

Directors' and Officers' Liability

German Report

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DIRECTORS' AND OFFICERS' LIABILITY

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DIRECTORS' AND OFFICERS' LIABILITY

The Status Quo I

- The liability rule: directors' liability codified in sec 93(2) AktG:
 - Directors are liable to the company if they (1) fail to comply with their duties and (2) the company suffers damage as a result of the relevant actions.
 - Liability for simple negligence.
 - Burden of proof is upon managers.
 - Nature of this liability (contractual/non-contractual) is subject of academic debate, but without practical relevance.
 - Liability in the case of director's dissent only excluded if director actively seeks to prevent violation of duty by the management board.



DIRECTORS' AND OFFICERS' LIABILITY

The Status Quo II

- Standard of care defined in sec 93(1) AktG:
 - Directors must act with the due care and diligence of a careful and conscientious manager.
 - Measured by objective criteria.
 - Business Judgement Rule (BJR), intended to provide a safe harbour for managerial decision making. Developed by the courts, now codified in sec 93(1)(cl 2) AktG. However, strict standards regarding the gathering of information and compliance with legal requirements.



DIRECTORS' AND OFFICERS' LIABILITY

The Status Quo III

- No general obligation to set up an internal compliance system:
 - Board must ensure legal compliance, but sec 76(1) AktG grants wide discretion concerning internal organisation.
 - However, sec 91(2) AktG mandates establishment of an early-warning monitoring system to identify dangerous developments.



DIRECTORS' AND OFFICERS' LIABILITY

The Status Quo IV

- No contractual exclusion or limitation of liability:
 - Liability under sec 93(2) AktG is mandatory and cannot be modified, limited or excluded by contract.
 - Contractual limitation agreements are null and void under German law.
- Waiver of claims against directors:
 - Pursuant to sec 93(4) AktG, only shareholders' meeting can waive claims against directors, and can only do so under very strict conditions.



DIRECTORS' AND OFFICERS' LIABILITY

The Status Quo V

- Unlimited damages
- Comprehensive Insurance:
 - D&O liability insurance contracted and paid for by the corporation.
 - As of 2009, mandatory deductible of at least 10% of damages or 1.5 x annual salary.



The Status Quo VI

- Principle of concentration of liability:
 - Directors generally are liable only to the company, not to shareholders or third parties.
- Multi-layered enforcement:
 - Duty and authority of the supervisory board to bring claims against negligent directors and officers.
 - Shareholder assembly may require supervisory board to take action.
 - Individual shareholders may sue on a derivative basis.



Deficits of the Status Quo

- Deficient enforcement:
 - Supervisory board is a failure:
 - Personal ties to executive officers.
 - Risk of self-incrimination.
 - Shareholder assembly remains a force in being due to incentive problems of collective action.
 - Individual shareholders have weak incentives to take on the risk of derivative litigation.



Deficits of the Status Quo II

- Comprehensive insurance:
 - Seamless and comprehensive coverage destroys incentives to take care generated by the liability system.
 - Group insurance for all members of the executive and supervisory boards frustrates attempts to accurately price individual risks and to deploy tools of experience rating.
 - Mandatory deductible to be borne by Ds and Os personally is a step in the right direction. However, the remaining possibility to self-insure the deductible is a major shortcoming.



Deficits of the Status Quo III

- Unlimited liability in 'big cases':
 - D&O insurance is capped at approx EUR 0.5 billion (or a little more).
 - D&O insurance does not cover intentional wrongdoing; however, intention is a broad and vague concept. If one board member did not act intentionally, rather: intention cannot be established, the D&O insurer is liable.
 - In exceptional cases damages are way above the insurance ceiling.
 - Where D&O insurance fails, Ds and Os remain personally liable, generating the well-known negative effects for their decision-making.



Functions of D&O Liability

- Compensation: no valid function of D&O liability:
 - Corporations pay for any gains from successful damages suits ex post in the form of increased salaries ex ante.
 - Rational shareholders have no interest in compensation as they diversify away the risk of losses.
 - Corporate practice reflects these interests as premiums on D&O insurance policies are paid for by corporations directly.
- Deterrence: the sole function of D&O liability:
 - Threat of liability generates incentives to take care and to abstain from disloyal or reckless behaviour.



Functions of D&O Liability II

- Limits of deterrence in corporate law:
 - Managers do not internalise the full gains from the upside risk of their decisions.
 - Under a negligence regime that is implemented imperfectly, managers bear part of the downside risk associated with their decisions.
 - As a result, managers will behave in a risk-averse manner, ie will favour decisions that do not carry the risk of large losses.
 - For correcting the asymmetry, full sharing in gains is not a valid option.
 - Proposal: restrictions on the full sharing in losses.



Redesigning the Current System I

- Strengthening enforcement – reforming the derivative action:
 - Abolishing the distinction between a preliminary and a merits stage.
 - Allowing shareholders to share in the gains of successful derivative suits.
 - Size of the share should reflect the cost risk associated with unsuccessful suits that the reward is designed to offset.



Redesign II

- Restricting D&O liability insurance:
 - Group insurance as the 'source of all evil'.
 - Mandatory deductible is adequate response, but option to self-insure must be abolished.
 - The size of the deductible must be redesigned so as to adequately offset potential gains from risky decisions:
 - Contingent part of executive compensation should be the primary measure for the deductible.
 - In order to prevent strategic shifts to fixed salaries, a share of the fixed salary needs to be put on the line as well.



Redesign III

- Limiting quantum:
 - Objective: preserving the incentive scheme that is most favourable to the interests of shareholders.
 - Mechanisms:
 - Limiting D&O liability to the deductible, the latter being adequately designed.
 - Restricting the damages claim of the corporation to the amount of the (D&O 'liability') insurance policy it bought and paid for.



Conclusion

Replacing a paper tiger with a system that relies on sanctions that are (much) less strict but more effective in practice.

