time of adoption of new protection as the dependent variable, allowing the independent variables to vary over time. Since no firm responded more than once to *Schoon* we treat firms as exiting the sample at the time they adopt protection. The results of these regressions are presented in Table 6. Table 6 includes six regressions using three sets of covariates, with and without industry dummies Models one and two use the indicator for *any* interlock with an adopting board: outside or inside directors. This measure of board interlock has very low significance. Models three and four report results using two indictor variables for the presence of interlock within the inside and outside directors treated as separate groups. In these models, only adoption interlock with outside directors is significantly predictive. This is consistent with our finding that the number of outside directors, but not inside directors, is significantly related to legal responsiveness.

One possibility to be addressed is that director networks are important aside from interlock with adopting firms. A firm with many directors on other boards is more likely to have a director on a board that responded to *Schoon*. If interlock predicts adoption of protection, regardless of whether the interlocking firms responded, then this could provide an alternative explanation for the results of models three and four. To address this possibility, models five and six, include a control variable for the total number directors on each company's board that sit on other boards in our samples, regardless of whether those boards responded. Controlling for total interlock increases the economics and statistical significance of the adoption interlock indicator for outside directors, while interlock does not significantly predict responsiveness.

One potential alternative explanation for our results could be that companies with interlocked boards also share legal advisors or draw from similar pools of directors. While data about outside counsel is not available, we can proxy to some extent for this by controlling for geography (Bizjak et al, 2009). In unreported regressions we include dummy variables for firms headquartered in New York, California, and firms headquartered elsewhere. The interlock effect is robust to these controls. Our inclusion of industry controls also helps address the possibility that firms in similar industries might use similar outside lawyers (Bizjak et al, 2009). Finally, having directly examined the memoranda prepared by outside counsel, the relative uniformity of advice suggests companies were unlikely to be getting disparate legal advice. To further evaluate the robustness of our results, we rerun our regressions and include firms missing E Index data, using industry average E index for the missing firms. These unreported regressions show statistically stronger effects for the outside director interlock variable.

Finally, and for completeness, Table 7 presents a set of ordered logit models examining the level of protection post-*Schoon*. Similar to Table 3, to the pre-*Schoon* results, inside directors are associated with lower levels of protection, while the E index is associated with more protection. The absence of outside directors as a significant variable here reflects the fact that most firms did not respond to *Schoon,* and, in particular, that a large number of firms had pre-existing indemnification contracts and therefore did not need to respond.

Section 5. Conclusion

We find that information about the case swiftly diffused through the legal community. The firm-level response was more complex. Many firms responded to the *Schoon* decision by adopting stronger indemnification provisions, but not all firms acted in response to the disruptive legal change, and some firms went unprotected. Firms with more outside directors were more likely to respond post-*Schoon*. We use interlocking directorships to shed light on the outside director result and find that the board size effect is driven by outside directors holding seats at other firms that adopted protection. This result suggests that outside directors may have played a role in initiating legal change.

Insufficient indemnification leaves outside directors vulnerable and therefore a less effective check on management. As we argue above, the clear advice of outside counsel, as well as intuitions about sound governance suggest that enhancing indemnification protection after *Schoon* is the best response, particularly for firms without any vesting protections. If outside directors must fend for themselves by initiating changes in their own indemnification arrangements, this is a potential cause for concern. We are left with the question of whether corporate general counsels are effective in optimizing protection for their firms' outside directors

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Figure 1: Histogram of Adoption of Indemnification Protection After *Schoon*

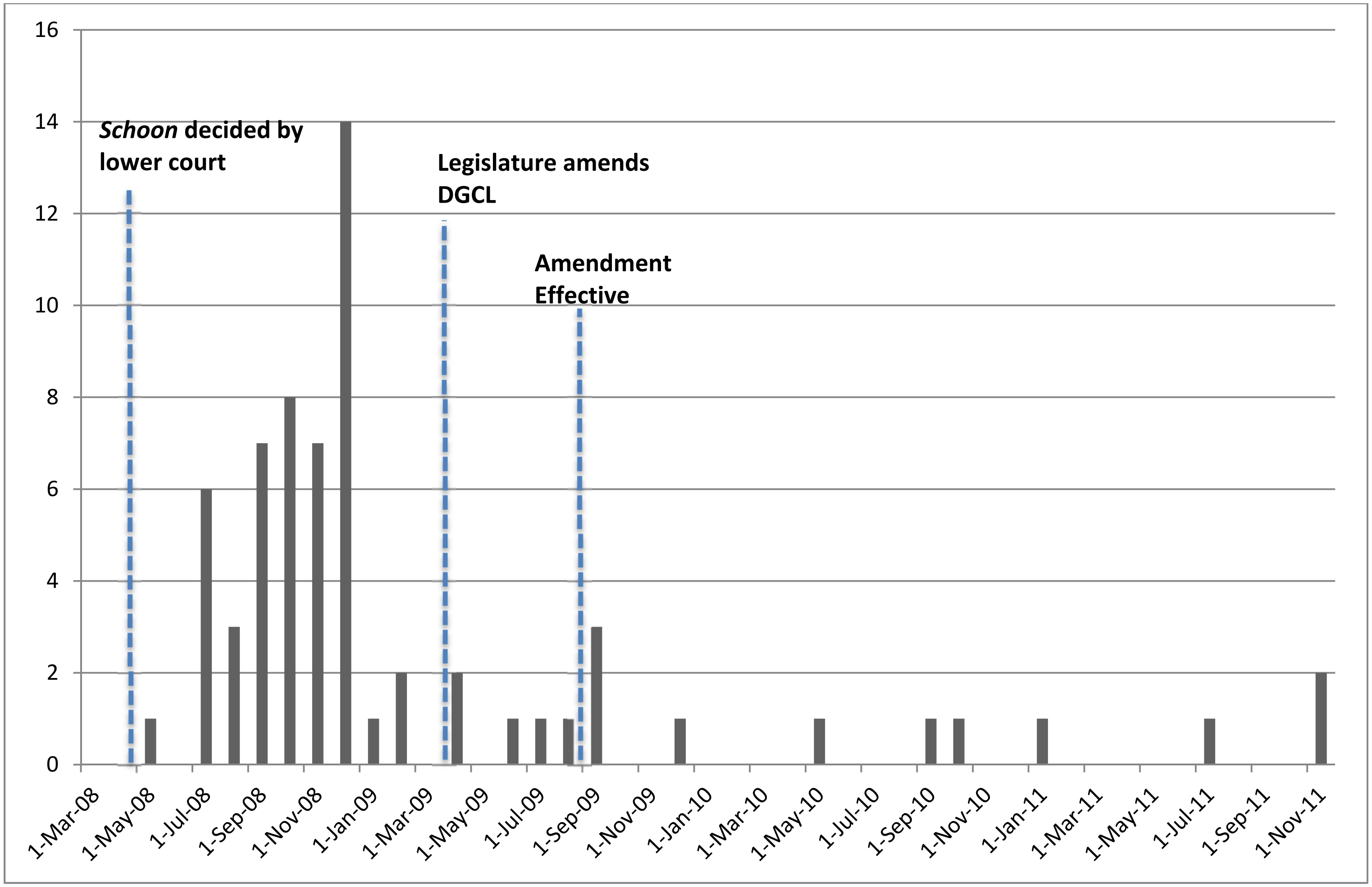

Table 1. Levels of Protection

Panel A. Counts by Protection Type for Each Before and After *Schoon*

	None	Contract	Bylaw (Vesting)	Bylaw (No Change)	Any Protection
Before	69	117	2	170	224
Adopted	229	21	22	41	64
After	35	135	24	206	258

N=293

Panel B. Maximum Protection in Effect Before and After *Schoon*

	Contract	Bylaw (Vesting)	Bylaw (No Change)	None
Number of Firms Before Schoon	117	1	102	71
Number of Firms (As of 2010)	135	17	103	36

Table 2. Map from Prior Protection to Adopted Protection

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="4">Prior Protection</td></tr>
<tr><td>Contract</td><td>Bylaw (Vesting)</td><td>Bylaw (No Change)</td><td>None</td></tr>
<tr><td rowspan="4">Protection Adopted</td><td>Contract</td><td>3</td><td>0</td><td>10</td><td>9</td></tr>
<tr><td>Bylaw (Vesting)</td><td>4</td><td>0</td><td>11</td><td>10</td></tr>
<tr><td>Bylaw (No Change)</td><td>8</td><td>0</td><td>5</td><td>41</td></tr>
<tr><td>None</td><td>105</td><td>2</td><td>148</td><td>35</td></tr>
</table>

N=293

Table 3. Summary Statistics for Covariates

A. All Firms

	Mean	Median	SD	Min	Max
Outside Directors (Count)	8.330	8.000	2.328	2.000	15.000
Inside Directors (Count)	1.416	1.000	0.834	0.000	6.000
Size of Board	10.588	10.000	2.243	5.000	19.000
E Index	2.198	2.000	1.315	0.000	6.000
Market Cap ($B)	16.043	5.379	26.938	0.037	188.752

B. Non-Responding Firms

	Mean	Median	SD	Min	Max
Outside Directors (Count)	8.132	8.000	2.264	2.000	14.000
Inside Directors (Count)	1.439	1.000	0.853	0.000	6.000
Size of Board	10.439	10.000	2.271	5.000	19.000
E Index	2.138	2.000	1.305	0.000	6.000
Market Cap ($B)	22.463	22.402	1.605	17.415	25.964

C. Responding Firms

	Mean	Median	SD	Min	Max
Outside Directors (Count)	8.984	9.000	2.433	3.000	15.000
Inside Directors (Count)	1.339	1.000	0.767	0.000	5.000
Size of Board	11.081	11.000	2.091	5.000	16.000
E Index	2.390	3.000	1.339	0.000	5.000
Market Cap ($B)	22.675	22.539	1.109	20.265	25.154

Table 4: Ordered Logit Regression of Most Effective Degree of Protection Prior To *Schoon*

This table presents ordered logit regressions of a variable denoting the maximum degree of indemnification protection present prior to the *Schoon* decision. The variable takes the value 3 for contracts, 2 for vesting bylaws, 1 for no-change bylaws, and 0 for no protection. Cut points and industry dummies are omitted from the reported results.

	(1) Protection Prior to Schoon	(2) Protection Prior to Schoon	(3) Protection Prior to Schoon	(4) Protection Prior to Schoon
Size of Board	-0.0535	-0.0446		
	(-0.92)	(-0.74)		
# of Outside Directors			-0.0101	0.0119
			(-0.17)	(0.19)
# of Inside Directors			-0.167	-0.249*
			(-1.20)	(-1.82)
E Index	0.142	0.192*	0.136	0.186*
	(1.44)	(1.89)	(1.36)	(1.80)
Log(Market Cap)	0.0428	0.0262	0.00697	-0.0151
	(0.49)	(0.28)	(0.08)	(-0.17)
Industry Dummies	No	Yes	No	Yes
Observations	234	234	234	234
Pseudo R^2	0.006	0.023	0.007	0.027

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 5: Logit Regression of Firms Adopting Protection After *Schoon*

This table presents logit regressions of an indicator variable indicating the adoption of vested indemnification protection in either contract or bylaws after the *Schoon* decision. The indicator takes a value one if a firm adopted new protection after *Schoon*, regardless of prior protection.

	(1) Adopted Protection	(2) Adopted Protection	(3) Adopted Protection	(4) Adopted Protection
Size of Board	0.0996	0.128		
	(1.29)	(1.56)		
# of Outside Directors			0.168**	0.197**
			(2.02)	(2.18)
# of Inside Directors			-0.00334	0.0101
			(-0.02)	(0.05)
E Index	0.226*	0.218	0.212	0.203
	(1.71)	(1.56)	(1.58)	(1.46)
Log(Market Cap)	0.0687	0.0445	0.0203	0.00289
	(0.65)	(0.40)	(0.19)	(0.03)
Prior Indemnification Contract	-1.308***	-1.333***	-1.340***	-1.378***
	(-3.65)	(-3.53)	(-3.76)	(-3.62)
Constant	-3.839*	-3.586	-3.088	-2.871
	(-1.68)	(-1.52)	(-1.30)	(-1.18)
Industry Dummies	No	Yes	No	Yes
Observations	236	236	236	236
Pseudo R^2	0.074	0.093	0.085	0.105

t statistics in parentheses * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 6: Cox Proportional Hazard Model: Director Interlock and Response

This table presents Cox proportional hazards regressions in which the dependent variable is in indicator variable taking the value 1 if the firm adopted new protection at time t 0 otherwise. Observations are monthly, and the panel runs form 2008-2010. Adopting Interlock Indicator takes the value one if the firm had at least one outside director serving on another board in the sample that adopted protection after *Schoon.* Percentage of Adopting Interlock Directors and Number of Adopting Interlock Directors are the percentage and number of directors who serve as outside directors and are on another board in our sample for a company that adopted protection after *Schoon.*

	(1)	(2)	(3)	(4)	(5)	(6)
Adoption Interlock Indicator	0.516	0.510				
	(1.57)	(1.48)				
Adoption Interlock Ind. (Outside)			0.596*	0.584*	0.758**	0.717*
			(1.81)	(1.71)	(2.06)	(1.90)
Adoption Interlock Indicator (Inside)			0.159	0.227	0.199	0.249
			(0.23)	(0.32)	(0.29)	(0.35)
Total Interlocking Directors					-0.0927	-0.0795
					(-1.18)	(-0.99)
Number of Outside Directors	0.0454	0.0443	0.0445	0.0414	0.0681	0.0621
	(0.95)	(0.84)	(0.93)	(0.78)	(1.31)	(1.10)
Number of Inside Directors	-0.295*	-0.233	-0.296*	-0.233	-0.297*	-0.239
	(-1.74)	(-1.24)	(-1.72)	(-1.23)	(-1.71)	(-1.25)
Prior Indemnification Contract	-1.165***	-1.140***	-1.159***	-1.140***	-1.171***	-1.148***
	(-3.47)	(-3.24)	(-3.44)	(-3.21)	(-3.43)	(-3.21)
E Index	0.180	0.176	0.174	0.172	0.179	0.174
	(1.54)	(1.45)	(1.48)	(1.42)	(1.50)	(1.42)
Log(Market Cap)	0.0415	0.0343	0.0353	0.0289	0.0804	0.0702
	(0.48)	(0.38)	(0.39)	(0.31)	(0.86)	(0.69)
Industry Dummies	No	Yes	No	Yes	No	Yes
Observations	7071	7071	7071	7071	7071	7071

Table 7: Ordered Logit Regression of Most Effective Degree of Protection After *Schoon*

This table presents ordered logit regressions of a variable denoting the maximum degree of indemnification protection present after to the *Schoon* decision. The variable takes the value 3 for contracts, 2 for vesting bylaws, 1 for no-change bylaws, and 0 for no protection. Cut points and industry dummies are omitted from the reported results.

	(1) Protection Prior to Schoon	(2) Protection Prior to Schoon	(3) Protection Prior to Schoon	(4) Protection Prior to Schoon
Size of Board	-0.0120	0.0104		
	(-0.19)	(0.15)		
# of Outside Directors			0.0328	0.0723
			(0.51)	(1.08)
# of Inside Directors			-0.159	-0.247*
			(-1.12)	(-1.77)
E Index	0.180*	0.233**	0.169*	0.222**
	(1.89)	(2.35)	(1.76)	(2.21)
Log(Market Cap)	0.0501	0.0442	0.0129	0.000867
	(0.51)	(0.41)	(0.13)	(0.01)
Industry Dummies	No	Yes	No	Yes
Observations	234	234	234	234
Pseudo R^2	0.007	0.022	0.009	0.029

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$