

Directors' and Officers' Liability

# A Law and Economics Perspective

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DIRECTORS AND OFFICERS LIABILITY

## 1. Introduction

- D&O liability heavily debated because of trade-off:
  - Potential to solve the P-A problem
  - May lead to undesirable risk aversion
- L&E contributes to the debate
- Benefits of Law and Economics
  - Helps to understand incentives
  - Helps to ask the right question
  - Also in a comparison
  - Identity trade-offs



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## 1. Introduction

- But lit and law-making strongly US influenced
- Nothing wrong:
  - Business judgment rule
  - disclosure



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## 2. Contractual D&O Liability: Creditor Protection

- Starting point: limited shareholder liability
  - Coase: the nature of the firm
  - Creates positive externalities
  - Possibility of diversification (portfolio theory)
- Creditor protection
  - Informed contracting (Coase 1960) for voluntary creditors
  - But potential contract failures
  - Involuntary creditors?



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## 2. Contractual D&O Liability: Creditor Protection

- Contracting liabilities
  - Limited liability only problem with uninformed creditors or fraud/misrepresentation
  - Extending D&O liabilities (by contract) problematic



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## 3. Owner Protection

- Owner protection doubtful (if for escaping liability) but:
  - Managers of other people's money
  - Misuse of limited liability could lead to veil piercing
- Inside liability
- Potential moral hazard as a result of dispersed ownership
- Various monitoring devices available (eg non-executive directors/supervisory directors)
- Market for corporate control



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#### 4. Liability for Damage to the Corporation and Shareholders

##### 4.1 Fiduciary duty (no stealing)

- No-conflicts rule: liability suit probable
- Conflict approval: by the principal
  - Law should provide constraints
  - Eg delegation to independent (supervisory) director



#### 4. Liability for Damage to the Corporation and Shareholders

##### 4.2 Duty of care (no shirking)

- Business judgment rule:
  - Reaction to rational risk-aversion
  - Informed decision-making
  - Monitoring duties



#### 5. Waivers and Indemnities

- Leading to under-deterrence? Not necessarily
- *Ex ante* waiver: US yes, EU no
- Real effects often limited and overestimated
- Mandatory liability undesirable
- Balanced approach
- Therefore waivers (*ex post*) accepted in most jurisdictions



#### 6. Liability for Damage to Third Parties

##### 6.1 Third party liability

- Breach of duty towards creditor
- Useful if agent easier to deter than principal
- But potentially averse effects

##### 6.2 Financial disclosure

- Directors' liability for misrepresentation in prospectus
- To cure information asymmetry



#### 6. Liability for Damage to Third Parties

##### 6.3 Insolvency

- Not necessarily proof of misbehaviour
- But problem of incentives in a last-period situation
- There contracting fails



#### 7. Concluding

- D&O liability represents many challenges
- Overstressing of liabilities dangerous
- Balanced approach needed
- Breaches of fiduciary duty likely to lead to successful liability suits
- Breaches of duty of care less (understandable)
- But many challenges remain eg:
  - Drawing line between loyalty and care
  - Balancing liabilities towards third parties
  - And many more...

