Board Interlocks and Outside Directors' Protection

We examine the role of outside directors' interlocks, in restoring directors' indemnification protection in response to the Delaware case *Schoon v. Troy Corp.* The case, which permitted a board to alter indemnification and advancement of expenses arrangements for a former director retroactively, left directors vulnerable unless their firm acted to restore protection. Using a hand-collected data set, we find that firms became more than two times as likely to adopt enhanced indemnification protection once a firm with which they share an outside director adopted protection. Our results suggest that interlocks contribute to outside directors' knowledge and bargaining power within the boardroom. Consistent with the bargaining power hypothesis we find that other measures of outside directors' power: (i) a large proportion of outside directors; (ii) a designated independent lead director, and, with marginal significance, (iii) more board meetings in executive session. These results have legal and practical implications for corporate governance.

Michal Barzuza*
University of Virginia School of Law

Quinn Curtis
University of Virginia School of Law

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* Corresponding author. 580 Massie Road, Charlottesville, VA 22903. Ph. 434-924-7810. mbarzuza@virginia.edu

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1. Introduction

In a surprising March 2008 decision, *Schoon v. Troy Corp.*,[1] the Delaware Court of Chancery validated a company's amendment to its bylaws eliminating a provision for advancement of legal fees to a former director with whom they had a dispute. As a result of the decision, directors suddenly had to worry that advancement and indemnification rights, which cover litigation expenses if they are sued as board members, could be altered retroactively. Corporate law firms flagged *Schoon* as one of the surprising decision of the year and were quick to suggest potential steps to restore pre-*Schoon* protection by altering bylaws or adopting personal contracts that cannot be changed retroactively. Delaware eventually amended its corporate law to restore protection, but for more than a year many directors in Delaware, and outside directors in particular, were exposed to a significant risk that could be mitigated only through board action to adopt enhanced indemnification. *Schoon* created a sudden, uniform change in corporate governance, and the case provides an opportunity to study the diffusion of legal protections for directors and sheds light on the spread of corporate governance practices generally. We use a hand-collected dataset of changes in corporate indemnification agreements to analyze how firms responded to the case.

Drawing on the literature on board interlocks and corporate governance, we focus on interlocking directorships, directors who serve on more than one board, as a channel through which governance changes in response to *Schoon* may have propagated. We hypothesize that sharing a director with a responding firm would increase a firm's probability of responding to *Schoon.* There are several plausible reasons interlocks might have a causal effect in this context: Outside directors are often not lawyers or corporate governance experts and may have been unaware of the decision or its importance until put on notice by a director serving on a responding board. Even if directors were aware of *Schoon* they may have had difficulty persuading a firm to undertake change, been reluctant to raise the delicate issue of indemnification, or simply relied on the advice of the general

[1] 948 A.2d 1157 (2008).

counsel to take a wait-and-see approach.[2] Interlocks to another firm that had already responded to *Schoon* could increase outside directors' information, conviction, and leverage to effect a change.

To identify the effect of interlocks, we hand-collect SEC filings for the 268 Fortune 500 firms incorporated in Delaware, and code their indemnification arrangements before and after the *Schoon* case. We find substantial variation across firms in whether and when companies responded. Of the 158 firms that did not already have individual indemnification contracts in place (the most effective post-*Schoon* protection), 65 acted to adopt some form of protection, and most firms did so within eight months of the opinion. Thus, a significant number of large firms found the case important enough to warrant a response, while many vulnerable firms decided not to act.

Using an empirical specification equivalent to a hazard model, we find that companies with outside directors sitting on the board of firms that had already altered their indemnification arrangements were significantly more likely to adopt *Schoon* protection themselves. We measure this effect while controlling for the total number of interlocks between firms, so it is not connectivity generally, but connectivity to a responding firm, which drives our results. The effect is statistically and economically significant. Firms became more than two times as likely to respond once a firm with which they shared an outside director responded. Our results are robust to different specifications of firms' prior protections, controlling for geography of firm headquarters, and treating inside and outside interlocks as a single class of interlock, in which case the aggregate interlock variable with an adopting firm continues to predict adoption.

We also identify several measures for outside directors' power and independence that are associated with responding to *Schoon*. We examine whether firms' response to *Schoon* is associated with three governance features related to the power of outside directors relative to insiders: the proportion of outside directors, the number of times the outside directors met in executive session and whether the firm has a designated lead independent director. We find that

[2] Interviews we conducted with practitioners, analysis of law firm memos issued after the *Schoon* decision, and a hand-checked subsample of insiders employment contracts suggest that amending indemnification bylaws or contracts in response to *Schoon* was a major concern for outside directors, but less of a priority for general counsels or corporate insiders. See p. 14-15 *infra*. Consistent with this view we find that response was a function of different measures of outside directors' power.

all variables are associated with an increased probability of responding, though the effect of outside meetings is sensitive to the specification of the model. These results are consistent with firms that have more active and influential outside directors being more likely to adopt enhanced protection in the aftermath of *Schoon.*

Our study highlights a positive role for interlocks in empowering outside directors within the boardroom. Consistent with this hypothesis, recent studies find that firms with well-connected outside directors are associated with higher value, fewer value destroying acquisitions, less earnings manipulation, less free cash flow retention, increased sensitivity of turnover to performance, and the sudden death of well-connected outside directors result in significant negative abnormal returns (Fogel Ma and Morck 2015).[3] Yet, it is likely that powerful, highly reputable directors are nominated to more boards, so general connectedness might be associated with director effectiveness even if there is no causal relationship (Fogel, Ma and Morck 2015). Intintoli, Kahle, and Zhao (2016) find that well-connected board members face weaker career concerns, which could result in more power within the boardroom, so connectedness generally could be important apart from connectedness to a responsive firm. Our results show, though, that connectedness to a responding firm is associated with responding to *Schoon*, even holding constant the total number of interlocks. In fact, we find that general connectedness is not strongly associated with a response to *Schoon*, only connectedness with a responding firm. This suggests that, in this context, interlocks are not merely a sign of status, but rather, specific knowledge and experience acquired on another board have a direct impact on governance. [4]

A number of other studies have pointed to interlocks as a channel for the spread of potentially costly practices such as backdating (Bizjak, et al., 2009), takeover defenses (Davis

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[3] Intintoli Kahle and Zhao (2016) report similar findings for a particular subset of well-connected directors, those that were not appointed by the CEO. Omer, Shelly and Tice (2014) find a positive valuation effect for well-connected outside and inside directors, with a larger effect for the former.

[4] In addition, the similar interest of all independent directors in restoring protection post *Schoon* reduces some endogeneity concerns that these studies raise. For example, in Fogel, Ma and Morck (2015) it could be that well-connected outside directors are less aligned with a CEO, for reasons other than their connectedness. In our context all independent directors have a clear interest in responding to *Schoon*

1991), and—for interlocks involving CEOs—less efficient compensation (Hallock, 1997) and generally worse performance (Fahlenbrach, Low, and Stulz, 2010).[5] But board interlocks can have benefits as well, as shown in more recent studies, which find board connectivity to be associated with better operational performance and higher returns, especially in new, high-growth firms (Larcker and Tayan, 2010; Larcker, So and Wang, 2013), and with better governance and reporting practices (Bouwman 2011).

There are several advantages to the *Schoon* setting, which make this study a novel contribution. First, unique among interlocks studies, the need for corporate governance change was imposed exogenously and uniformly, which helps ameliorate concerns about the endogeneity of the director network that are common to the interlocks literature. Second, our study also highlights the importance of intra board politics and outside directors' bargaining power (Hermalin and Weisbach, 1988; Shivdasani and Yermack, 1999; Baker and Gompers, 2003) by identifying a setting in which outside directors had heightened need of change. Consistent with this, we find that responsiveness was associated not only with interlocks, but also the proportion of outside directors, executive sessions and the presence of a lead independent director. That responsiveness to *Schoon* is a function of outside directors' power suggests that interlocks may go beyond simply increasing directors' information. Indeed, it is possible that some directors knew about the case, but were reluctant to raise a sensitive issue or were persuaded to wait and see, until another firm on which they held a board seat acted.[6] Importantly, while it is not possible to isolate the exact channel through which interlocks to a responding firm might cause a response, this paper is the first to provide evidence that interlocks assist outside directors in advocating for, and protecting, their interests.

Our findings have policy implications as well. First, commentators have suggested that the interests of outside directors may not be perfectly served by general counsels who often report to

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[5] Other studies have identified effects related to director networks other than interlocks. Golden parachute diffusion is associated with geographical proximity (Davis and Greve 1997). Executives' compensation and acquisition strategies are similar to those of their past section peers at Harvard MBA program to which they were randomly assigned (Shue 2013)

[6] See discussion infra Part 6.

the CEO. (Bainbridge, 2012; Veasey and DiGuglielmo, 2012). Our findings, as well as the views of some of our interviewees that general counsels may have waited to be pressured by strong outside directors to act to restore protection, tend to corroborate these concerns. If general counsels serve the interest of outside directors perfectly, then interlocks should be irrelevant, as outside directors would already get the information and advice they need and the response would not depend on network effects. Similarly, the proportion of outside directors on the board, executive sessions, and the nomination of lead independent directors would not matter. Our results thus are consistent with potential conflicting incentives with respect to general counsels advising outside board members

Second, our results suggest a positive role of interlocks. Early work on interlocks pointed to potentially costly practices that might spread through interlocks, including takeover defenses and back-scratching CEO compensation arrangements. Perhaps because of this work, as well as concerns about a large number of director positions keeping directors excessively busy, the influential proxy advisory firm Institutional Shareholder Services has expressed a degree of skepticism regarding interlocking directorships,[7] and certain types of interlocks are banned by exchange rules.[8] Our results suggest, consistent with recent work, that interlocks may play a positive role in enhancing the effectiveness of outside directors. Shareholders and corporate governance practitioners would do well to consider potential benefits as well as costs of interlocks when choosing directors.

The remainder of this paper proceeds as follows. Section 2 describes the *Schoon* decision and legal response. Section 3 discusses data. Section 4 presents our methodology and results. Section 5 examines potential alternative explanations for our results. Section 6 discusses implications of our results, and Section 7 concludes.

2. Indemnification Rights and the Surprising *Schoon* Decision

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[7] *U.S. Corporate Governance Policy: 2013 Updates*, ISS 8 (Nov. 16, 2012), *archived at* http://perma.cc/5VFN-B7YJ (recommending withholding votes from directors serving on six or more company boards).
[8] NYSE, *Listed Company Manual*, 303A.02(b)(iv); NASDAQ, *Listed Company Manual*, Board of Directors and Committees, 5605.

This section begins by explaining the background of the *Schoon* case and the corporate governance disruption created by the decision. As evidenced by contemporaneous commentary and an unusual intervention in the court proceedings by a group representing corporate directors, directors were concerned about the decision. The second part of the section turns to the legal response. Drawing on public law firm memos and a series of interviews with law firm partners, we show that outside lawyers overwhelmingly encouraged firms to enhance their indemnification protection after *Schoon.*

3.1. The 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 lawsuits until settlement is reached. Companies typically 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, that is, if he acted in bad faith. Since cases rarely go to trial and settlements typically do not contain an admission of bad 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 and advancement 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. *Schoon* held that indemnification and advancement could be altered, even with respect to past actions, so long as litigation against the director had not commenced as of the change.

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 advancement of expenses. Troy then counterclaimed against Schoon and Bohnen, 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. Vice Chancellor Lamb held 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. That Troy clearly anticipated filing a lawsuit following the amendments was held not to be relevant. The court held that Bohnen was not subject to advancement of expenses.

As a result of *Schoon*, companies could strip directors of protection and then initiate litigation. As a result, disputes among board members carried considerable danger. Typical directors and officers (D&O) insurance policies would do little to protect a director caught in such a scenario. The reason has to do with how such policies handle retention, or the deductible, which can run well into six figures. All large companies have some type of D&O insurance, and these policies typically include two types of coverage: The "side B" policy, protects the company's balance sheet by paying costs that the company would otherwise have to bear; the "side A" policy, provides direct, personal protection for the directors' litigation expenses and protects directors from costs that the company is legally prevented from paying on their behalf.[9] Typically, the side B policy, which protects the company, includes a significant deductible. The side A policy, which provides personal protection to the directors, typically does not include a deductible and therefore covers the first dollar of loss.

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[9] Individual insurance policies are not disclosed. Indeed, Sean Griffith has argued that the SEC should mandate such disclosure. Sean Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details concerning Directors' and Officers' Liability Insurance Policies* 154 U. PENN. L. REV. 1147 (2006).

This arrangement creates the risk to the insurer that the company might shift a loss from the company itself to a director personally, and thereby avoid paying the deductible, simply by refusing to indemnify the director. To prevent such a scenario, D&O policies at the time *Schoon* came down typically included a *presumptive indemnification* section that effectively limited full side A coverage to expenses for which the company could not, by law, provide indemnification.[10] If the company is allowed to indemnify by law but chooses not to, as in *Schoon*, then the deductible specified in the Side B policy would apply to the Side A policy as well.[11] Since retention typically reaches several million dollars for large firms, insurance would not provide protection for a director whose indemnification or advancement rights were canceled. Indeed, our interviewees suggested that, for this reason, insurance did not solve the *Schoon* problem. Accordingly, no law firm client memorandum we examined suggested that insurance alone would solve the *Schoon* problem, though some memos suggested that insurance could provide some protection.[12] Furthermore, we identified memos from insurance brokerages and risk management companies

[10] "[M]ost policies deem [indemnification] to be required in every case in which a corporation is legally permitted to do so." Baker & Griffith (2013). Since individual insurance policies are not disclosed we do not have a firm specific policy information.

[11] This excerpt from a policy from Chubb is representative:

> 14. If the Organization fails or refuses, other than for reason of Financial Impairment, to indemnify an Insured Person for Loss, or to advance Defense Costs on behalf of an Insured Person, to the fullest extent permitted by statutory or common law, then, notwithstanding any other conditions, provisions or terms of this coverage section to the contrary, any payment by the Company of such Defense Costs or other Loss shall be subject to:
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> (i) the applicable Insuring Clause 2 Retention set forth in Item 4 of the Declarations for this coverage section; and
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> (ii) the applicable Coinsurance Percentage set forth in Item 3 of the Declarations for this coverage section.

[12] This interpretation, that D&O insurance did not provide meaningful protection from *Schoon* due to "presumptive indemnification" clauses in D&O insurance policies, was supported by the interviews we conducted.

issued subsequent to *Schoon*, which encouraged firms to respond to *Schoon* and implied that having no *Schoon* protection might result in a higher insurance premium.[13]

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

> 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. [14]

The response of law firms to *Schoon* was swift and close to uniform. 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*.[15] Thus, information was abundant. While possible, it is highly unlikely that there are general counsels in the Fortune 500 companies who were not exposed to the case. The memos included recommendations for firms to review their

[13] John Orr and Tara Cummins, "D&O Update: Delaware Case Affects Rights of Former Directors to Indemnity and Advancement" (August 2009) (noting that after *Schoon*, "executives may find themselves faced with having to satisfy often significant policy retentions." Since "D&O insurers apply these retentions when the corporation is permitted by law to indemnify.")

[14] Ropes & Gray, "Delaware Court Allows Retroactive Repeal of Director Advancement Rights" (May 5, 2008) *available at* http://www.ropesgray.com/newspubs/detail.aspx?publication=919

[15] 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

indemnification plans and recommended specific changes to governance documents to avoid the risk created by *Schoon*.

To understand legal practitioners' view of the decision, we conducted informal interviews with seven senior corporate practitioners. Some of the interviewees wrote client memos or other legal commentaries on the *Schoon* case. The interviews took approximately half an hour, with promised anonymity. 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 overwhelmingly suggested that firms ought to have some protection from *Schoon*. The uniformity of practitioners' advice is important for the empirical approach we adopt in this paper. While the urgency of adopting a poison pill as studied by Davis (1991), for example, would have varied across firms insofar as they were more or less likely to be a takeover target,[16] significant variation across firms in the response to *Schoon* is inconsistent with the prevailing legal advice. With the exception of firms that already had indemnification contracts in place, which we are able to identify, the memos point to no firm-specific characteristics that would mitigate the risk presented by *Schoon*, nor do they identify classes of firms at particular risk.[17] The lack of variation across memos also suggests that the response to *Schoon* is unlikely to turn on the identity of the firm's outside counsel, a variable for which we cannot directly control.

Advocates for corporate directors were sufficiently concerned about the *Schoon* decision that they filed an amicus brief through the National Association of Corporate Directors (NACD) with the Delaware Supreme Court asking the court to hear an appeal even after the underlying

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[16] 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 24 hours in a board meeting over the phone.

[17] We confirm that our results are robust to controlling for the litigation risk measure of Kim and Skinner (2012). As noted in Section 6, exposure to heighted securities litigation or derivative litigation risk would not be directly relevant to the risk of an intra-board dispute as in *Schoon*.

dispute had been settled. The brief highlighted directors' concerns, with a particular focus on outside directors. "It is directors who go against the grain – whistle blowers and other dissenters – who are most likely to be targeted by corporate boards…A guarantee that advancement or indemnification will be honored serves both to aid recruitment of board members who will provide independent viewpoints and to promote the directors' assertions of these views without fear of distribution." [18] This request for the Delaware Supreme Court to intervene is, to our knowledge, the only amicus brief the NACD has filed. That they asked for a review of a case that had been settled highlights the concern that directors had regarding the decision. Our interviewees confirmed the significance of *Schoon* for outside directors. While the likelihood of a *Schoon* scenario is low, outside directors, it was suggested, used to take comfort in their option to resign in case of a board disagreement, but post-*Schoon* a resigning director could face substantial risk.

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. This law took effect shortly thereafter, and restored what many had assumed to be the status quo.

3.2. Outside Directors Network

We focus on the role of outside directors' networks in diffusing the response to *Schoon* because the decision posed a particular threat to outside directors. While insiders' employment contracts with the company frequently include indemnification rights (Schwab and Thomas, 2006), many outside directors rely entirely on bylaws for their indemnification and advancement protection.[19] Outside directors are also more vulnerable to retroactive changes, as in *Schoon,* since

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[18] Brief for amicus at 7, *Schoon*.

[19] To confirm the role of executive employment contracts in protecting insider board members, we hand-collected disclosures related to executive employment agreements from a randomly chosen subsample of 20 firms. For 16 of these firms we were able to locate disclosures related to the terms of executives' employment agreements. Two firms explicitly stated that they did not use employment agreements and that executives served at will. Both of these firms had board indemnification contracts. Of the 14 remaining firms, six had separate indemnification contracts for directors, of the remaining eight firms, five included

their service on the board is likely to be shorter and they are therefore vulnerable to changes after the end of their tenure. Furthermore, if a CEO wishes for the firm to respond to *Schoon* he is less likely to be dependent on his networks, (Davis and Greeve 1997), since general counsels are likely to be responsive to insiders' needs, as they typically report to the CEO.

Outside directors' protection, however, may not have the same priority. General counsels are not employed by the outside directors, and their requests may carry less immediacy. Furthermore, in some companies, insiders and general counsels might have been reluctant to extend indemnification protection that would serve to make outside directors more independent and potentially combative in the event of a board dispute. Thus, general counsels might not raise the issue if they are not specifically asked to do so by the outside directors. Our interviewees echoed this tension: "[Responding to *Schoon*] is more important for the outside directors," but General counsels focus on "what the officers think is important," according to one interviewee. "The truth is in large part I am not going to volunteer [a change] unless somebody asked for it," said another, speaking in the voice of a hypothetical general counsel. Some interviewees thought that general counsels might be even averse to a change, as they think, in the words of one outside corporate counsel explaining the thought process of a general counsel, "Why should we tie our hands? It is our interest to have flexibility."

Interlocks with adopting firms may increase the likelihood that outside directors obtain enhanced protection in several ways. First, directors who serve on the board of an adopting firm are more likely to be aware of the *Schoon* case and its implications. By way of example, one of the interviewees explained, "When you sit in a board meeting with a board and discuss their indemnification arrangement – one or more directors will say I also sit on that board and our arrangement with that company says xyz – does our arrangement say the same?"

Second, interlocks may provide leverage, since a reluctant general counsel would have less capacity to be dismissive about the need for changes to indemnification when a director has already received such protection at another firm. Third, serving on an adopting board may increase

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explicit language in the employment agreement that would have functioned as contractual indemnification protection even after *Schoon*. All told, insiders had pre-*Schoon* protection in 13 out of 16 firms for which insider contract information was available, while outside directors would have been protected at only 7.

directors confidence that changing indemnification is the proper course of action and they are less likely to take "no" or even "not now" for an answer. Fourth, an instance of outside interlock may also make a director's request more persuasive to other directors on the board, and weaken suggestions to wait out for Delaware legislation.

3. Data

This study examines firms' response to *Schoon* between the decision in the case on March 28, 2008 and the adoption of the change in law, which eliminated the need for firms to respond. To investigate firms' responsiveness to *Schoon* we hand collect data on firms' indemnification arrangements. In particular, 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. Since data on firm responsiveness must be hand collected, we limit our sample to Delaware-incorporated firms in the Fortune 500.[20] We match the hand-collected data with data on firm size and board characteristics from Corporate Library.[21] This results in a sample of 268 firms.

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

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[20] Specifically, we use the Fortune 500 list from 2011 as the basis for our sample.

[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.

divide indemnification protection into three classes in descending order of effectiveness corresponding to the categories of response advocated in law firm client memos:

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 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.[22]

For each firm we observe the indemnification arrangements before and after *Schoon* and are able to determine if a change was made in the period following the case. While changes to the bylaws are public, we do not directly observe contracts. Nevertheless, under Regulation S-K any change to director indemnification arrangements must be reported.[23] We code firms as having a contract if any of the filings make reference to a contract with respect to indemnification.

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[22] *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).
[23] 17 CFR 229.702.

Table 1 Panel A shows, 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 with 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 one company 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, 56 firms had no protection against a removal of indemnification.

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, 65 firms responded to *Schoon* by adopting one or more of these options. Many firms responded by adopting more than one protection. For example, a firm might adopt a no-change bylaw and indemnification contracts with its directors at the same time. Only 20 firms remained entirely unprotected after *Schoon*.

Panel B of Table 1 shows the count of firms by the most effective protection they have in place based on our coding of protection types as described above. 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. The table shows that most firms ended our observation period with a contract, with a no-change bylaw being the second most popular choice.

Two features of these tables are notable. First, the response is not uniform. While many companies responded, not all did. Among those that responded, many chose to not adopt the most effective form of protection: entering into indemnification contracts with their directors. Second, the response is substantial. Of the 56 unprotected firms at the start of the period, only 20 remained unprotected as of the end of the period. Of the 166 firms that did not start the period with indemnification contracts, 61 made some type of change. Thus, the observed pattern of response is neither uniform in adopting protection, which would suggest a lockstep and frictionless accommodation of the prevailing advice, nor is it uniform in ignoring the decision, which would suggest that firms discounted the risk completely.

The timing of adoption also varies. 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 after 2008, with relatively few firms adopting changes in the days after January 2009. Activity did not completely stop even after the Delaware legislature amended the DGCL to effectively overturn *Schoon*.

Table 2 presents basic summary statistics for the primary covariates reported in our regressions.

4. Methodology and Results

As the summary statistics in Table 1 indicate, the vulnerability to indemnification changes resulting from the *Schoon* case was addressed by some, but not all, firms, and as illustrated in Fig. 1 there was substantial variation in the timing of board adoption. Once the *Schoon* decision was handed down, it was clear that many corporate directors were lacking fully vested indemnification protection. The time it took each firm to adopt enhanced indemnification reflects time during which the directors remained unprotected. Our data therefore invites a panel treatment, and since firms that responded did so only once, we analyze adoption using the equivalent of a hazard model.

We construct a monthly panel of firm-level observations running from the beginning of 2008, before the *Schoon* decision until the end of 2010, at which point the responses to *Schoon* had largely trailed off.[24] For each month, we observe whether a firm has responded and the composition of the board. We draw data for other covariates from the Corporate Library company datasets for the corresponding year.

For reasons outlined above, 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 measure the effect of interlocks we code several interlocks variables. We characterize a director on firm *i*'s board as an instance of *Adopting Interlock* at time *t* if the director sits on the board of another company, *j*, (as either an insider or an outsider) that has already

[24] We are aware of four firms that adopted enhanced protection in 2011, after the end of our panel.

responded to the *Schoon* decision as of time *t*. We construct three measures of interlock for both inside and outside directors. *Adopting Interlock Indicator* is an indicator variable that takes the value 1 when a company's board includes at least one director who exhibits Adopting Interlock at time *t*. The insider and outsider versions of Adopting Interlock Indicator separately flag 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 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 less likely to be the catalysts for enhanced indemnification protection. We similarly construct *Adopting Interlock Percent*, representing the fraction of either inside or outside directors who interlock with adopting boards. Since the percentage is over total inside or outside directors, the value ranges from 0 to 1 for each of inside and outside directors at each firm. Finally, we calculate the percentage of directors who sit on other boards in our sample regardless of whether the firm has responded, *Percent of Directors on Other Sample Boards.* This is a measure of general connectivity. Table 3 presents summary statistics for the panel data, and shows the fraction of firms with outside and inside interlock during each time period, as well as the average percentage of inside and outside directors at each firm that interlock with adopting firms. The fraction of firms with interlocks increases as firms adopt protection, peaking at about 36% of the sample.

Table 4 presents univariate statistics over firm-month observations. These statistics show that, at the time they adopted protection, adopting firms had 41% greater incidence of at least one director with interlock. These firms also had a 36% larger portion of their outside board members exhibiting adoption interlock.

If director interlocks are 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.

Drawing on the literature on director interlocks, and Bizjak, et al. (2009) in particular, we test the impact of adoption interlock using a multi-period logit model with date dummies and dropping firms that respond from subsequent dates in the pane. The dependent variable is in indicator that takes the value one if the firm adopted additional protection for directors that is responsive to the holding of *Schoon* during the month of the observation. This specification is equivalent to a hazard model, and allows us to estimate the effect of covariates on the likelihood that firms that have not yet responded will respond, controlling for the unconditional likelihood of response. Since our specification includes time dummies, we implicitly control for time trends in adoption.[25] In some specifications we also include a selection of corporate governance and other control variable discussed below. Finally, we control for whether each firm already had an indemnification contract in place.

The results of these regressions are presented in Table 5. The table includes four regressions. The first two regressions present only the board interlock variables and a control for whether the firm already had a contract in place. The third and fourth regressions include a variety of controls for the structure of the board. Each specification includes industry and date dummies.

The independent variables related to interlock are designed to isolate the effect of outside directors interlocking with other firms that have already adopted protection. Thus, we control for both interlocking insider directors, and the percent of directors who interlock with other boards regardless of whether the interlocking firms have responded to *Schoon*. Models 1 and 3 use indicator variables, and models 2 and 4 include variables reflecting the fraction of the total number of outside or inside directors that interlock with adopting boards. 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*, and therefore interlock with an adopting firm. To measure the effect of interlocks with firms that

[25] In particular, the time dummies ensure that our results are not driven by the simultaneous growth in both the likelihood of adoption and the number of interlocks to adopting firms. We confirm that time dummies address this issue in unreported numerical simulations.

have already responded, as opposed to interlocks generally, we include as independent variables the measures of Adopting Interlock described above as well as a control for the number of directors on another sample board. Thus, we measure the effect of connection to an *adopting* firm conditional on the *total* connectivity of each firm to adopters and non-adopters.

The third and fourth regressions include a number of controls for the structure of the board. The set of controls is based on Bizjak, et al. (2009), but excludes those variables that are not directly relevant to board structure. We include a control for the percentage of directors on the board that are independent. This is potentially relevant since outside directors are more affected by *Schoon* than inside directors and may resist change, as discussed above. CEO is Chair is a dummy variable that takes the value 1 if the CEO is chairman of the board and zero otherwise. This is a proxy for the relative power that the CEO, who is, of course, and insider, wields over the board. Size of board is the number of directors, which has been shown to be an important determinant of board behavior (Yermack 1996). Classified board is a dummy variable indicates whether the board membership is staggered. Whether the company has a staggered board is potentially significant for two reasons. First, a staggered board is a potent takeover deterrent, so firms with this feature are less likely to be the subject of a hostile takeover, which could leave directors vulnerable. Second, a staggered board generally ensures that a director will not be removed from the board until the expiration of her term. Models 3 and 4 also control for market capitalization, as in Bizjak, et al. (2009).

We also include two variables designed to capture the relative power of outside directors. First, we include an indicator variable that takes the value 1 if the firm is coded by Corporate Library as having a designated outside lead director and zero otherwise. This is potentially important, as a designated lead independent director would have the power to put a response to *Schoon* on the agenda for the executive session. Second, we include a variable, Outside Board Meetings, which is the number of times the outside directors on the board met in executive session in the previous calendar year. This is a proxy for how active the outside directors are and their degree of independence from the insiders on the board. Furthermore, as the commentary to the NYSE rule which requires companies to hold executive session suggests, executive session facilitate communication while preventing "any negative inference from attaching to the calling of executive sessions." Thus if the company regularly holds several sessions it could facilitate communication among the outside directors regarding *Schoon*. We use the number of meetings for the previous year to capture general activity while minimizing the likelihood that the value includes meetings to discuss the companies' *Schoon* responses specifically.[26]

In addition to the board controls, all regressions include the *Had Contract*, which takes the value 1 if the firm had a contractual indemnification in place prior to *Schoon*. In unreported regressions, we substitute a variable that takes the value 3 if the firm had an indemnification contract, 2 if the firm had a vesting bylaw but no contract, 1 if the firm had only a no-change bylaw, and 0 if the firm had no *Schoon* protection. These codings reflect the relative strength of each type of protection. Since firms with strong protection in place are less likely to respond to *Schoon*, this is an important factor for which to control. Our results are robust to this alternative specification.

The regression results suggest that board interlocks play a role in firms' propensity to respond to governance changes, and that this effect is limited to outside interlocks. In each specification, the coefficient on outside interlock is positive and statistically significant. The existence of at least one outside interlock is associated with a marginal increase in the probability of adoption of 1.78% compared to a baseline probability of adoption over all firm-date observations of 0.7%, and increase in the likelihood of adoption of more than 150%. The magnitude of the interlock effect is relatively consistent between regression specifications. Only outside interlocks with adopting firms show a significant relationship with the tendency to respond to *Schoon*. There is no statistically measurable effect of interlocks when the interlocking director is an insider, though the sign on the coefficient is positive. The marginal effect for inside interlocks is small. Models 2 and 4, using the percentage of interlocks, are consistent with Models 1 and 3, which use the indicator variables.

The percentage of inside directors on the board is also negatively correlated with propensity to respond. A one standard-deviation increase in the percentage of outside directors (8.7%) is associated with a 0.7% decrease in the absolute likelihood of a firm responding, roughly equal to

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[26] While most of our controls are parallel to Bizjack, et al (2009), the independent lead director and executive session variables are not commonly used in the corporate board literature. Nevertheless, we include them because they capture important differences that may facility a response to *Schoon*. Unreported regressions demonstrate that our results are robust to the inclusion of these two control variables.

the unconditional probability. We also find that firms that had a designated lead independent director were more responsive to *Schoon* than firms that did not have one. The effect is both statistically and economically strong. Finally, we find that the activeness of the outside board members, as proxied by the number of meetings in executive session, is modestly associated with a higher likelihood of response, though this effect falls just below the cutoff for significance in one specification (the effect is stronger when the alternative construction of the prior protection variables is used). A one standard deviation increase in meetings of outside directors (4.18 meetings) is associated with a 0.38% increase in the likelihood of a firm responding. This suggests that particularly engaged outside directors had some capacity to protect their interests by responding to *Schoon*. All of these results are consistent with firms with more active and influential outside directors being more likely to respond to *Schoon*.

5. Robustness

Our results are robust to several alternative specifications. In addition to the alternative coding of the prior protection variables described above, we also run alternative tests including controls for legal risk. Facing a high probability of a securities lawsuit would not directly affect the decision to adopt *Schoon* protection, which deals with intra-corporate disputes, but firms that face substantial litigation risk may pay more attention to indemnification and advancement generally. Our results are robust to the widely used litigation risk measure of Kim and Skinner (2012), and litigation risk is not a significant predictor of responding to *Schoon*.

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.

Another concern is how to interpret the nonresponsive firms in our sample. The need for firms to adopt enhanced protection to secure directors against changes to indemnification bylaws was greatly reduced when Delaware revised its corporation law to effectively overturn the holding of *Schoon*. We cannot know with certainty whether firms that did not adopt protection were simply slow in acting and so were preempted by the law or would have left directors vulnerable indefinitely had the law not been passed. Even if all firms would have acted eventually, the delay is still informative. The delay in changing bylaws or adopting contracts constituted time during which directors were, in view of practitioners, insufficiently protected. That some firms delayed adopting protection suggests that enhancing protection was a higher priority at some firms than others.

Nevertheless, we can shed some light on the counterfactual scenario in which the Delaware legislature did not intervene. Fig. 2 shows the Nelson-Aalen cumulative hazard function for a firm with covariates fixed at mean values. The function is estimated as the sum of the proportions of firms adopting protection over all prior periods. The slope of the function drops sharply after December of 2008. The law was not proposed by the Delaware corporate bar until February 2009, and prior to that proposal its development was not public. Only as of February 2009 would the likelihood of a legal change become concrete. This suggests that the wave of firms adopting protection had begun to exhaust itself even before legal change became a concrete possibility.

Finally, even if all firms would have responded eventually, our results suggest that outside directors' network had an important role in the diffusion of the response.

6. Analysis

Schoon unexpectedly changed existing indemnification arrangements. All outside directors had an interest in responding to *Schoon,* but not all outside directors had their protection restored. Interlocks to responding firms, our results show, significantly increased the likelihood of firms responding. Our results therefore suggest that interlocks in this context played a role in making outside directors more effective at vindicating their interest.

Consistent with this finding, recent work on outside director interlocks finds a relationship between outside directors' interlocks and positive outcomes for fims. Fogel, Ma and Morck (2015); Intintoli, Kahle and Zhao (2016). One challenge in interpreting these the results of these existing studies, however, is that interlocking directors could simply be disproportionately powerful or reputable along some unobservable dimension causing them both to obtain multiple board seats and to be more effective in their role as directors (Fogel, Ma and Morck 2015). Thus it is difficult to give studies of director interlocks a causal interpretation based solely on a relationship between interlocking board seats and good outcomes for firms. Our findings, though, indicate that only interlocks to responding firms, and not interlocks in general, increased the likelihood to respond after *Schoon*. This is stronger evidence of a direct, causal role for interlocks, because if the effect was driven only by director power or prestige, it should hold for any well-connected directors and not just for directors at responding firms.

Our results illustrate the value to outside directors of having knowledge and experience from another board. While we cannot provide definitive answers as to exactly how experience from another board assisted outside directors in protecting their interests, two aspects of our study enable us to offer plausible accounts of why interlocks might matter. First, the practitioner interviews we conducted provide direct support for a number of channels through which interlocks might affect outcomes. Second, our interlock results occur in a setting in which change is particularly favorable for outside directors and conventional measures of outside director power are, along with interlocks, associated with responsiveness, corroborating the role of interlocks in increasing director effectiveness.

The first and most obvious reason interlocks may matter is that directors may have become aware of the need to respond to *Schoon* when an interlocking firm decided to respond. Even otherwise influential directors cannot request a response to a legal change of which they are unaware. While the *Schoon* decision was a major development in Delaware corporate law and caught the attention of corporate governance practitioners and general counsels, most directors are not lawyers and do not closely follow the Delaware courts.[27] Since some directors would likely have known about *Schoon* and many others would not, it's quite plausible that a director may have learned about *Schoon* from their service on another board and transmitted this knowledge via an interlock. Even among directors who knew of the *Schoon* decision, it may not have been obvious whether responding to the case was necessary or that other firms planned to respond, particularly at large firms as in our sample. Sitting on an adopting board at another firm may have communicated information, not just about the existence of the legal issue, but also about the importance of responding. One of our interviewees provided a concrete example of how transmission through interlocks might work, saying "When you sit in a board meeting with a board and discuss their indemnification arrangement – one or more directors will say 'I also sit on that board and our arrangement with that company

[27] Outside lawyers typically communicate with the general counsel rather than with the outside directors directly.

says xyz – does our arrangement say the same?'" Such pointed questions may have naturally led to increase in adoption among interlocking firms.

A second channel through which interlocks may result in increased adoption is by providing outside directors additional leverage and persuasive power when seeking a change. With respect to ordinary corporate governance matters, members of the board naturally look to the general counsel for legal advice, and, as a practical matter, the decision to respond to *Schoon* was largely in the hands of the general counsel. Indemnification arrangements and D&O insurance are sensitive subjects. As one corporate governance practitioner put it, "There is always an inherent tension when a company expands indemnification rights."[28] Under normal circumstances, outside directors are often advised to negotiate indemnification and advancement arrangements with the help of their own counsel before they join a board.[29] Once they are serving as a director, their leverage to ask for any changes is considerably reduced.

In the case of *Schoon*, though, indemnification arrangements were effectively changed judicially for sitting directors. Given the public nature of a bylaw change or contract adoption, a general counsel in the aftermath of *Schoon* might have advocated a wait-and-see approach or argued that the risk of a *Schoon* scenario at a large firm was low enough that a response was unwarranted. This was consistent with our interviewees' view that general counsels might be reluctant to act, especially for the benefit of outside directors to whom general counsels do not directly report. Once firms began to respond, though, a general counsel advising a wait and see approach would be less persuasive. It is one thing for a general counsel to downplay the risk of *Schoon* in a vacuum, but when another firm on which a director sits has taken a pro-active approach, a director is less likely to take "wait-and-see" for an answer. An interlocking adoption would also likely have persuasive value for other directors on the board.

Finally, interlock with an adopting firm might mitigate any potential negative signal sent by requesting a change. *Schoon* involved an extremely acrimonious dispute among board members. Corporate boards tend to prize collegiality, and a director raising the issue of *Schoon* might worry that they were suggesting some concrete concern about the future of the board. Asking one's fellow directors to contemplate potential liability in the presence of a complete breakdown of collegiality would be a potentially awkward conversation at best, and might raise one's fellow directors' suspicions regarding

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[28] "Director Indemnity Changes Reflect Litigation Risks" *Agenda* (September 7, 2010) *available at* http://agendaweek.com/c/57076/18584?referrer_module=SearchSubFromAG&highlight=indemnification

[29] *See*, e.g., David A. Katz, "So You're Thinking of Joining a Public Company Board," Harvard Law School Forum on Corporate Governance and Financial Regulation (February 1, 2016) *available at* https://corpgov.law.harvard.edu/2016/02/01/so-youre-thinking-of-joining-a-public-company-board/

future liability at worst. Given the relatively low risk of a *Schoon* scenario at a large public company, a director might have simply decided to stay quiet.[30] But in the presence of an interlock, this conversation would be considerably less awkward and any potential bad signal mitigated. At that point, the discussion could simply be framed as a question about why the company was behaving differently than an interlocking firm.

These explanations are not mutually exclusive, nor is it possible to empirically disentangle them in this context. Concerns about a negative signal for example, might discourage a director from vigorously disputing a general counsel's advice not to act. Importantly, though, this study provides the first evidence that interlocks, via any or all of these channels, make outside directors more effective at advocating for their interests.

7. Conclusion

Our results highlight the importance of outside director networks in affecting the ability of outside directors to protect their interests. We show that firms are more responsive if outside directors serve on the boards of other firms that responded to *Schoon*. We also show that boards with a higher proportion of inside directors are less likely to respond. These results demonstrate the importance of interlocks in a new governance context, and are the first to show a specific effect for interlock among outside directors. That outside directors' interlocks are relevant to the response to *Schoon* suggests that general counsels may play an imperfect role in protecting the interests of outside directors.

[30] Directors tend to be risk averse regarding matters of potential personal liability, but the risk of a *Schoon* type dispute at a large public company is likely small. That many companies never responded to *Schoon*, while many others did suggests that, for many firms, responding to *Schoon* was a close question. Under those circumstances it is plausible that concerns about negative signaling would have a measurable effect.

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

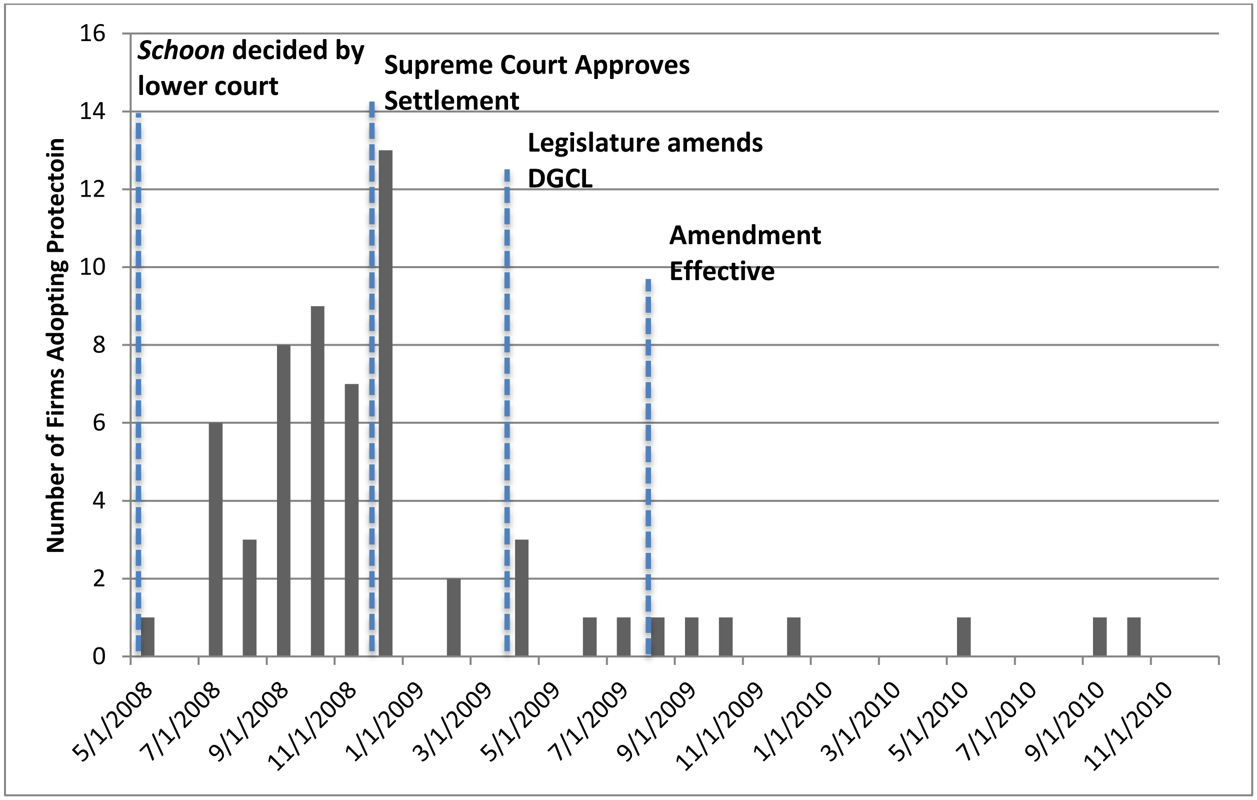

Figure 2: Nelson-Aalen Cumulative Hazard Function for Response to *Schoon*

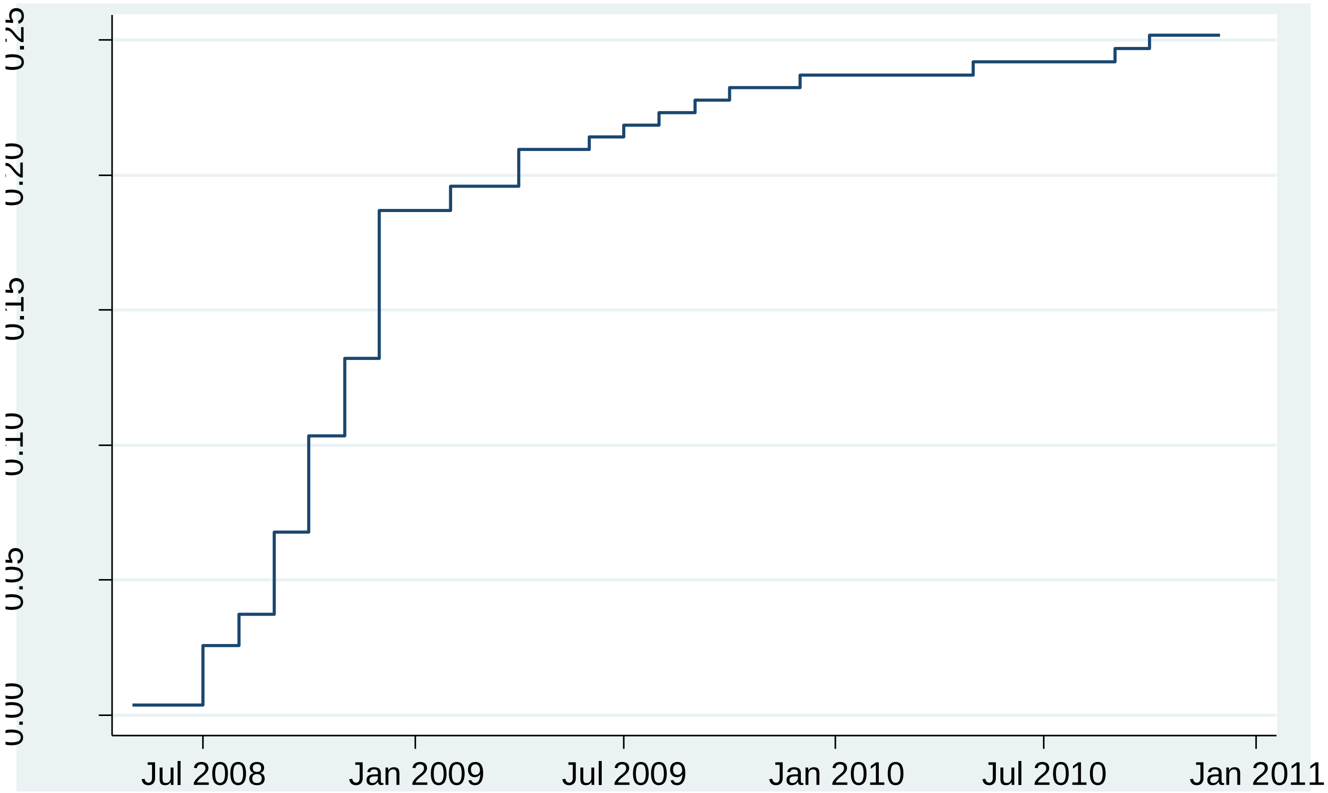

Table 1. Firms' Levels of Protection

This table shoes the types of indemnification in place prior to *Schoon* and after *Schoon* for each firm in our sample. Panel A shows, for each type of protection, the number of firms with that type of provision before and after *Schoon* and the number adopting a provision of that type in the aftermath of *Schoon*. Panel B shows the number of firms for which the type of protection was the strongest in effect at the firm before and after the decision. Contracts are stronger than vesting bylaws, which are stronger than no-change bylaws.

Panel A. Firm Protection Types

	None	Contract	Bylaw (Vesting)	Bylaw (No Change)	Any Protection
Before *Schoon*	56	110	1	165	212
Adopted in response to *Schoon*	203	24	21	41	65
After *Schoon*	20	130	22	202	248

N=268

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

	Contract	Bylaw (Vesting)	Bylaw (No Change)	None
Number of Firms Before Schoon	110	1	101	56
Number of Firms (As of 2010)	130	16	102	20

N=268

Table 2. Summary Statistics for Board Covariates

A. All Firms (N=268)

	Mean	Median	SD	Min	Max
Outside Directors (Count)	8.35	8.00	2.31	2.00	15.00
Inside Directors (Count)	1.41	1.00	0.83	0.00	6.00
Outside Lead Dir. Indicator	0.46	--	0.50	0	1
Size of Board	10.59	10.00	2.24	5.00	19.00
Market Cap ($B)	22.50	22.40	1.49	17.42	25.96

B. Responding Firms (N=65)

	Mean	Median	SD	Min	Max
Outside Directors (Count)	9.03	9.00	2.44	3.00	15.00
Inside Directors (Count)	1.32	1.00	0.75	0.00	5.00
Outside Lead Dir. Indicator	.54	--	0.50	0	1
Size of Board	11.11	11.00	2.12	5.00	16.00
Market Cap ($B)	22.66	22.54	1.11	20.26	25.15

C. Non-Responding Firms (N=203)

	Mean	Median	SD	Min	Max
Outside Directors (Count)	8.13	8.00	2.23	2.00	14.00
Inside Directors (Count)	1.43	1.00	0.85	0.00	6.00
Outside Lead Dir. Indicator	.44	--	0.50	0	1
Size of Board	10.42	10.00	2.26	5.00	19.00
Market Cap ($B)	22.45	22.39	1.59	17.42	25.96

Table 3: Summary Statistics for Panel

Summary statistics for panel by date. Fraction of boards with outside (inside) interlock is the fraction of boards with at least one outside (inside) director sitting on another board that has responded to *Schoon* as of the panel date. Average percentage of outside interlock directors is the firm-average percentage of directors sitting on another board that has responded to *Schoon* as of the panel date. Firms adopting protection is the number of firms changing bylaws or adopting contracts during the month beginning with the indicated date.

Date	Obs.	Fraction of Boards with Adopting Outside Interlock	Fraction of Boards with Adopting Inside Interlock	Average Percent of Outside Interlock Directors (%)	Average Percent of Inside Interlock Directors (%)	Firms Adopting Protection
1/1/2008	266	0.000	0.000	0.000	0.000	0
2/1/2008	266	0.000	0.000	0.000	0.000	0
3/1/2008	266	0.000	0.000	0.000	0.000	0
4/1/2008	267	0.000	0.000	0.000	0.000	0
5/1/2008	267	0.000	0.000	0.000	0.000	1
6/1/2008	266	0.000	0.000	0.000	0.000	0
7/1/2008	266	0.045	0.004	0.449	0.094	6
8/1/2008	260	0.062	0.008	0.677	0.192	3
9/1/2008	257	0.125	0.035	1.648	1.297	8
10/1/2008	248	0.177	0.052	2.358	1.882	9
11/1/2008	239	0.226	0.054	3.273	2.057	7
12/1/2008	232	0.328	0.082	4.852	3.161	12
1/1/2009	223	0.318	0.058	4.678	2.399	0
2/1/2009	223	0.332	0.058	4.828	2.399	2
3/1/2009	221	0.326	0.059	4.755	2.421	0
4/1/2009	222	0.338	0.068	5.009	2.785	3
5/1/2009	219	0.333	0.068	4.948	2.823	0
6/1/2009	219	0.338	0.068	5.040	2.823	1
7/1/2009	218	0.344	0.069	5.206	2.836	1
8/1/2009	217	0.346	0.069	5.210	2.849	1
9/1/2009	216	0.352	0.069	5.453	2.863	2
10/1/2009	214	0.360	0.070	5.390	2.889	1
11/1/2009	213	0.362	0.070	5.416	2.903	0
12/1/2009	213	0.362	0.070	5.494	2.903	1
1/1/2010	209	0.349	0.091	5.307	3.549	0
2/1/2010	209	0.349	0.091	5.307	3.549	0
3/1/2010	209	0.349	0.091	5.307	3.549	0
4/1/2010	209	0.349	0.091	5.307	3.549	0
5/1/2010	209	0.354	0.096	5.438	3.788	1
6/1/2010	208	0.356	0.091	5.464	3.566	0
7/1/2010	209	0.354	0.091	5.438	3.549	0
8/1/2010	209	0.354	0.091	5.438	3.549	0
9/1/2010	209	0.354	0.091	5.539	3.549	1
10/1/2010	209	0.359	0.091	5.613	3.549	1
11/1/2010	208	0.361	0.091	5.640	3.566	0
12/1/2010	208	0.361	0.091	5.640	3.566	0

Table 4: Univariate Comparisons for Firm-Month Observations with and Without Adoptions

This table shows the difference in means between firm-month observations where the firm adopted protection in response to *Schoon* during the month in question and firm-month observations without an adoption event. Firms are dropped from the sample after an adoption event.

	Non-Adoptions (A)	Adoptions (B)	(B)-(A)	t-stat on Difference
Percent Firms with Outside Adopting Interlock	24.44%	36.06%	11.62%**	2.10
Percent Firms with Inside Adopting Interlock	5.60%	4.92%	-0.68%	0.23
Mean Percent of Adopting Outside Interlock Dirs	3.67%	5.47%	1.80%*	-1.82
Mean Percent of Adopting Inside Interlock Dirs	2.21%	2.46%	0.25%	0.20

Table 5: Multiperiod Logit Regressions of Adoption of Enhanced Protection After *Schoon* (Odds Ratios)

This table reports the result of a series of multiperiod logit regressions on adoption of new protection in response to *Schoon*. Observations are monthly at the firm level, and the panel runs from 2008 to 2010. Firms that have adopted governance changes in response to *Schoon* are excluded from the panel thereafter. The regressions include Fama French 5-industry dummy variables and monthly date dummy variables. Adopting Overlap Indicator (Inside/Outside) takes the value one if at least one inside/outside director on the board sits on the board of another firm that has already responded to *Schoon* by adopting new indemnification arrangements as of the observation date and zero otherwise. Adopting Overlap Percent (Insider/Outside) is the number of directors at each firm who also sit on boards of other firms that have responded to *Schoon* as of the observation date divided by the total number of directors. Pct. of Dirs. on Other Sample Boards is the number of directors at each firm that sit on the board of other firms in the sample divided by the total number of directors. Had Prior Contract is a variable that takes the value 1 if the firm had indemnification contracts prior to *Schoon*, and 0 otherwise. Standards errors are clustered by firm. Marginal effects are reported in brackets.

[on next page]

		(1)	(2)	(3)	(4)
Interlock Variables	Adopting Interlock Indicator (Outsider)	2.528** [0.0178] (2.30)		2.540** [0.0177] (2.29)	
	Adopting Interlock Indicator (Insider)	1.156 [0.0024] (0.21)		1.366 [0.0054] (0.43)	
	Adopting Interlock Percent (Outsider)		1.040** [0.0006] (2.00)		1.045** [0.0007] (2.05)
	Adopting Interlock Percent (Insider)		1.016 [0.0002] (0.91)		1.018 [0.0003] (1.03)
	Pct. of Dirs. on Other Sample Boards	0.998 [0.0000] (-0.17)	0.999 [0.0000] (-0.10)	0.994 [0.0000] (-0.57)	0.991 [-0.0001] (-0.73)
Board Variables	Percent Inside Directors			0.946** [-0.0008] (-2.23)	0.943** [-0.0009] (-2.42)
	CEO is Chair			0.696 [-0.0057] (-1.16)	0.763 [-0.0041] (-0.82)
	Size of Board			0.948 [-0.0008] (-0.95)	0.955 [-0.0007] (-0.83)
	Outside Lead Dir. Indicator			1.985** [0.0107] (2.22)	1.854** [0.0096] (1.99)
	Classified Board			1.402 [0.0052] (1.12)	1.388 [0.0050] (1.08)
	Outside Board Meetings			1.053 [0.0008] (1.62)	1.062* [0.0009] (1.96)
Other Variables	Log(Mkt. Cap.)			1.020 [0.0003] (0.14)	1.032 [0.0005] (0.23)
	Had Prior Contract	0.356*** [-0.014] (-3.06)	0.367*** [-0.014] (-2.98)	0.301*** [-0.0183] (-3.27)	0.297*** [-0.0166] (-3.17)
	Constant	0.00418*** (-5.12)	0.00441*** (-5.07)	0.0114* (-1.80)	0.00984* (-1.90)
	Time Dummies	Yes	Yes	Yes	Yes
	Industry Dummies	Yes	Yes	Yes	Yes
	Observations	3743	3743	3743	3743
	$\chi2$	73.14	76.77	92.46	98.92
	Pseudo R^2	0.114	0.111	0.138	0.137