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Directors' and Officers' Liability: Economic Analysis

Law Working Paper N° 376/2017
January 2018

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ECGI Working Paper Series in Law

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Abstract

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Keywords: Directors, officers, liability, no-conflicts rule, business judgment rule, fiduciary duties, monitoring duties, Caremark, ARAG-Garmenbeck

JEL Classifications: K13, K22, K41

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I. Introduction

Directors' and officers' liabilities mark a centre point of the law and economics debate. They are a junction between the internal functioning of organizations and their internal and external responsibility towards shareholders, creditors and society as whole. An interdisciplinary account must consider the possible impact of directors' and officers' liabilities (D&O liabilities) on all constituencies. Alleviating the principal-agent-problem between shareholders and managers is just one aspect. The duties (mainly) of directors have been tightened by a number of legal reforms, mostly in reaction to large scale corporate scandals. Tightened duties cause expansions of liability. This leads to a trade-off between enhancing the individual incentives for good behavior and so-called chilling effects due to risk-aversion. Over-stringent liabilities jeopardize the social benefits from delegated management.

In law and economics research this trade-off is analysed with a view to exploring the individual incentives of the agent under the applicable liability regime. The method of methodological individualism promises insights into the possible effects of regulatory strategies like D&O liability and its interaction with related strategies that equally aim at influencing the behavior of actors. The results of the assessment can differ greatly depending on which jurisdiction is considered and on which other governance strategies are included in the analysis. A large body of interdisciplinary literature focuses on US law. Whilst general propositions might be universally applicable, the comparative approach taken here reveals partly nuanced, partly stark contrasts.

The following sections will explore the foundations of the law and economics debate on D&O liabilities and integrate relevant shifts of paradigms through recent developments. The article is organized as follows: Firstly, the concept of limited shareholder liability will be treated with a view to its consequences for undue risk shifting to creditors and excessive risk taking (below no 4 ff). Secondly, the duties of directors and officers towards the corporation and shareholders will be put in context to other corporate governance mechanisms that serve to align the interests of manager agents and owner principals (below no 41 ff). More specific questions arise from liabilities towards third parties, procedural law and, of course, the effects of insurance (below nos 91–114).

II. The Law & Economics Framework of Contractual D&O Liabilities

Limited shareholder liability is the starting point. Nominal corporate liabilities are, of course, unlimited but the satisfaction of claims is confined to the availability of corporate assets. As opposed to the members of a partnership, shareholders cannot be made responsible by a creditor for losses beyond their initial capital contribution.[1] Limited liability hence provides incentives to the owners of a corporation to internalize profits and externalize losses by taking risks that exceed the initial capital contribution (moral hazard).[2] Given their possibility to diversify capital, shareholders will benefit most from directors and officers that successfully take high risks. The pay will come as a dividend or as a stock price increase. Losses do not play a role when the shareholder is sufficiently diversified.

1. Outside Liability and Creditor Protection

Creditors' claims that exceed the available assets of the corporation will remain uncompensated due to limited shareholder liability. Accordingly, creditors bear the costs of risk taking failures of the corporation. Under dispersed ownership, the risk taking decisions will be delegated to the board of directors that oversees the acts of officers. It is precisely for this reason that D&O liabilities might be seen as a cure against adverse effects of limited shareholder liability.

a) Limited shareholder liability

A first hand solution for avoiding adverse effects would be, instead of D&O liabilities, to deny shareholders the limitation of their liabilities. In fact, courts have occasionally lifted the corporate veil and held shareholders liable. The relevant cases, however, tend to concern exceptional constellations in which the adverse effects of limited shareholder liability appeared to be unbearable.[3] As widely agreed, the societal benefits from (the remaining scope) of limited liability lie in the increased availability of funds for positive net values projects.[4] To support agreement with this claim of the welfare enhancing effects of limited shareholder liability, it seems advisable to have a closer look at its effects.

FH Easterbrook and *DR Fischel* suggest starting by exploring the alternative: 'under a rule of unlimited liability, the value of shares would be a function of the present value of future cash flows and of the wealth of shareholders.'[5] In

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1 *FH Easterbrook/DR Fischel*, The Economic Structure of Corporate Law (1991, reprint 1998) 40.

2 See *RJ Daniels*, Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance (1994) 24 Canadian Business Law Journal 229.

3 Below no 15.

4 *Easterbrook/Fischel* (fn 1) 44; *P Halpern/M Trebilcock/S Turnbull*, An Economic Analysis of Limited Liability in Corporation Law (1980) 30 University of Toronto Law Journal 117–150.

5 *Easterbrook/Fischel* (fn 1) 42.

that scenario the value of bargaining with a corporate actor would depend on the costs of monitoring a multitude of owners. Contractual solutions to deal with changes in the composition of corporate owners would, especially in the case of volatile ownership compositions, cause high or even prohibitive monitoring costs. The transferability (fungibility) of shares – which is one of the core features of the business enterprise and its societal acceptance – would be hampered or be impossible.

In the legacy of the seminal inquiry undertaken by *RH Coase* in 1937 into 'The nature of the firm'[6] the limited liability corporation has been described as a nexus *for* contracts, highlighting the transaction cost savings of having the firm as a single contractual partner for inside *and* outside creditors.[7] The savings of transaction costs depend on two components of the legal entity with limited liability:[8] The first element is legal personality of the corporation which, amongst other characteristics, shields the assets of the firm from creditors of its owners (entity shielding). Limited shareholder liability, in turn, shields the owners from the claims of creditors of the firm (owner shielding). Together, entity shielding and owner shielding allow owners and firms to run different lines of business (asset partitioning). It hence enables contracting for resource allocations that are tailored to the risk assessments of all parties concerned. For shareholders, the outcome is that they can diversify their investments and that they can abstain from costly monitoring of the management of single corporations within that portfolio.

With limited liability only the assets of the corporation, and possibly those of a subsidiary, are pledged as a security for the specific transaction. This, in turn, enables creditors to focus their monitoring efforts on only one debtor. Provided that creditors are able to assess the solvency of their debtor and provided that they will take precautions for changes in solvency ex ante, they serve as a capable and motivated monitor (cheapest cost avoider).

The line of argument presented is the essence, admittedly not an exhausting set of reasons, of why limited shareholder liability today is an almost universally accepted feature of business corporations. Positive externalities, of course, reach beyond the (naturally) simplified two-party world presented above. One important argument *for* limited liability is the growing need for capital market

6 *RH Coase*, The Nature of the Firm (1937) 4 Economica 386.

7 *J Armour/H Hansmann/R Kraakman*, What is Corporate Law? in: R Kraakman et al (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd edn 2017) 5. Earlier works described the firm as a nexus *of* contracts, highlighting the aspect of intra-firm organization of legal relationships; see *MC Jensen/WH Meckling*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure (1976) 3 Journal of Financial Economics 305.

8 *Armour/Hansmann/Kraakman* (fn 7) 5.

based private pensions. The possibility for owners to diversify their investments leads to an elimination of firm specific risks.[9] In consequence diversified shareholders can choose risk neutrality, as economists tend to term it, or, more explicatively, they prefer a relatively high risk as compared to debt holders or creditors. It is this clash of preferences which guides answers to the question of whether D&O liabilities can and should serve to prevent externalities stemming from limited shareholder liability.

b) Creditor protection

A closer look at the alternative of unlimited shareholder liability narrows the cogency of adverse effects: If limited liability was not an agreed feature, parties would most probably create it by contract. Such agreements on liability restrictions are seen in all sorts of contractual contexts. They are drafted on the basis of risks that can be anticipated ex ante and serve to tailor the availability of securities.[10] Conversely, unlimited liability might prevail when the risks are unknown by the counter-party. In practice, professional creditors like banks, demand guarantees from the managing owners prior to the supply of financial funds to the corporation. This is a response to the unity of risk taking and risk bearing in owner-operated firms. Creditors rightly suspect a considerable danger that owners will shoulder only small risks individually while they shift larger risks to the firm.

The nature of limited shareholder liability accordingly turns out to be a mere default rule. Informed contracting will not yield excessive amounts of risk taking. Following the basic assumptions of the theorem derived by *RH Coase* in 1960,[11] contracting in the context of clearly specified property rights and at negligible transaction costs, the legal prescription of limited liability might not matter at all for sufficiently informed creditors.[12] Voluntary creditors can – this is undisputed – contract risk premiums or insurance cover in advance.[13] Professional creditors may insist on price adjustment clauses which, for example, take account of material adverse changes in the corporation's business. Assessments of financial reports by information intermediaries, such as auditors, credit rating agencies or financial analysts, where available, further

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9 *HJ Manne*, Our Two Corporation Systems: Law and Economics (1967) 3 Virginia Law Review (Va L Rev) 259.

10 *Easterbrook/Fischel* (fn 1) 41.

11 *RH Coase*, The Problem of Social Cost (1960) 3 Journal of Law and Economics (JL & Econ) 1.

12 *Easterbrook/Fischel* (fn 1) 52.

13 *H Hansmann/R Kraakman*, Toward Unlimited Liability for Shareholder Torts (1991) 100 Yale Law Journal (Yale LJ) 1879.

alleviate information asymmetries between the parties. Where such assessments are not publicly available, in developed economies, expert services can be contracted.

The assumption that voluntary creditors have the power to change the terms of the bargain, arguably, is often wrong for the simple reason that many contractual creditors are not in a position to negotiate for modifications to the default rule.[14] This assertion may or may not be true in the particular case. More importantly, if unequal bargaining power was the decisive argument it would have to apply to contract law in general, and hence call for a general prohibition of liability limitations where one party is weaker than the other.

Contracting failures jeopardize the *Coasean* picture of welfare-enhancing bargaining. In the corporate context of limited liability, contracting failures are sometimes cured by a piercing of the corporate veil which leads to direct shareholder liability towards creditors.[15] Under US law, corporate veil piercing serves to give creditors a direct claim against the parent company of a subsidiary.[16] In Germany, statutory corporate group law provides compensation rights for subsidiaries and for creditors. Some of these liabilities extend directly to managing directors.[17]

Generally, legislators or courts are willing to support direct enforcement against shareholders with a view to avoiding misuses of the corporate form. Liability dangers for shareholders are severe where the stock of the corporation is closely held and accordingly management and ownership are united.[18] The assertion of a misuse is particularly likely in cases of undercapitalization of the firm. Veil piercing based on an alleged undercapitalization mainly shows elements of a tort, whichever legal qualification the relevant jurisdiction might provide.

The foregoing assessment leads to a more general insight which equally applies to shareholder liabilities as well as to D&O liabilities: Whilst voluntary creditors are protected ex ante through pre-contractual disclosure rights and do not necessarily deserve protection beyond the terms of the negotiated contract, involuntary creditors can only be protected ex post. In essence, voluntary as

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14 *TK Cheng*, An Economic Analysis of Limited Shareholder Liability in Contractual Claims (2014) 11 Berkeley Business Law Journal 113.

15 For a comparative account see *Forum Europaeum Konzernrecht*, Corporate Group Law for Europe (2000) 1 European Business Organization Law Review 165 ff.

16 *Easterbrook/Fischel* (fn 1) 56.

17 See sec 291 ff German Stock Corporation Act. For a comparative overview see *L Enriques/G Hertig/H Kanda/M Pargendler*, Related-Party Transactions, in: R Kraakman et al (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd edn 2017) 161.

18 Ibid 114, 162.

well as involuntary creditors need to be protected (and usually receive protection) when or because they are unable to assess the risks accurately in advance. This mainly concerns actual malice in cases of fraud and misrepresentation. Depending on the facts this should and often will lead to either liabilities of shareholders, D&O liability, or both.[19]

c) Contracting liabilities

The preceding sections have mainly explained two aspects of the law and economics framework of D&O liabilities: Firstly, excessive risk taking along with limited shareholder liability does not lead to adverse effects when creditors are sufficiently informed and able to contract for adequate liability. Secondly, a misuse of limited liability should and often will lead to shareholder liability towards uninformed creditors. In addition, personal liability of directors and officers may attach where directors and officers are responsible for fraud or conscious misrepresentation.

The question remains whether and to what extent D&O liabilities towards creditors should be extended beyond these constellations to complement the existing framework. Answers to this question so far have been developed from different angles, of which some need to be reviewed before we turn to the risk shifting techniques which are used in practice to make directors judgment proof.

The absence of a general rule of shareholder liability is commonly justified by reference to efficiency considerations of which not all hold. To start with, better capitalization of the corporation is a mere fiction.[20] Cases of corporate veil piercing show that corporations may be strategically undercapitalized. Owner-run closely held corporations may tend to distribute corporate profits to managers. Similarly, ongoing related party transactions can reduce the corporate capital for the benefit of persons or entities not involved in the specific transaction. This does not explain existing limits to D&O liabilities.

A more differentiating view explains the absence of general D&O liabilities from the viewpoint of asset specificity. A particular good or individual capacity is specific when it is of less value in an alternative use. The result is a hold-up problem which makes the asset vulnerable to exploitation (appropriation of quasi-rents) by the other party. Whilst shareholders are or can be diversified, executive directors and officers normally invest (almost) their entire human capital in the corporation. Over time, their firm-specific human capital increases. Through growing specificity, the threat by the

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19 For details see *RH Kraakman*, Vicarious and Corporate Civil Liability, in: M Faure (ed), Tort Law and Economics (2009) 135.

20 See already *S Shavell*, Economic Analysis of Accident Law (1987).

individual director or officer to terminate the agency relationship loses credibility. Much in a sense of *OE Williamson's* fundamental transformation of initial competition into post-contractual bilateral monopolies, continued interaction within long-term contractual relationships leads to changes of the incentive structure.[21] Leaving possibly important behavioral aspects untouched, the growing dependency of the individual on the survival of the corporation is foremost a result of specific human capital. Initially, these considerations let us assume a certain alignment of directors' and officers' incentives to the risk preferences of creditors, which are comparably lower than those of equity holders.

Including contracting between shareholders on the one side and directors and officers on the other, changes the outcome of the assessment: As in other contractual relationships, parties who anticipate hold-ups will find solutions ex ante. Increasing the wages of directors is an obvious possibility. As further discussed below, this strategy will often not be a sufficient cure given the possibility for outrageous liabilities vis-à-vis limited nominal amounts of individual wealth.[22] Under a liability rule, the inability of directors and officers to diversify their human capital will give incentives to profit-oriented shareholders to undo the threat of a loss of private wealth through liability restrictions. This is a technique the effects of which need to be considered in more detail below.[23] The consequence will be that the risks deriving from a liability rule will most probably be shifted from directors and officers to the corporation. To be sure, the probability that risks are shifted to the corporation contrary to the preferences of shareholders is larger when ownership is dispersed and owners accordingly underlie a rational control apathy.

To underpin the foregoing considerations, three points are important: Firstly risk shifting of the kind described is what happens by common practices of D&O insurance (presumably) everywhere.[24] Secondly, as a consequence, traditional beliefs of agency law scholarship in the dual responsibility of principals and agents do not hold in practice. This insight was gained around 30 years ago in a seminal article published by *RH Kraakman*.[25] At the time, shielding non-executive directors from liabilities did not play a great role. Today liability of directors that perform a monitoring function (non-executive

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21 *OE Williamson*, Transaction-Cost-Economics: The Governance of Contractual Relations (1979) 22 JL & Econ 233, 241.

22 Below no 79 ff.

23 *Easterbrook/Fischel* (fn 1) 61 ff.

24 Below no 103 ff.

25 *RH Kraakman*, Corporate Liability Strategies and the Costs of Legal Controls (1984) 93 Yale LJ 857, 858

or supervisory directors) attracts greater attention. This is true for Germany and also for the Netherlands.[26] Earlier reluctance to hold directors liable for monitoring failures appears to be a thing of the past.[27] Regarding officers' liabilities the ongoing series of suits against Deutsche Bank following the recent Libor scandal and other investigations of misconduct show that civil liabilities together with criminal sanctions today are a real threat not only for directors, but also for officers.

What should we expect from extending D&O liabilities? To summarize the above results: The risk bearing capacity of undiversified individuals is low and the incentives of owners, to a considerable degree, are aligned with their risk taking agents, but not with creditors. As a new thought, legislative inducements for agents to comply with the interest of creditor stakeholders could, from a welfare perspective, lead to better outcomes. The latter aspect leads us to the next section where we will explore the effects of D&O liabilities in the context of the principal-agent-relationship between shareholders and directors and shareholder centred corporate governance vis-à-vis stakeholder oriented approaches.

2. Inside Liability and Owner Protection

The main field of operation of D&O liabilities concerns the responsibilities towards the corporation (inside liability). From the viewpoint of corporate governance, D&O liabilities are seen as a strategy for constraining agents' behavior. Corporate governance has been defined as the system by which companies are directed and controlled. It accordingly extends beyond agents' constraints and envisages the interplay of strategies relevant to safeguard well-behavior.[28] Constraining agents' behavior by liability prescription is one but not the only strategy within the system of legal or contractual mechanisms to align the incentives of principals and agents.[29] Other governance strategies include trusteeship and rewards, selection and removal, initiation and veto rights.[30] Together with these strategies – and only in cooperation – D&O liabilities will serve to reduce the overall costs from delegated management by

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26 See the recent judgment on outside director liability by the Gerechtshof Amsterdam, 2.11.2015, 200.135.666/01 OK, available under: <http://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL: GHAMS: 2015:4454>, checked on 9.6.2017.

27 A comparative account has been prepared for the European Commission by *C Gerner-Beuerle/P Paech/EP Schuster*, Study on Directors' Duties and Liability, London, April 2013, 238 ff.

28 Report of the Committee on The Financial Aspects of Corporate Governance (Cadbury Report) 1.12.1992, para 2.5.

29 *Armour/Hansmann/Kraakman* (fn 7) 31.

30 Ibid.

aligning the agents' interests with those of the owners. The economic goal of D&O inside liabilities relates to safeguarding good behavior ex ante rather than to ex post compensation.[31]

a) Ownership structures

D&O liabilities are needed as a strategy for the protection of the owners of a corporation depending on the relative effectiveness of other monitoring mechanisms inside and outside the corporation. Ownership structures can serve as one proxy for determining the relative importance of these mechanisms. In closely held corporations with a controlling shareholder, ownership and management are united. In those corporations internal monitoring mechanisms tend to be strong and they will outweigh external mechanisms like the market for corporate control. In publicly held corporations with dispersed ownership, in contrast, decision-making does not rest with the owner principals, but is undertaken by their agents. The need for internal and external monitoring devices is accordingly more important in corporations with a dispersed ownership structure.

This insight is not new. The moral hazard danger of unconstrained agents and the need for corporate governance mechanisms was known in Europe already some 400 years ago by the owners of the first listed stock corporations, the Joint East Indian companies.[32] In 1776 Adam Smith explained the problem by the fact that the decision makers are 'the managers rather of other people's money than of their own.'[33] In their seminal article of 1932, Berle and Means laid the foundations for the discussion of what since then has been known as the problem of separation of ownership and control.[34]

Dispersed owners lack incentives to exercise their control rights due to a calculus that has been termed rational control apathy. Costly individual efforts of a single shareholder would have collective effect for all shareholders but

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31 *DE Schwartz*, In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley (1986) 71 Cornell Law Review (Cornell L Rev) 327; *JC Coffee/DE Schwartz*, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform (1981) 81 Columbia Law Review 261.

32 *E Gepken-Jager/G van Solinge/L Timmerman* (eds), VOC 1602 – 2002: 400 Years of Company Law (2005) 249.

33 *A Smith*, An Inquiry into the Nature and Causes of the Wealth of Nations, Book 5, Ch 1.3.1.2 (5th edn 1789).

34 *AA Berle/GC Means,* The Modern Corporation and Private Property (1932, 10th reprint 2009) 6.

remain uncompensated. Collective action is absent as a consequence of prohibitively high coordination costs.[35]

The protection of dispersed owners accordingly depends on a sound interplay of governance strategies. Internal liabilities are a part of those but do not exhaust the repository. A functioning market for corporate control is considered to be the most powerful external monitoring mechanism.[36] The ex ante constraining effect of a control shift following a takeover on directors and officers lies in the threat that a successful acquirer will replace incumbent management by own candidates. Generating a high market capitalization through increasing the stock price makes a bid less lucrative, less probable and hence serves best to protect directors and officers from losing their positions.[37]

Against this background, a functioning market for corporate control aligns the interests of shareholders with those of the owners.[38] Arguably, professional investors continuously scrutinize listed corporations with a view to exploring the merits of a takeover bid. The probability of a control shift, however, depends on a number of contingent factors, especially volatile prices for financing a bid. Although no doubt important, even the market for corporate control will only serve as one, and cannot be an exclusive mechanism to protect owners.

The most important non-contingent monitoring device within internal corporate governance is the board of directors. Executive board directors, of course, lack incentives to sanction themselves for misconduct and will be reluctant to disclose the misconduct of officers whose supervision is a key task of the board. In the course of the corporate governance movement, internal monitoring has been entrusted to non-executive directors. For the internationally predominant one-tier board, a task description of non-executive directors is widely agreed upon that resembles that of supervisory directors in a two-tier board system.[39]

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35 *M Olsen*, The Logic of Collective Action: Public Goods and the Theory of Groups (1965).

36 *HG Manne*, Insider Trading and the Stock Market (1966).

37 *Easterbrook/Fischel* (fn 1) 96, 109 ff.

38 *HG Manne*, Mergers and the Market for Corporate Control (1965) 73 Journal of Political Economy 110, 112.

39 UK Corporate Governance Code (2016), para A.4, supporting principle: 'Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.'

Enforcing liabilities is a primary responsibility of the board of directors, especially of its non-executive directors. Specialized committees are set up and entrusted, for example, with the task of internally auditing the annual accounts, financial disclosure and review of the external statutory auditor report. In the language of economists, the board and its committees serve to overcome information asymmetries between the owner principals and their director and officer agents: Screening candidates, nomination and/or appointment alleviate the danger of an affiliation with unqualified or opportunistic agents (hidden information). Continued monitoring serves to distinguish between effects of behavior that can be endogenously traced back to the agents' efforts and those that are exogenous and unrelated to the agents' decision making (hidden action).

These two types of information asymmetries are a result of delegated management. In other words, the delegation of decision making together with the diversification of assets causes agency costs. Internal monitoring and the use of other strategies serve to minimize agency problems but each of those strategies, including D&O liabilities, causes its own costs.

b) Agency costs

The costs of D&O liabilities obviously include enforcement, fees for lawyers, litigation in court or arbitration. Where costs are more or less calculable ex post, liabilities for misconduct might firmly serve compensation. The ex ante costs of liability are less easy to calculate. Liability deters agents from misconduct but it can also lead to risk aversion. Choosing an adequate risk exposure for the firm is in the interest of shareholders and also in the interest of society. Welfare increasing innovation to a large degree depends on risk exposures of firms that are able to manoeuvre within the triangle of capital contribution, limited liability and delegated management. Setting the deterrence of liability at the optimal level is hence the major challenge for those who are responsible for drafting the contracts with directors and officers as well as for legislators.

Optimal deterrence depends foremost on the possibilities of the agent to control the own behavior and to foresee in advance whether a decision will harm the principal. The distinction between different types of duties, loyalty and care, reflects this insight. Generally, breaches of loyalty duties are deemed to be better foreseeable than breaches of the duty of care. Court control is less subject to possible hindsight biases regarding the former than the latter. Legislation and corporate charters often specify concrete loyalty rules, whilst they rely on rather vague standards for prescribing the care level.[40] The distinction is, of course, much clearer in theory than in practice. Corporate donations vs dividend rights, profitable corruption vs legal compliance and other problems alike blur the line between acceptable and non-acceptable behavior.

Under-deterrence will give leeway to opportunistic behavior. Conversely, over-deterrence precludes benefits from delegated management for shareholders and society. Both types of error represent failures to set liability levels correctly. Shareholders (or their representatives on the board of directors) are, in principle, free to set the deterrence level. This is, however, only true for inside D&O liabilities towards the corporation, whilst external liabilities, especially those towards third-parties, are determined by legislation or legal doctrine.

c) Stakeholder protection

The duties of officers are set by employment contracts and can be (heavily) influenced by mandatory labour law, those of directors to large extents are prescribed by corporate law. It follows that the shape of directors' duties depends on whether corporate law understands the corporate form as a type of association of individuals or whether it sees it as a function of capital, management, and interests of stakeholders like labour. Some corporate laws like that of US Delaware follow the first approach and accordingly center on shareholder value.[41] In particular continental European jurisdictions and, to a certain extent, the UK follow the second approach by including stakeholder interests.[42] The distinction between the two approaches is relevant for defining the corporate interest and .accordingly it influences the legal test to be applied for determining D&O liabilities.

The shareholder approach promises a clear cut test that asks whether a certain behavior has value enhancing or value destroying effects. In practice, it can of course be difficult to determine the relevant time horizon as some groups of shareholders might be more interested in short-term stock price increases

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[40] *L Kaplow*, Rules Versus Standards: An Economic Analysis (1992) 42 Duke Law Journal 557; *idem*, A Model of the Optimal Complexity of Legal Rules (1995) 11 Journal of Law Economics and Organization (JL Econ & Org) 150.

[41] *SM Bainbridge*, Director primacy, in: CA Hill/BH McDonnell (eds), Research Handbook on the Economics of Corporate Law (2012) 18.

[42] *M Blair/LA Stout*, A Team Production Theory of Corporate Law (1999) 85 Va L Rev 247; *M Blair*, Corporate Law and the team production problem, in: CA Hill/BH McDonnell (eds), Research Handbook on the Economics of Corporate Law (2012) 33.

whilst others prefer long-term gains.[43] The stakeholder approach, in principle, underlies the same difficulties but it arguably aggravates the danger of diffuse agent incentives. A strong form of the stakeholder approach would allow the avoidance of liabilities from net value destroying projects where those projects are justifiable by virtue of any of the other factors to be included in decision making by managers.

It seems, however, that the outcomes of the opposed approaches to what constitutes the corporate interest do not necessarily lead to different results in developed economies.[44] Whilst sec 172 of the UK Companies Act prescribes that directors should also have regard to the interests of the company's employees, the community and the environment, case law on liability for non-compliance with the interests of non-shareholder constituencies is still awaited.[45] In Germany commentators interpret sec 76 Stock Corporation Act in a way that, absent exceptional circumstances, profitability considerations will prevail where shareholder and stakeholder interests conflict.[46]

The possible impact of the stakeholder approach on D&O liabilities should accordingly not be overemphasized. Its real impact stems more from a decision rights strategy that might take different forms. Creditors are not included, at least not directly, in corporate decision making outside certain restructuring arrangements. Contrary to that, employee co-determination, for example in Germany, provides decision rights for workforce representatives on the supervisory board. It has been argued that the decision rights under mandatory co-determination enable employees to bargain for contract terms which would not be enforceable bilaterally. The bargaining opportunities become clear when we consider that in a two tier board model the supervisory board is normally responsible for implementing all or most relevant governance strategies that serve to reduce agency costs. The German supervisory board, for example, is responsible for rewarding managing directors but also for filing a liability suit in case of misbehavior.

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43 *L Enriques/H Hansmann/R Kraakman/M Pargendler*, The Basic Governance Structure: Minority Shareholders and Non-Shareholder-Constituencies, in: R Kraakman et al (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd edn 2017) 91.

44 This can be different in transition economies. On the example of privatization failures in Russia *MB Fox/MA Heller* (eds), Corporate Governance Lessons from Transition Economy Reforms (2006) 8.

45 *Enriques/Hansmann/Kraakman/Pargendler* (fn 43) 91.

46 *M Kort* in: H Hirte/PO Mülbert/M Roth (eds), Großkommentar zum Aktiengesetz (5 edn 2015) § 76 para 53 ff.

3. Interdependencies of Inside and Outside Liabilities

Inside and outside liabilities, to a certain extent, are interdependent. The continuing threat of inside liability towards the corporation, together with other mechanisms that induce good behavior, may serve as an incentive structure that prevents wilful asset deterioration or waste of corporate welfare. To be sure, this preventive effect is also in the interest of creditors. Outside liabilities to creditors enhance external monitoring powers and can serve as an equally useful device to prevent misconduct by directors and officers. Depending on the ownership structure and the relevant mechanisms of information processing through the market, the relative importance of monitoring by creditors can well exceed that of diversified owners. It follows that the ratio of deterrence by either internal or external liabilities for the corporate governance system as a whole can differ.

III. Liability for Damage to the Corporation and Shareholders

Liabilities for damage to the corporation and shareholders – in the above terminology: inside liabilities – stand in the center of the corporate law and economics debate. Most of the available studies focus on directors' liabilities, fewer on officers' liabilities.[47] Generally, the degree to which inside liabilities influence behavior of directors and officers depends on how the law defines their duties and how it treats possible breaches.

Courts distinguish between the duty of loyalty and the duty of care. In essence, the duty of loyalty seeks to prevent self-dealing (no stealing), whilst the duty of care seeks to safeguard attentiveness (no shirking). Some fiduciary duties can be described ex ante and accordingly be formulated as precise rules. A commonly agreed rule allows loans from the corporation only upon approval from disinterested (supervisory) directors. In contrast, optimal care levels are less easily foreseeable and are therefore mostly formulated as mere standards, like acting in the best interest of the corporation. Compared to rules, standards leave the determination of their precise scope largely to ex post court control which, however, over time carves out the duty scope through case law. An economic assessment of how each type of duty serves to reduce agency costs depends on two closely connected factors: first the legal test of a breach, and second – mostly as a sub-factor – the interplay of constraints set by liability with other governance strategies.

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[47] For a short account of evolving officers' liabilities see *CA Hill/BH McDonnell*, Fiduciary duties: The emerging jurispridence, in: CA Hill/BH McDonnell (eds), Research Handbook on the Economics of Corporate Law (2012) 148.

As a bottom line, liability dangers are high with regard to self-interested decision makers.[48] Conversely, liability dangers are low when decision making is backed up by participation of or approval by independent directors. As we will see in the following, this bottom line applies to both types of duties, loyalty and care, albeit under different economic rationales and distinct legal tests.

1. Duty of Loyalty

Fiduciary duties require loyal behavior. In the event of a conflict with his or her own interests the manager must give priority to the corporate interest. Trusteeship obligations of this type are at the heart of agency law. The contractual view of the corporation, prevailing in economics, explains the existence of fiduciary duties as a mechanism to fill the gaps of the incontingent long-term relationship between shareholders and managers.[49] Specifying all possible future events would be prohibitively costly or simply impossible.[50] Whilst the rights against suppliers, labour, and creditors can be specified to a relatively high degree of completeness, those against managers cannot. Delegated management is a necessary prerequisite for achieving the benefits of diversified investment. Investors will, however, only agree to this arrangement if managers credibly commit to discharging their tasks honestly.[51]

a) No-conflicts rule

Preventing conflicted decisions is the core of the duty of loyalty. Where decisions are taken by a conflicted manager, the success of a liability suit is highly probable. The economic rationale of this strong form of the constraints strategy lies in the expectation that breaches of the fiduciary duty will not be optimally deterred by other mechanisms, including costly monitoring.[52]
The striking difference between care and loyalty violations lies in the possible payoffs from misconduct. Too low an effort level will normally become observable over time and one-time defalcations will not lead to a proportionate increase of the managers' individual wealth. In contrast, one-shot appropriations of the companies' wealth are subject to a calculus determined by the amount of the wealth transfer and the probability of detection.

48 *Hill/McDonnell* (fn 47) 136.

49 *Williamson* (1979) 22 JL & Econ 233, 241 See also *DR Fischel/M Bradley*, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis (1986) 71 Cornell L Rev 261, 264.

50 *Easterbrook/Fischel* (fn 1) 90.

51 *Easterbrook/Fischel* (fn 1) 91.

52 *Hill/McDonnell* (fn 47) 137.

Incentives to appropriate funds of the other party become dominant at the end of an initially cooperative bargaining game (last-period problem). Whilst misaligned incentives in the pre-retirement period may be cured by pension promises, abrupt terminations of office following a takeover or insolvency of the corporation cannot. Liability constraints then serve to overcome the problems resulting from the non-availability of contractual solutions ex ante. With a view to deterring large one-shot appropriations, arguably a spectre of civil liability and criminal penalties will be needed.[53]

The operation of the no-conflicts rule differs amongst jurisdictions. A common element of the legal test for asserting liability requires proof that the terms of a conflicted transaction do not equal those of a market transaction at arm's length. Commentators have highlighted that this legal test reflects the contractual view of the corporation in economics.[54] Where the determination of a market price is possible, the costs of the constraints strategy seem to be lower regarding the loyalty duty than for the duty of care. Investigating appropriations by price comparisons is easier than inquiries into negligence and will accordingly less often be subject to court error.[55]

For many types of conflicted transactions, market prices are not available. An illustrative example is the so-called empire building: Expanding the size of a corporation is generally considered to be useful until the marginal costs of organizing *intra*-firm contracts (contracts within the firm) exceed those of *inter*-firm contracts (market transactions).[56] At first sight the forecast of costs appears to be a simple business judgment that lies outside the scope of the loyalty duty. Expanding firm size, however, can also be used by the director to shield against takeover threats. Acquisitions may hence reflect the managers' own positional interest more than being in the corporate interest. The increase in agency costs due to a lessened takeover threat can hardly be determined accurately. They accordingly lie outside the scope of a no-conflicts rule that simply tests the fairness of the acquisition price. This is why the following procedural safeguards are necessary.

b) Conflict approval

In contractual agency relationships, the agent does not breach her fiduciary duties when the act has been approved by the principal. Possible breaches may, of course, result from inadequately informing the principal prior to approval.

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53 *Easterbrook/Fischel* (fn 1) 98.

54 *Easterbrook/Fischel* (fn 1) 104.

55 *Easterbrook/Fischel* (fn 1) 103.

56 This distinction goes back to *Coase* (1937) 4 Economica 386.

In the corporate context, the law often requires shareholder approval of fundamental transactions and obliges directors to properly inform shareholders about the merits. A merger agreement, for example, requires at least a two third majority under the EU merger directive. In some jurisdictions that foresee a two-tier board structure, capital increases, like issues of shares, are explicitly made subject to approval by supervisory directors by law. In countries with a one-tier board structure, compliance with the no-conflicts rule often requires approval by a majority of independent directors.[57]

When these procedural steps are complied with, courts will not inquire into a comparison of the transaction with market conditions, or at least show reluctance to do so by employing the Business Judgment Rule.[58] Decision making procedures hence serve as a cheap substitute for liability rules in assuring contractual performance.[59] Similar to the situation with contractual agency, liability dangers may arise when relevant information is withheld from those entrusted with the approval right. As a consequence of delegation of the approval right, the additional question arises as to under which conditions the independent (supervisory) directors can be held liable for giving consent to value destroying transactions, ie for not properly exercising their monitoring duties.[60]

Approval rights are seen as a decision rights strategy that serves to safeguard proper decision making by managers who are – under delegated management – in control of the corporate assets. It widely replaces the ultra vires doctrine that was used earlier by courts to invalidate conflicted transactions. The evolvement of approval rights is in line with economics in that procedural safeguards provide a mechanism to solve or alleviate conflicts of interest instead of banning worthwhile dealings.[61] Absent direct approval by shareholders, the decision rights strategy will only be functional where it is backed up by operative additional governance mechanisms that control possible conflicts of those who are entrusted with the approval task.

The first additional strategy is called trusteeship and serves to remove conflicts of interest ex ante by a delegation of the approval right to independent

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57 For a short account of the majority-independence rule see *PC Leyens*, Corporate governance in Europe: foundations, developments and perspectives, in: T Eger/H-B Schäfer (eds), Research Handbook on the Economics of European Union Law (2012) 187.

58 *JR Brown*, Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty (2003) 54 Hastings Law Journal 641.

59 *Easterbrook/Fischel* (fn 1) 104.

60 Below no 55 ff.

61 *Hill/McDonnell* (fn 47) 133 ff, 137.

directors.[62] As opposed to remuneration and liability, trusteeship relies on low-powered incentives like conscience and reputation. Independent directors may be efficient trustees because they presumably profit from conflicted transactions to a much smaller extent than executive directors. Their human capital is diversified, ie it reveals a much lower degree of specificity with regard to the corporation than that of executive directors. Possible consequences of wrongdoings will accordingly hit independent directors in other markets. These assumptions, however, show a certain vagueness of the trusteeship strategy. Its main proponents argue that the costs and risks of approval by disinterested parties are lower than the costs and error rate of the legal system at large.[63]

Whilst in the US the majority independence principle has long been accepted, especially in countries with two-tier board structures, including Germany, it has been argued that such requirement would be an unjustified intervention in the legitimate interests of controlling owners. This latter aspect reveals a less obvious effect of the trusteeship strategy: Appointing directors to the board who are independent from major shareholders implicitly increases the control rights of minority shareholders.[64]

As discussed above, the protection of diversified minority shareholders can exacerbate the short-termism of managers and the probability of excessive risk taking. For creditors who can specify their exit rights upon material increases of risk exposure, this effect will not necessarily be adverse. Those with fewer options, especially labour, will often not benefit from decisions that follow short-termism of minority shareholders. In informed financial markets the alleged opposition of minority shareholders and other stakeholder groups might be less severe than presumed. One influential factor concerns investment guidelines of institutional investors, which tend to prescribe abstention from firms with too high risk exposures.[65]

c) Selected distinctions

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62 *J Armour/H Hansmann/R Kraakman*, Agency Problems and Legal Strategies, in: R Kraakman et al (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd edn 2017) 35.

63 *Easterbrook/Fischel* (fn 1) 104 ff concede that independent (‘disinterested’) directors ‘are quite interested in maintaining the managers’ esteem and places on the board, which are worth something’.

64 *J Armour/L Enriques/H Hansmann/R Kraakman*, The Basic Governance Structure: The Interest of Shareholders as a Class, in: R Kraakman et al (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd edn 2017) 65.

65 On the possible role of institutional investors in the EU *Leyens* (fn 57) 191 with further references.

In legal practice the scope of the no-conflicts rule for loyalty breaches vis-à-vis the less strict Business Judgment Rule for breaches of the duty of care is less clear than in economic theory. A comprehensive comparative legal account is still awaited. A few eclectic examples must suffice for the purpose of illustrating the distinction problem.

Takeover defences have possibly received the greatest attention in comparative research.[66] Under US Delaware Corporation Law, upon approval by a majority of independent directors, managers get leeway to take defensive measures (just-say-no-rule).[67] Conversely, the UK model as laid out in the London City Code on Takeovers and Mergers depreciates an active role of incumbent managers in deciding over the success of a bid (no-frustration rule).[68]

Possible liability threats must be determined against the background of these two different forms of a decision rights strategy: Whilst in the US the possibility of taking defensive measures fosters the role of directors as agents for shareholders to negotiate the terms of the bid, the UK approach denies directors a say due to their (obvious) positional conflicts. In its takeover directive of 2002 the EU, in principle, followed the model of the London City Code. The EU directive, however, allows deviations which a number of EU Member States make use of. Arguably, the reluctant approach of EU Member States to providing a level playing field for takeovers is due to fears of losing national champions to foreign investors.

Ex ante indemnification of defensive measures by shareholders apparently does not play a great role in countries like Germany. Ad-hoc authorization of defensive measures by supervisory boards during the bid period does though. Supervisory directors might well be representatives of controlling shareholders. Minority shareholder protection in takeover situations accordingly cannot rest solely on the division of management and supervision by a two-tier board model. This is why additional independence requirements for some of the supervisory board members might be justified.

Monitoring by non-executive (or supervisory) directors, however, is another field that blurs the line between care and loyalty. In fact, it is difficult to see a difference between low effort levels of executive managers and failures to

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66 *KJ Hopt*, Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis (2014) 20 Columbia Journal of European Law 249; *KJ Hopt/P Davies/W-G Ringe*, Control Transactions, in: Kraakman et al (eds), The Anatomy of Corporate Law: A Comparative and Functional Approach (3rd edn 2017) 211, 215 with further references on the following disjunction in decision making strategies.

67 *Unocal Corp v Mesa Petroleum Co*, 493 Atlantic Reporter, Second Series (A2d) 946 (Del 1985).

68 Panel on Takeovers and Mergers, The City Code on Takeovers and Mergers, 12.9.2016, rule 21.1.

exercise due monitoring by non-executive directors. It has been argued, with considerable convincing force, that the no-conflicts rule is an incomplete test especially with regard to compensation decisions by non-executive directors.[69] When we accept the commonalities between management decisions and entrepreneurial decisions like those on remuneration, it seems justifiable to apply the Business Judgment Rule not only to managers but also to their monitors.

Against this background one might ask whether legislative or judicial reliance on independent directors is justified and to what extent approval by independent directors should play a role for shielding executive directors against failures to comply with the no-conflicts rule.[70] The answers depend on the ability of independent directors to prevent misconduct. This ability is widely determined by their duties to investigate and sanction misconduct of executive directors. The most important prerequisite for successful execution of this task is information, which so far is mainly discussed as a component under the Business Judgment Rule that will be explored in the following section.

2. Duty of Care

Duties of care exist in all contractual relationships including agency and labour contracts. In as far as a jurisdiction considers the agency relationship with officers as a labour contract, liabilities will be decided along traditional lines with possible modifications under national employee protection policies.[71] For directors, the operation of the duty of care exhibits specific characteristics that, as compared to the duty of loyalty, lead to a rather loose liability danger. The doctrinal basis for this outcome and the availability of contractual indemnifications differ from country to country. The economic rationale for protecting directors from liabilities for breaches of the duty of care is generally seen in agency costs savings.

a) Business Judgment Rule

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69 *Easterbrook/Fischel* (fn 1) 103.

70 The most comprehensive accounts are provided from the US perspective *GN Gordon*, The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices (2007) 59 Stanford Law Review 1465, and from a transatlantic European perspective by *M Roth*, Labor and Comparative Corporate Governance in Times of Pension Capitalism: Independent Directors, Shareholder Empowerment and Long-Termism (2013) 18 Fordham Journal of Corporate & Financial Law 751.

71 *Enriques/Hansmann/Kraakman/Pargendler* (fn 43) 84.

In the US and in a number of other countries the duty of care is subject to the so-called Business Judgment Rule. As formulated by the Delaware Supreme Court in its landmark case *Aronson v Lewis* of 1984, the Business Judgment Rule 'is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. (…). Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.'[72]

According to the court in *Aronson v Lewis,* the main elements of the duty of care include information, good faith, best corporate interest. In some countries, like Germany, these elements have been codified.[73] Under German law, however, the burden of proof is on the director.[74] The example of sec 174 of the UK Companies Act 2006, which sets an objective care standard, shows that the US version of the Business Judgment Rule is not accepted universally. Court practice in all jurisdictions, however, seems to indicate reluctance in second-guessing business judgments.[75] Arguably, the real differences in the operation of the duty of care stem from the availability of contractual liability limitations. US law widely allows contractual liability limitations whilst they are precluded in Germany and the UK (see sec 3).

The Business Judgment Rule, in effect, is an abstention doctrine that denies courts the power to review whether loyal decisions are taken in compliance with the duty of care.[76] The assumption that investors' wealth would be lower if business judgments were routinely subjected to ex post judicial scrutiny finds backing by interdisciplinary research.[77] It might be going too far to believe that judicial decision making is per se not well positioned to assess business decisions made under market pressure.[78] It is convincing though to question the accuracy of ex post assessments on the basis of what is known in behavioral sciences as hindsight bias. Business judgments, in essence, are forecasts on the expected value of a transaction. That forecast is often made under a considerable degree of uncertainty.[79] Judicial review after knowing the

72 *Aronson v Lewis*, 473 A2d 805 (Del 1984).

73 Sec 93 para 1 sent 2 German Stock Corporation Act.

74 Sec 93 para 2 sent 2 German Stock Corporation Act.

75 *Armour/Enriques/Hansmann/Kraakman* (fn 64) 69.

76 *Hill/McDonnell* (fn 47) 137.

77 *Easterbrook/Fischel* (fn 1) 94.

78 *Easterbrook/Fischel* (fn 1) 100; *Enriques/Hansmann/Kraakman/Pargendler* (fn 64) 79.

79 *FH Knight,* Risk, Uncertainty, and Profit (1921, reprint 2009).

outcomes, ie under certainty, is prone to a natural tendency towards overestimating predictabilities.[80]

A widely agreed argument for judicial abstention from reviewing business decisions is based on the problem of rational risk aversion of managers.[81] Managers cannot diversify their human capital and, therefore, they might have lower risk preferences than diversified shareholders. Their gains from risk taking are disproportionate to the profits of shareholders, whilst losses will ultimately lead to removal. Routine exposure to judicial review (and error) decreases incentives for risk taking and hence eliminates a core advantage of delegated management.

For the governance of publicly held corporations, care liability is said to have only limited usefulness.[82] Attentiveness of directors, it is believed, can be sufficiently motivated by other mechanisms that in sum might come close to a self-enforcing agency contract. In particular the reward strategy, ie remuneration, can be employed to provide incentive compatibility. Experience with exorbitant bonuses, however, seems to show that a principle of 'pay for performance' is not properly implemented in practice.[83] High bonuses may, in principle, be in the corporate interest. They are not when remuneration setting is de facto controlled by those who receive the bonuses. Independent remuneration committees of the board have long become a common feature but they apparently have not always been a cure.

Building on the 1930s US securities legislation, disclosure has become the governance paradigm within and outside the EU. Disclosure is said to enhance the information efficiency of capital markets, which can be seen as the most powerful device to safeguard self-enforcing agency contracts between shareholders and managers. Opinions on the capability of capital markets to efficiently process information differ. The delusive assumption of universally perpetual market efficiency is acknowledged, at the latest, after the award of an equally shared Nobel prize[84] 2009, on the one hand, to the strongest proponent of efficient markets *EF Fama*, and, on the other hand, to one of its strongest opponents *RJ Shiller*.[85] In corporate law and economics and arguably

80 For an intuitive reasoning see *Easterbrook/Fischel* (fn 1) 98.

81 *SM Bainbridge*, Corporation Law and Economics (2002); *Easterbrook/Fischel* (fn 1) 99 ff; *WT Allen/R Kraakman/G Subramanian*, Commentaries and Cases on Law of Business Organization (4th edn 2012) ch 8.

82 *Williamson* (1979) 22 JL & Econ E 233.

83 *LA Bebchuck/J Fried*, Pay without Performance: the unfulfilled promise of executive compensation (2004).

84 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel.

85 See *EF Fama*, Efficient Capital Markets: A Review of Theory and Empirical Work (1970) 25 Journal of Finance 383, and *RJ Shiller*, Irrational Exuberance (2nd edn 2005).

in practice, the view prevails that developed markets, at least, over time prize information, although determining the relevant mechanisms might remain a quest.[86]

It seems plausible though to view directors of capital market oriented firms as repeat players. Repeat players judge the benefits of their current acts in anticipation of future sanctions. Sanctions might vastly exceed the gains from misrepresenting performance. Putting the agents' incentives in a repeat game setting, firstly explains that unduly risking other people's money will be detrimental if this precludes future participation in the market for managers.[87] It secondly helps to build up a theory on the reasons why managers will be careful to risk firm reputation outside a last period constellation.[88] Even if the corporation does not regularly have to resort to the capital market for raising corporate funds, managers' wealth might be and mostly is tied to the stock price through a reward strategy. Still, the mechanism commonly considered to be strongest is the removal threat upon a successful takeover.[89]

b) Informed decision

One element of the Business Judgment Rule deserves special attention: the duty to carry out informed decision making. In its landmark decision *Smith v Van Gorkom* of 1985, the Supreme Court of Delaware held that directors are in breach of their duties if they do not obtain sufficient information prior to a business judgment.[90] The case concerned the acceptance of a merger proposal at a large premium over the market price. Despite the fundamental nature of the transaction, the directors had failed to properly study the proposal and they had abstained from consulting outside experts.[91] Whilst these failures might be seen as outliers, the court decision could well have had the effect of a dangerous perforation of the judicial abstention principle under the Business Judgment Rule. On the basis of the decision, plaintiffs could routinely

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86 On the mechanisms of efficiency see *RJ Gilson/RH Kraakman*, Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs, in: CA Hill/BH McDonnell (eds), Research Handbook on the Economics of Corporate Law (2012) 456 with (minor) corrections of too optimistic beliefs in some earlier assumptions made by *idem*, The Mechanisms of Market Efficiency (1984) 70 Va L Rev 549.

87 *GS Becker/GJ Stigler*, Law Enforcement, Malfeasance, and Compensation of Enforcers (1974) 3 The Journal of Legal Studies (1974) 1; *EF Fama*, Agency Problems and the Theory of the Firm (1980) 88 Journal of Political Economy 295.

88 On the last period problem for managers of financially troubled corporations below no 98 ff.

89 Above no 28.

90 *Smith v Van Gorkom* 488 A2d 858 (Del 1985).

91 *Easterbrook/Fischel* (fn 1) 107.

challenge business judgments by alleging information deficits. The legislator prevented this outcome by introducing a section to the Delaware General Corporation Law[92] which allows contractual exclusion of liability for certain breaches of fiduciary duties, inter alia uninformed decision-making. This option is widely made use of in charters of US corporations.
One could well argue that a reasonable approach to what constitutes sufficient information might have better balanced out the dangers of frivolous suits against a loss of deterrence from fully entrenching management.[93] Under the German version of the Business Judgment Rule, challenging decisions on the basis of information deficits is a promising strategy, especially as the burden of proof is shifted to directors.[94] Together with the non-availability of liability exclusions and the recently extended period of prescription to ten years for stock listed corporations information deficits pose a considerable liability threat in Germany.[95]
The economic effects of the different versions of the Business Judgment Rule can hardly be determined in figures. In Germany, legal practitioners report a high demand by directors for pre-transactional expert opinions. This is a profitable business for counsels and other advisors. It arguably sets incentives for a welfare decreasing use of corporate resources for de facto prejudiced expert opinions (red tape). At the same time, it is a not to be underestimated benefit that irresponsible behavior of the *Smith vs. Van Gorkom* type is made actionable.

c) Monitoring duties

Maintaining a sufficient level of information is essential for effective internal monitoring. Directors of large corporations, normally also those of middle-sized corporations, spend most of their time on organizing the tasks of officers and supervising a proper execution. Monitoring does require information but it does not necessarily involve decision making. Liability issues therefore foremost arise from failures to gather and process the information needed for fulfilling the monitoring task.
The distinction between management and monitoring duties is well known in jurisdictions that prescribe the two-tier board model (eg Germany) or that optionally allow it (eg France, Italy, The Netherlands, Portugal).[96] Within the

92 Del Gen Corp L § 102(b)(7).

93 *PC Leyens*, Information des Aufsichtsrats (2006) 26 ff.

94 Above no 63.

95 Sec 93 para 6 German Stock Corporation Act.

96 *KJ Hopt*, Comparative Corporate Governance: The State of the Art and International Regulation (2011) 59 American Journal of Comparative Law (Am J Comp L) 1, 20.

internationally predominant one-tier board model (especially UK, US) non-executive directors perform a similar task to that of the members of a supervisory board in a two-tier model.[97] The separation of management and supervision on board level enables monitoring, last not least with a view to liability enforcement, but it also leads to an information problem.[98] This insight is crucial as governance strategies, including constraints, reward, veto and trusteeship will only be implemented properly when non-executive (supervisory) directors possess sufficient information.

Holding non-executive directors liable for information deficits, however, seems to be a difficult task which has most probably troubled courts everywhere.[99] The problem appears to be a 'double mirror' of the reasons that have led to abstention from judicial review of business judgments: Second-guessing business decisions on the basis of ex-ante information is already difficult. Reassessing which monitoring measures would have prevented or alleviated negative outcomes is even more vulnerable to hindsight biases, including misinterpretations of facts and legal error.

A short account of the state of US case law serves to illustrate the challenges of distinguishing between care and loyalty and prompts the conclusion that court control is only prepared to catch severe monitoring failures.[100] Recalling the starting point of judicial review, under the Business Judgment Rule information deficits can lead to a breach of the duty of care but corporate charters exempt directors from liabilities unless they are in breach of the duty of loyalty, ie they are not acting in good faith. In the already cited decision *Aronson v Lewis* the Delaware Supreme court held that directors are not observing good faith, when they intentionally fail to act in the face of a known duty to act, thus demonstrating a conscious disregard of the duty.[101]

A more recent judgment concerned the excessive remuneration of USD 130 million given to *Michael Ovitz*, the former CEO of Disney, for (allegedly) bad

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97 *KJ Hopt/PL Davies*, Boards in Law and Practice: A Cross-Country Analysis in Europe (2013) 61 Am J Comp L 301, 306 ff – together with further studies also published in: *P Davies/KJ Hopt/R Nowak/G van Solinge* (eds), Corporate Boards in Law and Practice, A Comparative Analysis in Europe (2013) 3; *KJ Hopt/PC Leyens*, Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy, ECFR 2004, 135, 139 ff, 160 ff.

98 *Leyens* (fn 93) 26, 87, 156, on the German supervisory board and the UK board of directors.

99 See eg the discussion in *In Re Caremark Int'l Inc Litig,* 698 A2d 959, 967 (Del Ch 1996).

100 For an overview see *Hill/McDonnell* (fn 47) 141 ff.

101 *Aronson v Lewis*, 473 A2d 805 (Del 1984).

services within a one year term of office.[102] Other decisions provide more general formulas for monitoring duties. In *Caremark* it was held that even in the absence of red flags, the board has a duty to set up a monitoring system to trace legal compliance by officers.[103] The *Caremark* judges, however, felt that choosing components of that system should be left to the discretion of the board. Since the decision in *Stone vs. Ritter*, monitoring duties are seen as loyalty duties. Following *In re Citigroup*, however, liability for failures of oversight depends on proof of bad faith, ie on proof of a conscious disregard of existing duties.[104]

Internationally, legislators have reacted to weaknesses of the duty of care – mainly after scandalous monitoring failures – by prescribing specific monitoring duties.[105] In the US these duties have been included in federal securities legislation. This often leads to spill-overs into the laws of single US states. Following the earth shaking collapse of the second largest US energy provider Enron in 2001, the Sarbanes-Oxley Act of 2002 obliges to report the effectiveness of internal controls regarding financial disclosure.[106] Similar attempts were made for example in German law which mandates management directors to run an operative risk management system and obliges supervisory directors to supervise its effectiveness.[107]

Another layer concerns best practice recommendations and codes of conduct, the influence of which is increasing within the EU. The European Commission contributed to this development in 2005 by issuing a Recommendation on the tasks of non-executive or supervisory directors. The Recommendation mainly addresses the national makers of codes of conduct. In summary, it recommends a structure of committees to fulfil the main tasks of the board which are audit, remuneration and nomination. Providing guidance for safeguarding monitoring within a procedural system of best practice was already the approach under the UK Corporate Governance Code since its beginnings under the Cadbury Code of 1992. In another recommendation of 2014 the European Commission has tried to foster disclosure under the comply or explain principle. Following the implementation of an EU directive of 2006, stock listed corporations are

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102 *Hill/McDonnell* (fn 47) 141 report on the three leading opinions of *In re Walt Disney Co Derivative Litig*, 825 A2d 275 (Del Ch 2003), 907 A2d 693 (Del Ch 2005), and 906 A2d 27 (Del 2006).

103 *In re Caremark Int'l Inc Litig*, 698 A2d 959 (Del Ch 1996).

104 *In re Citigroup Inc Shareholder Derivative Litig*, 964 A2d 106 (Del Ch 2009).

105 For a short comparative account see *Armour/Enriques/Hansmann/Kraakman* (fn 64) 69.

106 *SM* Bainbridge, Corporate Governance after the Financial Crisis (2012) 157; *Armour/Enriques/Hansmann/Kraakman* (fn 64) 70..

107 Sec 91 para 2 German Stock Corporation Act.

already obliged to either comply with their national code of conduct or to explain their reasons for non-compliance.[108] Arguably, soft law regulation through codes of conduct and disclosure of code compliance will serve to enhance monitoring on board level.

3. Waivers and Indemnity

The possibility of excluding D&O liabilities by ex ante waiver or by promising indemnity heavily influences the above-discussed deterrence effects of D&O liabilities.[109] Under US law, as well as under the laws of states like Canada or Japan, ex ante contractual liability exemptions are widely available.[110] Within the EU, ex ante liability exclusions appear to be widely unavailable. For example, following a holding of the German Supreme Court in Civil Matters, the supervisory board, in principle, is obliged to enforce damage claims against management directors.[111] The shareholders may waive liability only ex post and only upon elapse of a three year period.[112]

The real effect of these differences should not be overestimated. As a consequence of D&O insurance and the promise by the corporation to cover legal expenses the so-called out of pocket liability (de facto payment) is much lower than the nominal liability (damages award).[113] Still, legal interventions into party autonomy as in the example of German law need justification.

a) Optional liability

Contracting between sufficiently informed parties improves the allocation of resources and hence stands for welfare increases. Liability is part of the

108 Art 46a Dir 2006/46/EC of 14.6.2006 [2006] Official Journal (OJ) L 224/1.

109 This corresponds with questions 21 and 23 of the questionnaire.

110 For the US see Delaware Code (Del Code) § 102 (7) which upholds a ‘provision eliminating or limiting the personal liability of a director (…) for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (…); or (iv) for any transaction from which the director derived an improper personal benefit (…)’.

111 German Supreme Court in Civil Matters (Bundesgerichtshof, BGH) 21.4.1997 – II ZR 175/95, Decisions of the BGH in Civil Matters (BGHZ) 135, 244, known as *ARAG v Garmenbeck*.

112 Sec 93 para 4 sent 3 German Stock Corporation Act.

113 *BS Black/BR Cheffins*, Outside Director Liability Across Countries (2006) 84 Texas Law Review 1385; *BS Black/BR Cheffins/M Klausner*, Outside Director Liability (2006) 58 Stanford Law Review 1055.

bargain and it comes at a price, just as remuneration.[114] The determination of performance and pay is the very core of party autonomy. None of the sample jurisdictions bans remuneration promises that take account of a high liability exposure, for example, when interim managers help to reorganize the business of a financially distressed firm.

As a contractual response to agency costs, liability restrictions such as waivers and indemnifications will and should be used when markets are cheaper monitors than courts.[115] This might not always be the case. There is some empirical evidence that the legislative adoption of a liability limitation provision is associated with insignificant stock price reactions for all firms, but with positive stock price reactions for poorly performing firms.[116] Hence, it seems that liability restrictions, similar to remuneration, may serve to increase the mutual gains from the agency relationship although the possibilities for shareholders to control the behavior of directors and officers will be reduced.[117] Liability restrictions can be used to share the savings of costs that would otherwise arise from complex monitoring but this strategy will only be promising when other mechanisms sufficiently induce good behavior.[118]

At least in theory, the reward strategy can be used to make directors' remuneration contingent on good as well as on bad performance.[119] The relative advantages over liability depend on how precisely the contingencies can be specified ex ante. Ex post liability indemnifications seem to have the advantage that the relevant specifications may be made on the basis of all facts. Specifications will hence be more precise and indemnifications accordingly come at lower costs.[120] With a closer look, however, only an ex ante agreement on an indemnification routine will overcome the problem of risk aversion.[121] In particular well capitalized firms that can afford to shoulder

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114 *M Gaber*, The Effect of D&O Insurance on Managerial Risk-taking: A Law and Economics Approach to the Managerial Liability Risk and the Role of D&O Insurance (2015) 24.

115 *Easterbrook/Fischel* (fn 1) 105.

116 *Y Brook/RKS Rao*, Shareholder Wealth Effects of Director Liability Limitation Provisions (1994) 29 Journal of Financial and Quantitative Analysis 481.

117 For a pointed statement see *J Bishop*, Indemnification of Corporate Directors, Officers and Employees (1964-1965) 20 Business Lawyer 833, 843: 'we make a monkey out of the stockholders remedy, if the money simply travels in a circle from the insiders' pockets to the corporations' treasury and back to the insiders' pockets.'

118 *Kraakman* (1984) 93 Yale LJ 857.

119 See *M Gutiérrez*, An Economic Analysis of Corporate Directors' Fiduciary Duties (2003) 34 Rand Journal of Economics 516.

120 See *Kraakman* (1984) 93 Yale LJ 857, 864.

121 *Gaber* (fn 114) 73.

losses may hence wish to insulate their managers from liability to avoid undesirable chilling effects and promote risk-taking in the corporate interest.[122]

b) Mandatory liability

Welfare enhancing effects of contracting are blocked when the parties to the bargain cannot obtain a sufficient level of information to determine the price of liability. Dispersed shareholders themselves generally lack the sophistication to determine the costs and benefits of liability. Relying on the advice of conflicted directors does not seem advisable. For some, this is an argument in favour of a mandatory prescription of internal liability.[123]

A full account needs to envisage that the assessment task today is commonly entrusted to remuneration committees composed by a majority or exclusively of independent directors. This use of the trusteeship strategy does alleviate but it, arguably, does not eliminate the problem. Independent directors might owe their office to a certain extent to executive directors. This problem might not be insurmountable, provided that the board has set up an independent nomination committee. However, in order to discharge their tasks independent directors depend on a continuous information exchange with managers, which might particularly lessen their vigour in sanctioning bad performance by lowering remuneration. Finally, they are responsible for making proposals on their own remuneration and they will not risk that the amounts are challenged by management. Best practice recommendations tend to propose the appointment of an independent remuneration advisor. Remuneration advisors are one type of a new industry of corporate governance service providers which firmly depend on being mandated by the corporation.[124] It remains to be seen to what extent enhanced independence standards for remuneration advisors could provide a solution to conflicts of interest.

Mandatory liability ignores information uncertainties that equally pertain to directors and officers. Liability exposures can change substantially over the lifetime of a corporation and individual terms of office. High nominal damages, but also the lower out-of-the-pocket liability, will often exceed private wealth. It is true that not only directors and officers face ruinous liability dangers. However, their abilities to control their own risk exposure seem to be more limited than, for example, those of a sole proprietor, for three

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122 *Kraakman* (fn 19) 144.

123 Inter alia *L Bebchuk*, Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments (1989) 102 Harvard Law Review 1820.

124 *P Rose*, The Corporate Governance Industry (2007) 32 Journal of Corporation Law 887. On the core issue of remuneration either by the corporation or by investors (issuer v investor pay) inter alia *Leyens* (fn 57) 196 with further references.

reasons: Firstly, the relational long-term agency contract specifies their duties incompletely and accepts that duties evolve over time. Secondly, their risks to a large extent depend on team production, ie on the willingness of team members to behave well, which might change over time. Thirdly, they cannot resort to a corporate form that provides limited liability when risks become excessive.

Against this background, it might well be argued that a complete legislative ban of liability restrictions is not justified. Such ban precludes all possible positive effects instead of taking a balanced approach that also looks at the availability of other deterrence mechanisms. A balanced approach that allows some but not all liability exclusions will – eg as under US law – certainly not allow severe loyalty breaches.[125] Most of those breaches will relate to conscious behavior (*dolus*), which is uninsurable and might lead to criminal sanctions.

c) Targeting officers

Officers can be held liable for breaches of their duties by the corporation. Labour law might grant them relief for non-conscious breaches.[126] So far, it has not been explored in detail to what extent they can or should be targeted by shareholder suits. Building on the simplified picture of a contract between shareholders and directors, interdisciplinary corporate governance research has been reluctant so far to permeate the hierarchical structures below board level. Further inquiry will possibly be needed due to the increased awareness of the decision making processes that, outside monitoring, ultimately concern the incentive structures of officers and other employees.

Under US law, liability suits can be filed against officers.[127] Two developments have facilitated this: Firstly, an amendment of Delaware corporate law of 2004[128] gives courts jurisdiction over officers. Secondly, the so-called Delaware exculpation only applies to directors. Together, these developments make officers an attractive victim of a liability suit.

For law making within the European Union, the possible effects of officers' liabilities and contractual liability exclusions could unfold in more detail should the role of employees in key functions be further strengthened through duty specifications in regulated industries like the banking or insurance sector.

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125 See the restrictions under Delaware law (fn 110).

126 An account of interdisciplinary research has been provided inter alia by *CL Estlund/ML Wachter* (eds), Research Handbook on the Economics of Labor and Employment Law (2012).

127 *Hill/McDonnell* (fn 47) 148.

128 10 Del Code § 3114(b).

IV. Liability for Damage to Third Parties

The generally agreed welfare advantages of limited shareholder liability stand in a stark contrast to adverse effects. Adverse effects can derive from the possibility to misuse the corporate shell or from instrumentalizing delegated management to run excessive risks. The effect of such misuse is that gains are internalized by owners whilst losses are externalized to third parties. The claim that creditors can protect themselves (better than diversified shareholders) against losses through contracting risk premiums only holds true for voluntary creditors. Involuntary creditors, for example victims of a tort, lack this opportunity.[129] For the protection of involuntary creditors, D&O liability towards third-parties accordingly is more persuasive than in relation to voluntary creditors.

1. General Considerations[130]

Liabilities of directors and officers only occur if there is a breach of a duty towards the creditor.[131] Directors' and officers' acts are seen, with doctrinal differences, as acts of the corporation. Legislators or courts can choose to extend the duties of agents towards contractual partners of the principal.

Extending liabilities of directors and officers to third parties may serve to reduce the social cost of agency. The most important prerequisite is that the agent will be able to prevent or impede misconduct by the principal.[132] This is mainly discussed with a view to gatekeeper liabilities, for example, of the statutory auditor. The underlying idea of gatekeeper liability is that the agent can be deterred more easily than the principal. Gatekeeping is a particularly viable strategy when the principal cannot be sufficiently deterred. This rationale applies to directors and officers of widely held corporations.

The regulatory challenge runs along the lines of previous considerations on the costs of enhancing a particular liability strategy. Too high a degree of deterrence forecloses the societal benefits of delegated decision making. Too low a degree will lead to disproportionate welfare losses. This challenge is strongly palpable with a view to balancing compensation interests of investors and creditors with regard to liability for capital market information and, even more so, with regard to insolvency. As we will see in the following sections, in

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129 See *Hansmann/Kraakman*, 100 Yale LJ 1879.

130 This corresponds to question 23 of the questionnaire.

131 *Gaber* (fn 114) 13.

132 *RH Kraakman*, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy (1986) 2 JL Econ & Org 53.

both contexts directors might be liable for failures to prevent harm to external creditors.[133]

2. Financial Disclosure

Financial disclosure is an important mechanism to provide future principals (investors) with information about the agent (the corporation) ex ante and to enable exit ex post affiliation.[134] Disclosure duties are commonly divided into initial information through a prospectus and periodic disclosure of the annual accounts or ad-hoc disclosure of circumstances that will possibly influence the value of the investment.

Directors will be liable for actual malice (dolus). It is less clear whether they should also be liable for negligence. Liabilities for false or misleading financial disclosure concern compensation of pure economic loss. Accordingly they lead to a redistribution of wealth rather than to a restoration of resources. The view prevails that negligence liability for pure economic loss should be precluded.

With a closer look, liability for pure economic loss can be a useful institution to safeguard confidence in capital markets. It might be argued that a loss of confidence does lead to a (certain) loss of resources and goes beyond mere distributional effects.[135] This debate will probably continue especially as negligence liability is accepted in other areas of capital market information, for example under art 35a of the EU Rating Regulation as amended 2013.

3. Insolvency[136]

Insolvency clearly indicates unsuccessful risk-taking decisions but not necessarily misbehavior of managers towards shareholders or creditors. With a view to creditor protection, we have argued that, absent inducements for taking excessive risks, risk preferences of managers will over the course of the company' life not necessarily conflict with those of creditors.[137] Personal liability for wrongful trading that does not amount to a breach of tortious

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[133] See *M Petrin*, The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law (2010) 59 American University Law Review 1661.

[134] *Armour/Enriques/Hansmann/Kraakman* (fn 64) 69.

[135] *W Bishop*, Economic Loss in Tort (1982) 2 Oxford Journal of Legal Studies 1, 28; *idem*, Negligent Misrepresentation Through Economists' Eyes (1980) 96 Law Quarterly Review 360.

[136] This corresponds with questions 24 and 25 of the questionnaire.

[137] Above nos 11 ff and 79 ff.

duties under fraudulent trading accordingly needs a more specific justification.[138]

The compelling reason *for* personal liability lies in the changes of the incentive structure in a last-period situation.[139] In a last-period situation the incentives of the agent to cooperate cannot be created by the promise of rewards in future periods. In consequence there is a considerable danger that the agent will appropriate assets of the corporation and neglect interests of outside creditors. Too late a filing of insolvency or – as it has been termed in the discussion of bankers' failures in the crisis of 2008 – a 'struggling for resurrection' can be seen as the dominant strategy. This is why civil liability and criminal sanctions appear to be indispensable.

V. Procedure

The procedure that applies to court enforcement of liabilities in a corporate context needs to deal with distinct problems: Regarding tortious liabilities (outside liabilities), the low value of claims of dispersed victims will often render enforcement prohibitively costly. Some jurisdictions provide for procedural mechanisms of interest bundling like class actions to cure this problem.

Regarding liabilities towards the corporation (inside liabilities), the board of directors is responsible for bringing suits. Accordingly, enforcement problems mainly concern the liabilities of the directors themselves. In a two-tier model it is the responsibility of the supervisory board to bring suit against members of the managing board. At first sight the two-tier board model alleviates weaknesses of the one-tier board model. In practice, close ties between supervisory (non-executive) directors and managing (executive) directors might make enforcement equally unprobable in both board models. Procedural law can react to this problem in several ways, especially by giving legal standing to shareholders. Derivative shareholder suits are brought in the name of the corporation and lead to a damage payment to the corporation. The danger of adverse distributional effects is accordingly low.

Conversely, if single shareholders or shareholders with a small investment are entitled to individually claim compensation of losses of the corporation, the

138 For an account of US law see *SM Bainbridge*, Much Ado about Little – Directors' Fiduciary Duties in the Vicinity of Insolvency (2006) 1 Journal of Business and Technology Law 335; *DB Bogart*, Liability of Directors of Chapter 11 Debtors in Possession: Don't Look Back – Something May Be Gaining on You (1994) 68 American Bankruptcy Law Journal 155.

139 See *JH Arlen/WJ Carney*, Vicarious Liability for Fraud on the Market: Theory and Evidence (1992) University of Illinois Law Review 691.

danger of distributional effects is high.[140] The distributional effect, however, does not result from the compensation itself as its nominal amount will be pro rata. It rather results from a hold-up problem of other shareholders as group. The continuing threat of unjustified ('frivolous') suits increases the risk-averseness of managers. It hence hampers profits from delegated management and makes diversified investments less attractive.[141] Jurisdictions generally avoid this result by a doctrine firmly rooted in substantive, not procedural law: Directors owe their duties to the corporation, not to the single shareholder.

VI. Insurance

The economic function of insurance is generally seen in risk diversification. The law of large numbers enables insurers to cover risks at lower costs than individual persons or firms. Insurance against D&O liabilities can also serve as a third-party enforcement strategy. D&O insurance today is commonly used with a view to alleviating the problem of risk aversion, especially by large corporations. Accordingly, the impact of D&O insurance should be assessed in context with other mechanisms for reducing risk-aversion, such as liability restrictions, waivers and indemnifications. Where no such mechanisms exist, D&O insurance takes an exclusive role in alleviating risk averseness. The pivotal problem that pertains to all possible mechanisms, including D&O insurance, is that the complete removal of liability threats may lead to excessive risk taking.

1. Third-Party Control

Insurance premiums are set by actuaries on the basis of statistical assessments of possible incident probabilities and amounts of coverage. Ideally this calculation reflects all risks.[142] Premium calculation accordingly works as a device for collecting information about useful degrees of risk-taking and translating this information into prices. A rational client will measure the possible advantages of the chosen risk exposure against the premium payment for an adapted risk exposure ex ante. Based on this mechanism, the individual insurance premium reflects the client's willingness to pay for risk. The standardization of risk assessments and the large number of insurance contracts can hence be seen as a form of self-regulation that influences

[140] *Easterbrook/Fischel* (fn 1) 101.

[141] *Fischel/Bradley* (1986) 71 Cornell L Rev 261, 271; *Hill/McDonnell* (fn 47) 136.

[142] *S Shavell*, On Moral Hazard and Insurance (1979) 93 Quarterly Journal of Economics 541.

corporate risk-management arrangements. Regulation theory terms this a ‘more market-based approach’ to optimal risk taking.[143]

The premium calculation by insurers is a mechanism that shifts parts of the right to control the risk level of the corporation to a third party. Non-approval of certain arrangements by the insurer may de facto preclude a specific behavior. Accordingly, the insurer takes the role of a gatekeeper in a wider sense. The possible merits of gatekeeping have already been touched upon.[144] As gatekeepers, D&O insurers provide an additional layer of risk control, albeit to a rather limited degree.[145] The insurer might not prevent a particular behavior but the premium calculation might make that behavior prohibitively costly. Compared to other gatekeepers, like statutory auditors or rating agencies, D&O insurers appear to be less vulnerable to conflicts of interest and regulatory overreliance.[146]

A viable gatekeeper role of insurers firmly depends on whether they will contribute to setting optimal incentives and reducing moral hazard risks. [147] This will foremost depend on the accuracy of risk assessments. Empirical studies are divided:[148] Some point to evidence for the above-made assumption that internal corporate arrangements of risk control are accurately reflected by insurance premiums.[149] Interviews with practitioners, however, did not sustain the finding that premiums for D&O insurance do deter misconduct.[150] The persuasive power of snapshotting opinions by interviews can, of course, be doubted.[151] Results might also change over time: Risk management techniques evolve, best practice recommendations tighten the range of acceptable conduct

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143 *C Veljanowski*, Economic Approaches to Regulation, in: R Baldwin/M Cave/M Lodge (eds), The Oxford Handbook of Regulation (2010) 31.

144 Above no 92 ff.

145 For groundwork see *Kraakman* (1986) 2 JL Econ & Org 53.

146 *JC Coffee*, Gatekeepers: The Role of the Professions and Corporate Governance, Oxford (2006); *A Darbellay/F Partnoy*, Credit Rating Agencies and Regulatory Reform, in: CA Hill/BH McDonnell (eds), Research Handbook on the Economics of Corporate Law (2012) 273; *PC Leyens*, Intermediary Independence: Auditors, Financial Analysts and Rating-Agencies (2011) 11 Journal of Corporate Law Studies (JCLS) 33.

147 *O Ben-Shahar/K Logue*, Outsourcing Regulation: How Insurance Reduces Moral Hazard (2012) 111 Michigan Law Review 197–248.

148 For a summary of the literature with empirical evidence on the effects of D&O insurance see *Gaber* (fn 114) 129–161.

149 See *T Baker/SJ Griffith*, Predicting Corporate Governance Risk: Evidence from the Directors’ and Officers’ Liability Insurance Market (2007) 74 Chicago Law Review 487.

150 *T Baker/SJ Griffith*, How the Merits Mattered: Directors’ and Officers’ Insurance and Security Settlements (2009) 157 University of Pennsylvania Law Review 755 and see equally *T Baker/S Griffith*, Ensuring Corporate Misconduct (2010).

151 See *Gaber* (fn 114) 202–204.

and, last but not least, an emerging industry of corporate governance advisors scrutinizes the arrangements chosen by the individual corporation.

The viability of gatekeeping by D&O insurers furthermore depends on whether corporate risk exposures are monitored on a continuous basis. A proper test, that is capable of capturing the degree of external monitoring, would most probably have to look at evolutions of the qualitative factors relevant for determining insurance premiums. The highest probability of a continuous adaption of these factors can be found where the interests of insurer and the majority of the insured parties overlap. Examples can be found in specialized industries like banking. The voluntary arrangements of deposit insurance by the German banking industry, which top statutory insurance coverage, build on continuous scrutiny by a private association that determines the viability of arrangements chosen by its members against evolving standards and against risk exposure of other members.[152] A continuous alignment of premiums to risk levels might well seem more expectable within a homogenous industry than with regard to diverse corporate actors.

2. D&O Self-Retainers

Full relief from liabilities under D&O insurance hampers the effect of liability as a constraints strategy. A possible cure relates to mandating a self-retainer for the individual who caused the breach. Experience with best practice recommendations indicates that self-retainers will not be agreed to voluntarily. In reaction to a low compliance rate with the non-binding code of best practice, for example, the German legislator introduced a mandatory self-retainer into sec 93 of the Stock Corporation Act.

In theory, self-retainers can be employed to align the effect of a legal rule that provides for unlimited individual liability with the marginal deterrence effect it will have. Liability threats (far) beyond individual wealth will not unfold calibrated deterrence effects. Instead they will attract daredevil mangers or induce short-termed decision making (fly by night risks).

Mandatory self-retainers seem to be less effective in practice than they are in theory. Directors may choose to insure the self-retainer. If the premium payment is included in their remuneration, the threat value of the self-retainer nominally amounts to zero. The more relevant effect of D&O liabilities accordingly lies in in the unpleasant procedure of court proceedings and reputational damage.

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[152] *J Bigus/PC Leyens*, Einlagensicherung und Anlegerentschädigung (2008) 11; *C Hissnauer*, Die Reform der Einlagensicherung und Anlegerentschädigung in Deutschland (2013) 96 ff.

3. Corporate Indemnification

Corporations often seek to attain indemnification to cover their possible obligations from vicarious liabilities in incidents of D&O liabilities. In theory paying premiums for insurance against D&O liabilities could be explained as a means that makes use of the insurer as a cheap device for diversification of risks that derive from delegated management. Doubts can be raised about this explanation where insurance premiums paid over time will presumably exceed future indemnification payments.

It seems that the real reason for corporate indemnity lies in a control rights allocation, which ultimately allows agents to decide about generous insurance covers by the corporation.[153] In the case of insolvency the corporation loses the capability to keep any explicit or implicit indemnification promises towards agents. The decision about the size of corporate insurance coverage is normally laid in the hands of agents and will, accordingly, foremost mirror the interests of directors and officers.[154]

There are, however, also other reasons for involving an insurer in the settlement of D&O liabilities that are in the corporate interest.[155] One advantage is that the insurer may be better prepared to conduct negotiations between the corporation and the plaintiff. This, in essence, means that the insurer will serve as a mediator to overcome conflicts of interest between the corporation and directors or officers.[156] It has also been argued that signalling D&O insurance or corporate indemnification covers will serve to enhance trust into incumbent management.

Whether signalling insurance coverage plays a role in practice, so far, remains unclear. A necessary prerequisite, of course, would be that investors translate differences in insurance coverage into prices.[157] Single diversified investors will lack the ability or incentive to do so. Including the role of information intermediaries and their evolving ability to provide accurate assessments on corporate governance arrangements inside and outside the corporation might well become a determining factor for further assessments.

VII. Conclusions

153 *Gaber* (fn 114) 76.

154 Ibid.

155 For a summary of the argument see *Gaber* (fn 114) 82–84.

156 See equally *V Finch*, Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance (1994) 57 The Modern Law Review 880.

157 *Gaber* (fn 114) 84.

D&O liabilities affect the incentives of all parties involved, the behavior of directors and officers as well as that of shareholders and creditors. The identification of trade-offs from a law & economics perspective can help to guide a comparative analysis of solutions found in different jurisdictions. The general trade-off relates to the need for D&O liability in order to prevent stealing and shirking on the one hand, and on the other hand the risk of over-deterrence that will lead to chilling effects and hamper welfare maximization through diversification of investment and delegated management. Striking that balance is the crucial challenge for D&O liabilities.

D&O liabilities, from the viewpoint of law and economics, feature a constraints strategy that can be used to align diverging interests between managers and shareholders and between the corporation and creditors. Experience shows that constraints are an important, albeit not the only, strategy to align the interests between principals and agents. Providing for an efficiency enhancing system of mechanisms is a challenge for rule-makers and private parties. Over-reliance on single strategies will possibly not pay out for society. This can also be true for paired strategies like constraints and rewards (liabilities and remuneration), decision rights and trusteeship (approval by shareholders and independence of directors) or the market for corporate control and the role of gatekeepers (takeovers and information intermediaries like auditors and rating agencies).

Corporate liability is unlimited but the ultimately profiting owners cannot be held liable beyond fulfilling their duties to contribute to the corporate assets. This form of limited shareholder liability is a prerequisite for separating different lines of business, something which is indispensable, last but not least, for implementing a more capital market based pension system. There is no strong backing for adverse effects on claims of voluntary creditors, provided that risk premiums can be contracted by creditors in advance.

D&O liabilities towards the corporation (inside liabilities) are based on breaches of the duty of loyalty or the duty of care. Breaches of loyalty duties should lead to liability. Conversely, too narrow an approach to the duty of care would be detrimental to risk-taking and innovation. The widely accepted Business Judgment Rule for failures regarding the duty of care serves as an abstention doctrine that protects directors and (subject to labour law) officers from judicial second-guessing in hindsight and from risks of factual or legal court error. Remaining challenges concern drawing the line between loyalty and care with regard to monitoring tasks, especially the obligation to sustain an adequate level of information.

D&O liabilities towards third parties, ie towards tort victims or creditors outside the corporation, can serve to alleviate adverse effects deriving from too narrow a judicial approach to shareholder liabilities in accepted cases of corporate veil piercing. Tortious liability towards future shareholders for corporate misrepresentation and towards creditors in insolvency are a question of balancing out (justified) liabilities in case of a misuse of the corporate shell by shareholders or where managers are strategically induced by shareholders to take excessive risks.

Litigation procedures differ amongst countries. Regarding outside liabilities, the major challenge concerns techniques of enforcement for low value losses of dispersed victims. Regarding inside liability, enforcement by the corporation itself or by shareholders in the name of the corporation avoids distributional effects. Frivolous liability suits are precluded by a rule, according to which directors owe their duty to the corporation rather than to individual shareholders.

D&O insurance, or routinely provided waivers, indemnifications and other ex ante restrictions of the constraints strategy, limit the control powers of shareholders. Insurance companies may, however, serve as a cheap third-party control device.

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