Officers’ and Directors’ Liability
Under German Law — A
Potemkin Village

Gerhard Wagner*

The liability regime for officers and directors of German companies combines strict and lenient elements. Officers and directors are liable for simple negligence, they bear the burden of proof for establishing diligent conduct, and they are liable for unlimited damages. These elements are worrisome for the reason that managers are confronted with the full downside risk of the enterprise even though they do not internalize the benefits of the corporate venture. This overly strict regime is balanced by other features of the regime, namely comprehensive insurance and systematic under-enforcement. Even though the authority to enforce claims against the management is divided between three different actors — the supervisory board, the shareholders assembly, and individual shareholders — enforcement has remained the exception. Furthermore, under the current system of Directors’ and Officers’ (D&O) liability insurance, board members do not feel the bite of liability as they are protected by an insurance cover that is contracted and paid for by the corporation. Thus, the current German system may combine the worst of two worlds, i.e., the threat of personal liability for excessively high amounts of damages in exceptional cases, and the practical irrelevance of the liability regime in run-of-the-mill cases. The present Article analyzes the shortcomings of the present regime and submits proposals for reform.

---

* Professor of Law, Humboldt-University at Berlin, Germany, and Professor of Fundamentals of Private Law at Erasmus School of Law, Erasmus University, Rotterdam, The Netherlands. Visiting Professor of Law, University of Chicago Law School. Thanks to Itai Fiegenbaum and to the editors of the present journal for valuable comments.
The 2008 financial crisis was caused by the slump of the American housing market and the resultant devaluation of securities based on real estate loans, i.e., mortgage-backed securities (MBS) and other financial products using real estate loans as the ultimate equity value involved. It triggered the downfall of major parts of the U.S. investment banking industry. Two large players, Bear Stearns and Merrill Lynch, were taken over by large commercial banks at fire-sale prices, while Lehman Brothers went bankrupt.\(^1\) But the crisis had repercussions around the globe. Not surprisingly, it hit European banks that were active in the New York financial market, notably UBS of Switzerland and Deutsche Bank of Germany. The European institutions that suffered most, however, were not UBS and Deutsche Bank but smaller banks, particularly in Germany, that incurred huge losses due to investments in MBS and related products.

Most, but not all, of these institutions were banks owned by governmental entities, i.e., by the German states, the so-called *Landesbanken*. Formerly established for the purpose of supplying credit to local industry, they had lost most of their privileges in the course of the E.U.-led liberalization of the European banking market. These banks were fat with excess cash they had borrowed at low rates the hour before losing their public-sector privileges and were looking for opportunities to invest these monies.\(^2\) Investments in MBS and related securities promised high returns and carried a seemingly low risk. The *Landesbanken* invested billions in securities of this type, ordinarily through special purpose vehicles set up in the Republic of Ireland, which issued short-term commercial paper for which the *Landesbanken* provided a guaranty. When the housing market collapsed, the MBS-holdings of the special purpose vehicles lost most of their value and became unsalable while sources for refinancing them through commercial paper dried up. The *Landesbanken* became liable to the special purpose vehicles under their guarantees and thus were driven towards the brink of bankruptcy. Before their collapse, they were

---


rescued by the competent state or the federal government that pumped money into these institutions.³

The public answered the plans to rescue the Landesbanken at the taxpayers’ expense with an outcry. The government responded by promising measures to limit the remuneration of managers and tightening liability. In a speech before the German parliament in October 2008, Chancellor Merkel raised not only the issue of corporate compensation schemes and packages but also the issue of liability.⁴ In her view, the liability regime that was in place at the time was deficient, not because the liability rules were too lax, but because they were rarely enforced in practice. She promised that her government would change matters and improve the practical impact of officers’ and directors’ liability.

Starting in 2008, some measures were taken to limit the remuneration of managers. A provision in the German stock company act (Aktiengesetz — AktG) was changed so as to ban myopic compensation plans that were predicated on short-term gains in favor of compensation packages that were geared towards more sustainable goals.⁵ Board members of banks that had accepted government assistance during the crisis had to accept a cap on their salaries and remunerations. Managers of these corporations are not allowed to take home more than €500,000 per year.⁶

Whether these measures helped to solve a problem or rather created one is a matter of debate. Sure enough, the public furor has not subsided since 2008 but rather increased.⁷ There is a widespread sentiment that corporate managers, particularly those in the financial sector, are incompetent and overpaid, whereas individual firm owners are thought to act responsibly and

---

³ For an overview on the impacts of the financial crisis on German banks, see Die deutschen Opfer der Finanzkrise [German Victims of the Financial Crisis], handelsblATT (Sept. 10, 2013), http://www.handelsblatt.com/unternehmen/banken/bankhilfen-die-deutschen-opfer-der-finanzkrise/8682752.html (Ger.).

⁴ Declaration by Chancellor Dr. Angela Merkel, Deutscher Bundestag: Drucksachen und Protokolle [BT] 16/181, Oct. 7, 2008 (Ger.).


⁷ For an example of further demands for regulative measures, see Die großen Banken werden noch größer [Large Banks Are Getting Larger Still], ZEIT ONLINE (June 30, 2014), http://www.zeit.de/wirtschaft/2014-06/infografik-banken-markt (Ger.).
deserve their fair share. As a consequence, the incoming government has announced that it intends to tighten the rules on managerial compensation once again.\(^8\)

While there have been some activities on the remuneration front, the waters of officers’ and directors’ liability have remained still. It is only recently that commentators have begun to discuss possible changes to the current regime. This Article aims at contributing to the upcoming debate and to explore possible pathways for reform.\(^9\) Part I pictures the current state of the law on directors’ liability. It focuses on the relationship between corporation and director only, ignoring potential personal liability of corporate managers \textit{vis-à-vis} third parties, i.e., other persons than the corporate entity that they were hired to lead.\(^10\) The analysis is not limited to the liability rule on the books, but rather aims for the “law in action.” Issues of insurance and enforcement have a strong influence on the practical impact of liability regimes and are thus thoroughly discussed. Part II provides a brief sketch of the shortcomings of the current regime and the explanations for these shortcomings. Before jumping into the discussion of reform proposals, Part III lays the necessary groundwork by exploring the true functions of officers’ and directors’ liability. The central

---

\(^8\) Coalition Agreement between the Governing Parties, 18th Legislature ¶ 1.1 (2013) (Ger.).

\(^9\) The discourse on pathways towards a reform of the current system gained steam when the German society for law reform put the topic on its agenda. See Gregor Bachmann, Reform der Organhaftung? Materielles Haftungsrecht und seine Durchsetzung in privaten und öffentlichen Unternehmen, Gutachten zum 70. Deutschen Juristentag [Reform of D&O Liability? Substantive Law and Enforcement in Private and Public Enterprises, Report presented to the 70th Meeting of the German Law Reform Association] (Sept. 16-19, 2014) (Ger.).

\(^10\) An analysis of third-party liability would require a full-range review of the law of torts, together with the overarching issue of personal liability of actors behaving under corporate seal, i.e., within a corporate entity. Such an investigation is beyond the scope of this Article. However, it bears emphasis that liability \textit{vis-à-vis} third parties is closely linked to issues of liability of directors \textit{vis-à-vis} “their” corporation, as the misbehavior of a director may give rise to claims of the corporation and claims of the injured third party at the same time. To the extent that the corporation compensates the victim, it may try to recover the amounts paid out as damages from the culpable director. In this way, third-party liability may be transformed into a bilateral claim between the corporate entity and its manager. The present Article focuses on the bilateral relationship between officer or director and the corporation and abstracts from the various grounds of third-party liability that in turn may lead to a damages claim against the corporate entity and, down the road, to a recovery claim by the corporate entity against its director or officer.
question here is whether officers’ and directors’ liability serves the familiar double goals of compensation and deterrence, or whether it is different in that it is focused on deterrence only. After this issue has been settled, Part IV draws conclusions from the normative premises with regard to the design of D&O liability and insurance. One critical issue is the deficient enforcement regime that calls for the exploration of ways to improve incentives to bring meritorious claims. Another concern is insurance, which in its current form remains unsatisfactory. The Article discusses options for bringing Directors’ and Officers’ liability insurance (D&O insurance) in line with the social welfare goal. I also argue that limits on the amount of damages owed in cases in which directors are held liable are warranted and desirable, and explore different ways to assess the cap on damages to be applied across the range of cases in a way that helps to improve the quality of managerial decisions.

I. THE STATUS QUO AND ITS SHORTCOMINGS

This Part explains the main elements of the current system without evaluation or judgment in order to familiarize the reader with the main features of the German system. In doing so, it focuses on the essential elements that define the practical impact that liability systems may have on the actual behavior of subjects. These elements are the liability regime, i.e., rules that define the requirements for liability and amount of compensation, the allocation of the right to bring claims, and the degree to which liability risks are shifted to third parties, namely insurance carriers under so-called D&O insurance policies.11

A. The Liability Regime

Corporate managers are operating under a regime of fault-based liability. Officers and directors are liable for the harm suffered by the corporation for violations of the duty of care.12 Pursuant to this provision, officers and directors are bound to act diligently, i.e., with the care to be expected from a prudent and conscientious businessperson. The strict measure of simple negligence

11 For an English overview of the current system, see Verena Klappstein, Directors’ Duties and Liability in Germany, in ANNEX TO STUDY ON DIRECTORS’ DUTIES AND LIABILITY 323 (Carsten Gerner-Beuerle, Philipp Paech & Edmund Philipp Schuster eds., 2013), available at http://ec.europa.eu/internal_market/company/docs/board/2013-study-reports_en.pdf.
12Aktiengesetz [AktG] [Stock Company Act], Sept. 6, 1965, BGBI. I at 1089, last amendment in BGBI I at 2586, July 23, 2013, §§ 93(1)-(2) (Ger.). For an exposition in English, see Klappstein, supra note 11, at 335.
has been relaxed somewhat by the German version of the American business judgment rule. It provides that the due care standard is satisfied if the director, in making a business decision, reasonably believed he or she was acting on the basis of adequate information and in the best interest of the company. As in the United States, the business judgment rule is meant to offer a safe harbor for managers and to protect the court against falling prey to the effect of hindsight bias.

The German version of the business judgment rule is an almost verbatim translation of the language used by the American Law Institute in its Corporate Governance Principles. The interpretation of the German variant more or less follows the same paths as its American counterpart, with only one exception. Under German law, the officer or director bears the burden of proof, i.e., has

13 AktG § 93(1) cl. 2.
16 Am. Law Inst., Corporate Governance Principles § 4.01(c):
A director or officer who makes a business judgment in good faith fulfills his duty, if the director or officer is not interested in the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and rationally believes that the business judgment is in the best interest of the corporation.

For the gestation of this formulation, see William J. Carney, Section 4.01 of the American Law Institute’s Corporate Governance Project: Restatement or Misstatement, 66 Wash. U. L. Rev. 239 (1998).
to exonerate him- or herself by establishing that the decision complained of was in fact made within the purview of the business judgment rule.\textsuperscript{18} As far as substance is concerned, it is common to distinguish between violations of the duty of loyalty on one hand, and the duty to take care on the other.\textsuperscript{19} The domain of the business judgment rule is the duty of care, while disloyal behavior of the corporate agent can never be justified under it.

As to the duty of care, the few court rulings that have been published up to the present day are evidence of a rather strict approach to the liability of corporate managers. In one decision, the German Supreme Court (\textit{Bundesgerichtshof} — BGH) went so far as to require the director to explore \textit{all} available sources of information, even though the language of the statute clearly only calls for \textit{adequate} information.\textsuperscript{20} Furthermore, it is settled law that the business judgment rule does not apply to contraventions of the law or of the company charter.\textsuperscript{21} In other words, illegal acts can never be justified by the business judgment rule, i.e., upon a showing that the director reasonably believed he or she was acting within the confines of the law.\textsuperscript{22}

This sounds innocent, and it may be so in cases in which it is more or less obvious what the law requires. The reality is, however, that legal provisions restricting or regulating corporate behavior are numerous and growing in number and — more importantly — that criminal law punishes offences

\textsuperscript{18} AktG, 93(2) cl. 2; Klappstein, \textit{supra} note 11 at 339.

\textsuperscript{19} Klappstein, \textit{supra} note 11, at 335, 339.


\textsuperscript{21} It was the expressed intent of the lawmakers to provide no “safe haven for illegal activity.” \textit{DEUTSCHER BUNDESTAG [Bill to the UMAG (Act on Corporate Integrity)]}, [BT] 15/5092 (Ger.).

\textsuperscript{22} OLG Düsseldorf, ZIP [\textit{ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT}] [\textit{REV. BUS. L.}] 28, 31 (2010) (Ger.).
which are defined only broadly and vaguely.\textsuperscript{23} As a result, corporate managers cannot avoid making decisions and approving behavior that may arguably come within the perimeter of a crime in the form of a general clause. In such situations, the requirements for compliance with the law become known only \textit{ex post}. In order to lessen the burden imposed by the principle that managers must always comply with the law, commentators argue that a margin of appreciation needs to be granted in cases where it is not clear \textit{ex ante} what the law requires.\textsuperscript{24} Whether and to what extent the courts will follow remains to be seen.

B. Damages and Quantum

If a violation of the duty of care can be found, the director is personally liable to the corporation for the full cost of the harm caused.\textsuperscript{25} Her exposure to damages is thus unlimited. German labor law shields employees who cause harm to their employers from damages claims, provided that they did not act intentionally or with gross negligence. However, these privileges do not apply to executives and board members.\textsuperscript{26} Board members are liable to compensate the corporation in full, even if the loss was caused through

\textsuperscript{23} The most critical crime in this regard is breach of trust under Strafgesetzbuch [StGB] [Criminal Code], Nov.13, 1998, BGBl. I at 3322, last amendment in BGBl. I at 410, Apr. 23, 2014, § 266 (Ger.). The application of this rule to transactions in asset-backed securities (ABS) is discussed by Peter Kasiske, \textit{Aufarbeitung der Finanzkrisen durch das Strafrecht? Zur Untreuestrafbarkeit durch Portfolio Investments in Collateralized Debt Obligations} [Reappraisal of the Financial Crisis by Criminal Law? On Criminal Liability for Breach of Trust by Portfolio Investments in Collateralized Debt Obligations] 13 (2010) (Ger.).


\textsuperscript{25} AktG § 93(2).

\textsuperscript{26} Jacob Joussen, \textit{Der Sorgfaltsmaßstab des § 43 Abs. 1 GmbHG} [The Standard of Due Care of Sec. 43 ¶ 1 GmbHG], 8 GmbHR [GMBH-RUNDSCHAU] [GMBH-REV.] 441 (2005) (Ger.); Jacob Joussen, \textit{Der persönliche Anwendungsbereich der Arbeitnehmerhaftung} [The Personal Scope of Employees’ Liability], 3 Rda [Recht der Arbeit] [Law Work] 129, 134 (2006) (Ger.).
simple negligence, and even if the magnitude of the loss is of an order that far exceeds the personal assets of the liable board member. The sharp difference between the two systems for employees and managers is being justified with a view to the fact that managers, other than employees, are not subject to the orders or directions of a superior, but rather devise and implement such directions for others, and that they are being compensated for the associated risk of liability through generous compensation packages and comprehensive insurance schemes. Only recently has the principle of unlimited liability come under attack from commentators who argue in favor of extending the labor law principle to corporate managers and thus limiting the amount of damages in cases in which the harm was caused by simple negligence.

C. Multilayered Enforcement

One might think that a system that combines liability for simple negligence with unlimited damages is untenable because it exposes managers to a liability that they cannot safely avoid and of a magnitude that they cannot digest, as it is apt to consume their total wealth. Under such a regime, it may be surmised, managers behave risk-aversely to the extreme, as the desire to avoid personal liability looms large in their minds when they make a decision for the company that promises large gains but might also result in substantial losses. However, the system does work, or at least survive, in practice. While the measure to which German managers act risk-aversely remains unknown, it is fair to say that the threat of unlimited personal liability is simply removed for the majority of cases. The reason for this surprising result is that claims for compensation are never enforced.

In Germany’s two-tier structure, the authority to enforce claims against members of the executive board lies with the supervisory board. In Germany’s two-tier structure, the authority to enforce claims against members of the executive board lies with the supervisory board. In Germany’s two-tier structure, the authority to enforce claims against members of the executive board lies with the supervisory board. In Germany’s two-tier structure, the authority to enforce claims against members of the executive board lies with the supervisory board.

27 Holger Fleischer, Ruinöse Managerhaftung: Reaktionsmöglichkeiten de lege lata und de lege ferenda [Ruinous Officers’ and Directors’ Liability: Responses de lege lata and de lege ferenda], 28 ZIP [ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT] [REV. BUS. L.] 1305 (2014) (Ger.).


29 AktG § 112. For an exposition in English, see Klappstein, supra note 11, at 349.
or former members of the management board and demand compensation for losses incurred by the corporation. In response to the low frequency of enforcement by the supervisory boards, judges and lawmakers have intervened several times. In a landmark case, the Federal Supreme Court refused to let the members of the supervisory board access the safe harbor of the business judgment rule. The court held that the decision whether to bring a damages claim against members of the executive board is no “business judgment” and that, in principle, the supervisory board did not enjoy discretion in making this decision but simply had to act in the best interest of the company.

Parliament made several efforts at reforming the enforcement regime for claims against executives by directly or indirectly adding new parties to the class of potential claimants. To begin with, the shareholders have the right to force the supervisory board to go against the management through majority vote. If the shareholders believe that the supervisory board may not be diligent enough in the prosecution of such claims, they may appoint a special representative and place responsibility for the affair in his or her hands.

Another potential claimant was added in 2005, when some version of the American derivative suit was introduced into German law. Since then, a minority of shareholders which controls at least one percent or €100,000 of the nominal capital has standing to initiate legal proceedings against executives in the name and to the benefit of the company. If the claim succeeds, the damages have to be paid not to the claimants but into the corporate purse. While these

---

30 See Peter Ulmer, Die Aktionärsklage als Instrument zur Kontrolle des Vorstands- und Aufsichtsratshandels [The Shareholder Suit as an Instrument to Control Actions of the Management Board and the Supervisory Board], 163 ZHR [ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT] [J. ENTIRE COM. & BUS. L.] 318 (1999) (Ger.); Mathias Habersack, Perspektiven der aktienrechtlichen,Organhaftung [Perspectives on the Liability of Board Members in Joint-Stock Companies], 177 ZHR [ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT] [J. ENTIRE COM. & BUS. L.] 782, 785 (2013) (Ger.). For a more sanguine account, see Bachmann, supra note 9, at 73.

31 BGHZ [German Supreme Court Reports, Civil Cases] 135, 244, 254 (Ger.); see also Klappstein, supra note 11, at 349.

32 AktG § 147; Klappstein, supra note 11, at 349.

33 AktG § 148(1); Klappstein, supra note 11, at 349.

34 AktG § 148(4); see also Gerold Bezzenberger & Tilman Bezzenberger, in GROSSKOMMENTAR ZUM AKTIENGESETZ [COMMENTARY ON THE AktG], supra note 17, § 148 ¶ 224; Sebastian Mock, in GROSSKOMMENTAR ZUM AKTIENGESETZ [COMMENTARY ON THE AktG], supra note 17, at 127 § 148 ¶ 3; Schröer, in MÜNCHENER KOMMENTAR ZUM AktG, supra note 17, § 148 ¶ 70; Hans Christoph Grigoleit & Sebastian Herrler, in GRIGOLEIT AktG, supra note 24, § 148 ¶ 16.
features parallel the American derivative suit, the details of its German sister are quite different.\textsuperscript{35} In part, these differences reflect fundamentally divergent attitudes towards civil procedure in general and the funding of litigation in particular,\textsuperscript{36} and in part they are due to deep-rooted concerns about abusive litigation. The German law of civil procedure follows the loser-pays rule that poses particular problems for claimants who are suing in the public or corporate interest.\textsuperscript{37} Given that any gains from successful derivative suits are siphoned off in favor of the corporation, the costs of unsuccessful suits remain with the shareholder or group of shareholders who brought them. Given that the probability of prevailing is always less than one and can never be evaluated \textit{ex ante} with certainty, engaging in derivative suits is inevitably a losing endeavor from the outset. Across multiple cases, the shareholder cannot win anything and will certainly lose substantial sums of money upon unfavorable cost awards.

There are many solutions to the cost issue that would help to supply a more balanced set of incentives for shareholders willing to sue in the collective interest. The framers of the Stock Company Act adopted a model that divides the proceedings into two stages, a preliminary stage and a main stage. The preliminary stage is meant to identify and weed out weak claims with a low probability of success and to deter abusive litigation. If the court finds that the respective requirements are not met, the claim is dismissed, and a cost award against the unsuccessful claimant is issued.\textsuperscript{38} If, however, the court certifies the claim at the preliminary stage, then the costs of the main proceedings will be borne by the corporation even if the derivative suit turns out to be without merit.\textsuperscript{39} While there is much more to say on the details of cost allocation, the basic structure has become clear: the claimants bear the cost risk up to

\begin{thebibliography}{9}
\bibitem{35} American corporate law is state law so that each state operates its own statutory framework. For a representative example, see \textsc{Am. Bar Ass’n, Model Business Corporation Act} §§ 7.40-7.47 (2002), available at https://users.wfu.edu/palmitar/ICBCorporations-Companion/Conexus/ModelBusinessCorporationAct.pdf. For an exposition, see \textsc{Allen, Kraakman & Subramanian, supra} note 14, at 363. For a comparison of the two variants of the derivative suit, see \textsc{von Hein, supra} note 17, at 821-30.
\bibitem{36} For a comparative treatment prior to the introduction of derivative suits in Germany, see Ángel R. Oquendo, \textit{Breaking on Through the Other Side: Understanding Continental European Corporate Governance}, 22 U. Pa. J. Int’l Econ. L. 975, 1013 (2001).
\bibitem{37} See \textsc{Zivilprozessordnung (ZPO)} [Code of Civil Procedure], Dec. 5, 2005, BGBl. I at 3202, last amended in BGBl. I at 890, July 8, 2014, §§ 91 et seq. (Ger.).
\bibitem{38} AktG §§ 148(2), (6) cl. 1.
\bibitem{39} AktG § 148(6) cl. 5.
\end{thebibliography}
certification, while the cost risk with regard to the main proceedings is on the corporation, regardless of the outcome of the litigation. This system is meant to stimulate meritorious derivative suits and at the same time to avoid abusive litigation.

D. Comprehensive Insurance Coverage

Another weak spot of the liability regime set up by the Stock Company Act is that most of the risk associated with directors’ personal liability is shifted to insurance companies through D&O liability insurance contracts. Liability insurance is nothing out of the ordinary, so that the dominance of D&O liability insurance as such is hardly surprising. What makes D&O insurance special when compared to other lines of liability insurance is that it is not bought by the parties threatened with liability — directors and officers — but by the company itself. The company buys insurance coverage for its managers as a group, not on an individual basis. As a consequence, premiums do not reflect the individual risk represented by one particular board member or executive. Rather, the policy must be priced according to the aggregate risk presented by all board members and executives combined. For a long time, it was common for companies to shield their directors and officers from liability completely, without allowing for a deductible that remained with the person that had committed the wrong in question. Under this practice, directors and officers did not bear any part of the loss they had caused themselves as the loss was shifted completely to insurance carriers. The price to be paid for such comprehensive coverage was borne by the company itself.

One important qualification must be added to the description of D&O insurance in Germany. As of 2009, insurance policies need to include a deductible that must be at least equal to ten percent of damages or 1.5 times the size of the fixed annual salary (excluding bonuses), whichever figure is smaller. This deductible is not covered by the insurance policy but must be borne by the culpable board member herself. However, corporate managers are free to go out themselves and buy insurance that specifically covers the

40 See ANNEX TO STUDY ON DIRECTORS’ DUTIES AND LIABILITY, supra note 11, at 184 (indicating that D&O insurance is available in all Member States).
41 Bachmann, supra note 9, at 38; Klappstein, supra note 11, at 344 (“The company is contracting partner, policy holder and premium debtor.”). Again, this is the way it is ordinarily done in Europe. See ANNEX TO STUDY ON DIRECTORS’ DUTIES AND LIABILITY, supra note 11, at 184 (“In most Member States, the company is party to the insurance policy. D&O insurance is available in all Member States. It . . . will in practice usually pay the premium.”).
42 See AktG § 93.
II. DEFICITS OF THE STATUS QUO

As this Part will show, German law provides a fragmented and somewhat contradictory scheme of officers’ and directors’ liability. Some elements of the scheme seem to be overly strict, others strikingly lax or even dysfunctional. Broadly speaking, an exceedingly harsh liability regime is coupled with a weak enforcement mechanism and the remaining threat of personal responsibility cushioned by overly comprehensive insurance arrangements. The following discussion focuses on three main areas that are considered fundamental to the practical impact of the current system, namely enforcement, insurance, and quantum or damages.

A. The Liability Regime

For obvious reasons, the liability rule itself is one of the cornerstones of any liability system. In spite of its significance, its problems are not within the scope of this Article. One explanation for this choice of focus is that the deficits within the other components of the liability regime — enforcement, insurance, quantum — are so serious that they deserve a thorough discussion. This pragmatic reason is supplemented by a substantive concern, namely that any liability rule, even if perfectly designed, can serve its functions only if the overall framework within which it operates is sound. If the latter is deficient, improving the liability rule is wasted effort. This would be different if it were possible to devise a liability rule that worked to perfection so that managers would always avoid wrongdoing and never cause recoverable harm to the corporations they were running. Within such a perfect world, it does not matter much whether the rules and institutions governing quantum, insurance and enforcement are substandard or not — there would be no harm to compensate, no claim to enforce, and no liability to cover anyway. However, such a perfect world must remain an illusion.44 This is true for liability systems in general, but also for D&O liability in particular. In this context, the business judgment rule was designed to provide a safe harbor for managers.45 Nonetheless, a serious

---

43 Fleischer, supra note 15, at § 93 ¶ 254.
45 Supra note 15 and accompanying text.
risk of liability remained, be it because courts were overly strict in applying the business judgment rule, or because illegal behavior remains outside its scope of protection. Even though changes addressing these concerns are possible, imperfections will remain. One source of imperfection is that courts may misinterpret the rule or misconstrue the relevant facts; another involves misjudgments of the respective executive who may fail to grasp the requirements of the law or misunderstand the factual circumstances of the decision she is about to make.

B. Quantum

Where an executive officer of a German stock company is found to have failed the applicable standard, he or she is liable for the entire harm caused. The harm caused by careless behavior may be enormous, and its size tends to grow with the size of the business the executive was managing. Typically, the amount of damages will far exceed the assets of the liable party. In serving on the board of a corporation, the manager risks losing his or her personal wealth.

So long as the coverage provided by D&O insurance is sufficient to absorb claims brought against members of the management board, this risk is shifted to insurers. However, insurance coverage is always limited to particular amounts that apply to the maximum size of individual claims and to maximum expenditures per year. The ceilings in D&O insurance policies of large companies in Germany are set at €500,000,000 or more. Where these sums are exhausted, the excess liability must be borne by the insured.

In rank and file cases, these limitations remain inconsequential, as the value of successful claims remains within the ceilings defined in the insurance contract. However, there are rare outliers that go beyond these limits. In antitrust cases, the E.U. Commission has increased fines to amounts in excess of one billion euros. The most prominent case of recent years in the field of

46 Supra note 20 and accompanying text.
47 Supra note 21 and accompanying text.
48 Infra note 89 and accompanying text.
litigation involved lawsuits that had been brought by the former media mogul Leo Kirch and continued by his heirs against Deutsche Bank and its former CEO Rolf Breuer for damages in excess of three billion euros.\textsuperscript{51} Pursuant to newspaper reports, the D&O insurance policy that Deutsche Bank had bought for its CEO is limited to €500,000,000.\textsuperscript{52} In early 2014, the current executive board of Deutsche Bank settled the disputes for a total payment of more than €900,000,000.\textsuperscript{53} It seems that the D&O insurers were left out of this settlement, as they had denied their obligation to provide cover on the ground that Breuer was charged with having caused the harm intentionally. The question of recourse against Breuer still seems to be open.\textsuperscript{54} Of course, Breuer would be ruined if Deutsche Bank demanded payment of an amount in the order of €900,000,000. Pursuant to press reports, the parties are negotiating for a settlement in the vicinity of €3,000,000.\textsuperscript{55}

The problem with this kind of excessive liability is not that it may be unfair to the manager to hold her personally liable for damages of exceptional magnitude that she will never be able to pay up. Rather, the incentives generated by the threat of such liability are worrisome. A corporate manager who risks her personal assets and her earning capacity, above a minimum level necessary for subsistence anyway, has an incentive to behave risk-aversely. Such behavior is not in the best interest of shareholders as the owners of the business. Shareholders are risk-averse too, but they can easily contain their risk by spreading their investments across a portfolio of independent securities. Such a well-diversified investor-shareholder does not gain anything if the managers of each of the corporations she is invested in behave in a risk-averse manner.

---

\textsuperscript{51} See the most important judgments: 166 BGHZ 84 et seq.; and OLG München, 12 ZIP 558 (2013) (Ger.).

\textsuperscript{52} Deutsche Bank könnte Rolf Breuer verklagen, supra note 49.


\textsuperscript{54} Koch, supra note 53, at 429

Quite to the contrary, the shareholder has an appetite for risk with regard to each individual firm she is invested in. More precisely, the well-diversified shareholder prefers management decisions that maximize the expected value of the firm, even if the probability of total failure is greater than zero.

Exposing management to a liability of such proportions creates incentives for risk-averse behavior with regard to decisions involving the possibility of high losses, even if the probability that such losses will actually materialize is negligible. More precisely, management will avoid investment projects that carry a risk of losses exceeding the ceiling of the D&O insurance policy.

C. Deficient Enforcement

Until recently, it was received wisdom that the German system of officers’ and directors’ liability was not working well, or even not working at all. This view was shared by Chancellor Merkel in her October 2008 speech, in which she stated that the regime of officers’ and directors’ liability was hardly ever used in practice. Even though there has been more activity in this area during the last few years, the current state of affairs remains far from satisfactory. One reason why there is so little litigation is the lack of incentives to bring suits on the part of the supervisory board, another is the weakness of the shareholders’ assembly, and a third are deficits of the German version of the derivative suit. Together these observations explain why damages claims against directors are so rarely enforced.

As far as the supervisory board is concerned, one reason for its reluctance to prosecute claims against incumbent or retired managers lies in personal relationships between members of the managerial board and those serving on the supervisory board. This explanation was particularly plausible in the

---


57 Declaration by Chancellor Dr. Angela Merkel, supra note 4.
old days before the turn of the century when cross-appointments between boards of different firms, with the executives of company A supervising the managers of company B, and vice versa, were common. In the years following the 1990s, the degree of entanglement between the business elite has decreased substantially and, with this development, relationships between executives and their supervisors have become less amicable and considerate. It still remains true, however, that in many corporations members of executive and supervisory boards have been working together in various functions for years and thus are likely to display some loyalty when it comes to enforcing damages claims of perhaps exceptional magnitude.\textsuperscript{58}

Apart from personal relations, there is another force that tends to moderate the zeal of the supervisory board, and that is the danger of self-incrimination. After all, it is the duty of the supervisory board to monitor the management and to intervene in cases of mismanagement.\textsuperscript{59} While it is certainly true that misbehavior on the part of the executives does not automatically suggest that the supervisory board was negligent with regard to its own duties, it is obvious that such allegations may call the supervisory board’s own role into question. A further investigation of the relevant facts may reveal that not only was there a management failure but that the supervisory board failed as well. Such an outcome is not only embarrassing for the members of the supervisory board but also poses a financial threat: members of the supervisory board are liable under the same principles as the executives, i.e., for simple negligence in the discharge of their supervisory function.\textsuperscript{60} Thus, they may easily become jointly and severally liable next to the members of the management board whom they intended to hold accountable. The prospect of such an outcome strongly counsels against vigorous efforts to investigate potential failures of the executive board.

In reality, the likelihood of members of the supervisory board being sued in damages for a lack of the necessary diligence in controlling the management is negligible, for reasons very similar to those explaining the under-enforcement of claims against the management. Again, there is no entity that has a strong interest and effective means to bring such claims.\textsuperscript{61} Thus, damages claims

\textsuperscript{58} Habersack, supranote 30; Marcus Lutter, Zur Durchsetzung von Schadensersatzansprüchen gegen Organmitglieder, in Festchrift für Üwe H. Schneider, 763 (Ulrich Burgard, Walther Hadding & Peter O. Mülbert eds., 2011) (Ger.); Ulmer, supranote 30, at 318.
\textsuperscript{59} AktG § 111; Gerald Spindler, in Spindler & Stilz, supra note 15, § 111, ¶¶ 6 et seq.
\textsuperscript{60} AktG § 116.
\textsuperscript{61} Habersack, supranote 30, at 786.
against members of the supervisory board are unheard of. What has happened several times, though, is that members of the supervisory board lost their offices or were forced to resign in the aftermath of a corporate scandal. There is much anecdotal evidence of members of the supervisory board who were forced to resign after the company had fallen into crisis due to alleged mismanagement that had occurred under the eyes of the supervisors. One of the most spectacular examples of the recent past was the forced resignation of the chairman of the supervisory board of ThyssenKrupp AG, Gerhard Cromme, in response mainly to massive losses caused by ill-fated investments in trans-Atlantic steelworks.\textsuperscript{62}

It seems that these concerns were shared by the lawmakers who, since the revision of the Stock Corporation Act in 1965, have been reluctant to count on the supervisory board only and thus introduced additional claimants. Among those, the shareholders’ assembly was the first choice, and one that might seem a logical one as the shareholders are the owners of the company and thus the ones who bear the ultimate harm caused by mismanagement.\textsuperscript{63} However, it is received wisdom that shareholders of publicly held corporations are passive, and rationally so.\textsuperscript{64} While active participation in a shareholders’ meeting imposes substantial costs on the individual shareholder, the expected gains from participation to the active shareholder remain low. Even if the shareholder succeeds in persuading a majority to prosecute a claim, the final outcome of the litigation remains open, and any damages won on behalf of the successful suit benefit passive shareholders as much as active ones. As a consequence, there is a strong incentive to free-ride on the activities of other


\textsuperscript{63} The right of the general assembly to pursue claims against the supervisory board is enshrined in AktG § 147.

shareholders, and cases where the shareholders successfully took the initiative to prosecute claims against directors are unheard of.\textsuperscript{65}

The deficiencies of the dual enforcement system with the supervisory board as the born claimant and the shareholders’ assembly as a backup force were the motives behind the reforms of 2005 that introduced the action pro socio, i.e., the shareholder action as a variant of the American derivative suit.\textsuperscript{66} The new Section 148 of the Stock Company Act vests standing to sue in the name of the corporation in individual shareholders or groups of shareholders that represent at least one percent or €100,000 of the corporation’s nominal capital. For success, the claimants first need to overcome a preliminary stage designed to weed out unmeritorious claims in order to then proceed to the merits stage. If the claim is rejected by the court at the preliminary stage, the costs of the proceedings, including the fees of the respondent’s attorney, are to be borne by the shareholder-claimants. In case of defeat at the merits stage, the costs of the proceedings, including attorney’s fees on the part of the claimants, are to be borne by the defendant corporation unless it turns out that the claimants had misled the court at the preliminary stage and thus had obtained leave to pursue the claim through unlawful means. If the claimants win on the merits, they are reimbursed by the corporation for costs incurred. The damages awarded by the court do not flow into the pockets of the successful claimants but into the corporate purse, thus benefiting all shareholders. The lawmakers introduced this scheme with a view to strengthening the enforcement of damages claims against negligent directors and, further, to improve the incentives of management.\textsuperscript{67} It did not work that way as, since the introduction of the new law in 2005, only three cases have been filed in Germany, and none of these suits turned out to be successful.\textsuperscript{68}

\textsuperscript{65} Bachmann, supra note 9, at 85; Lutter, supra note 58.


\textsuperscript{67} \textit{Deutscher Bundestag: Drucksachen} [BT] 15/5092 (Bill of the Act to Reform the Stock Corporation Act and to Improve the Integrity of Businesses).

This outcome should not have surprised anyone, as the German variant of the derivative action bears certain features that severely undermine the incentives for individual shareholders to bring such suits. While the framers of the 2005 reform act saw the problem posed by the loser-pays rule, their response was misconceived. The bifurcation of the proceedings against corporate managers into a preliminary stage and the main merits stage turned out to be a futile attempt to achieve two conflicting goals at once, namely to incentivize shareholders through cost privileges and to deter abusive litigation. Obviously, these goals are in conflict with one another, and the conflict has been resolved in favor of the second goal, i.e., deterrence of abusive litigation. The critical point is that the threshold for success at the preliminary stage is not \textit{lower} than the one that applies at the main merits stage, but \textit{higher}. On the merits, a damages claim against corporate managers merely requires a showing of prima facie negligent behavior that caused harm to the corporation, while the burden is upon the defendants to plead and prove that their decisions were made with the necessary diligence or within the safe harbor of the business judgment rule. Surprisingly, this is not the standard for the certification of a shareholders’ claim at the preliminary stage. Rather, the claimants need to establish facts strong enough to justify the suspicion that the defendants caused the harm through disloyal behavior or gross violations of the law or of the corporate charter. If the claimants fail to meet this standard, their claim is rejected and they not only have to bear their own costs, but must also reimburse the defendants for their attorney’s fees.

It is easy to see that the risk associated with such adverse costs is substantial, and it is equally important to remember that there is nothing in the game to balance this risk, as even in the case of certification and ultimate success at the merits stage, the best that the shareholders can hope for is a cost award in their favor.\textsuperscript{69} Any damages for which the defendants are found liable go exclusively to the corporate purse.\textsuperscript{70} Thus, the institutional design of the derivative action is such that it provides no incentive to shareholders to sue in the common interest but rather deters such actions.\textsuperscript{71} Therefore, the dearth


\textsuperscript{69} Schmolke, \textit{supra} note 68, at 398, 406.

\textsuperscript{70} In the United States the gain from a successful derivative suit to the individual shareholder is often trivial. \textit{See} John C. Coffee & Donald E. Schwartz, \textit{The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform}, 81 \textsc{Colum. L. Rev.} 261, 304 (1981) (“\textsc{O}nly . . . a few pennies a share.”).

\textsuperscript{71} In the United States the derivative suit (only) works because the cost risk is borne by the lead plaintiff’s counsel — who is in turn compensated by a share
of claims during the eight years of its existence is no happenstance but was to be expected.\footnote{In the eight years since its inception, only three cases have become known in which the courts had to deal with derivative suits. In all three cases, the claim was rejected. See Habersack, \textit{supra} note 30, at 790; Martin Peltzer, \textit{Das Zulassungsverfahren nach § 148 AktG wird von der Praxis nicht angenommen! Warum? Was nun? [The Certification Procedure of § 148 AktG Has Failed in Practice! Why? What Now?], in \textit{Festschrift für Uwe H. Schneider, supra} note 58, at 953; Jochen Vetter, \textit{Reformbedarf bei der Aktionärsklagenach § 148 AktG [Reform Needs Regarding the Shareholders’ Derivative Suit According to § 148 AktG], in \textit{Festschrift für Michael Hoffmann-Becking [Commemorative Publication for Michael Hoffman-Becking]} 1317, 1319 (Gerd Krieger, Marcus Lutter & Karsten Schmidt eds., 2013) (Ger.).}}

In summary, German corporate law is still missing a mechanism for the enforcement of claims against negligent managers. The three potential actors on the scene — the supervisory board, the shareholders’ assembly, and individual shareholders — each lack the necessary incentives to instigate suits and to prosecute them in the interest of the corporation.

\section*{D. Comprehensive Insurance}

Another shortcoming of the current system is associated with D&O liability insurance. The problem here is that the insurance policies shift the risk of liability to insurance carriers, so that even those managers who are found to have been at fault and to have caused harm to the corporation do not feel the bite of liability. Knowing that this is the case, they have no financial incentive to behave diligently in the first place.

The potential of liability insurance to dilute or even destroy the very incentives which liability systems are designed to generate, is well known under the name of moral hazard.\footnote{See Gerhard Wagner, \textit{Tort law and Liability Insurance, in 1 Tort Law and Economics} 377, 389 (Michael Faure ed., 2d ed. 2009).} Ultimately, moral hazard is caused by the inability of the insurer to monitor the insured after the insurance contract has been signed. It is also received wisdom that there are ways and means for insurance contract law and the parties to insurance contracts to preserve or restore incentives to take care and to choose efficient activity levels. One strategy is to focus on the \textit{ex ante} stage and to try to adjust the premium to the risk associated with the insured activity as accurately as possible. This requires a thorough assessment of the risk in question, together with quasi-
regulatory interventions by insurance carriers. Alternatively, the insurer may also try risk-rating *ex post*, e.g., by implementing a *bonus/malus*-system that adjusts premiums to losses retroactively. Such a scheme provides strong incentives for the insured to avoid the burden of an increased premium in period two by taking the necessary care to avoid harm in period one. The same goal may be achieved with the help of deductibles that leave a part of the risk with the insured so that her incentives to take care persist, albeit in diminished form. While such measures cannot restore the incentives to take care perfectly, they work to mitigate the detrimental effects of risk shifting to insurance carriers significantly.

For an evaluation of D&O insurance in Germany, it is critical to understand that none of these tools to control moral hazard are available in the D&O line. The implementation of mechanisms such as risk-rating and *bonus/malus* schemes requires that risks can be assessed and priced individually rather than collectively. If losses are not allocated to particular insurance contracts and the individual insurees that stand behind them, the insurer has no choice but to charge an average premium. D&O liability insurance as it is offered in Germany operates with group policies that lump together all the directors and executives of a corporation and cover the aggregate risk in exchange for a lump-sum premium.\(^74\) Within such a contractual setting, the insurer cannot price individual risks accurately *ex ante* and adjust premiums *ex post* in light of the performance of the particular director or officer. Thus, the conclusion must be that D&O insurance destroys the incentives of the underlying liability regime.

Since 2009, one qualification to this dim conclusion must be added: in the aftermath of the financial crisis, the German legislature intervened and imposed a requirement that D&O insurance policies include a deductible that must be borne by the culpable board member herself. The minimum size of the deductible was written into law as well; it must be at least ten percent of damages or 1.5 times the size of the fixed annual salary (excluding bonuses), whichever figure is smaller.\(^75\) Unfortunately, the lawmakers did not go so far as to ban insurance of the deductible itself.\(^76\) Thus, corporate managers are

---

74. Horst Ihlas, *D&O: Directors and Officers Liability* 334 (2d ed. 2009) (“More than 90% of insurance policies are taken out by corporations.”) (translated by the author).
75. See Aktiengesetz (AktG) [Stock Company Act], Sept. 6, 1965, BGBL. I at 1089, last amended by Gasetz [G], July 23, 2013, BGBL. I at 2586, § 93 (Ger.).
free to go out and buy insurance that specifically covers the deductible that is excluded from the group insurance policy bought by the corporation. In practice, the same insurer that underwrote the D&O policy also provides the additional cover for the deductible. The company indirectly pays for the premium due for such additional coverage, i.e., through a surcharge on the manager’s regular salary. In spite of the 2009 reform, therefore, not much has changed with regard to D&O insurance. It still provides a comprehensive cover to managers who thus rarely feel the bite of personal liability.

E. Summary

The current German framework of managerial responsibility is highly ambivalent. The liability rule is strikingly strict, as it imposes liability in negligence for pure economic losses, shifts the burden of proof to the (former) board member, and fails to place limits on quantum. This regime can only survive in practice because claims against executives who mismanaged the firm or behaved in a disloyal fashion are rarely enforced. Where enforcement is successful, the costs are picked up by D&O liability insurance so that managers escape personal responsibility. But again, in rare cases insurance fails and managers may be exposed to liability of enormous proportions that far exceeds their assets and earning capacity.

In combining these contradictory elements, German law may well obtain the worst of both worlds. On one hand, the malfunctioning of the enforcement system together with comprehensive protection through insurance destroys whatever incentives for diligent behavior are created by the liability regime. However, for exceptionally large losses, insurance protection fails and the executive is exposed to liability of crushing magnitude. The effects that this ambivalent system creates for the behavior of managers will be investigated in the next Part.


77 Fleischer, supra note 15, § 93 ¶ 254.
III. Functions of Officers’ and Directors’ Liability

In the preceding Part, the regime of officers’ and directors’ liability has been the subject of serious criticism. Throughout this discussion it has only been tacitly assumed rather than explained that deterrence of undesirable behavior on the part of managers is the purpose that underlies this corner of the law or, at least, that deterrence should be the overriding principle governing D&O liability. It is now time to explore the functions of officers’ and directors’ liability.

A. Compensation

Following the civil law tradition, German law postulates compensation to be the primary goal of tort law and of liability systems more generally. This point of view maintains that deterrence, i.e., influencing human behavior through incentives to take care, is merely an ancillary function of liability systems, in the sense that deterrence is a welcome side-effect of compensation but not an independent purpose. As a consequence, it is not strong enough to shape or modify liability rules or to provide guidelines for the substantive and procedural frameworks in which liability rules are embedded. The general theory of the functions of liability systems carries over to the special case of officers’ and directors’ liability. Again, the compensation goal is placed in the front seat, while the deterrence rationale is relegated to an auxiliary role.

In fact, there are compelling reasons to displace compensation as the primary goal of the law of officers’ and directors’ liability and to rely on deterrence instead. Contrary to other areas of the law, corporations cannot be effectively compensated by their managers, as they would have to reimburse them for such payments in the form of higher salaries. Therefore, the ex post benefit of holding managers liable will be cancelled out by ex ante costs of the same value. In addition, corporations do not need compensation for the

78 Gerhard Wagner, in MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH § 823 ¶ 38 (Franz-Jürgen Säcker & Roland Rixecker eds., 6th ed. 2013) (Ger.).
79 Id. § 823 ¶ 40.
80 See Fleischer, supra note 27, at 1305, 1310; Holger Fleischer, in HANDBUCH DES VORSTANDSRECHTS [HANDBOOK OF EXECUTIVE BOARDS] § 11 ¶ 4 (Holger Fleischer ed., 2006) (Ger.); Klaus J. Hopt, in GROSSKOMMENTAR ZUM AKTIENGESETZ, supra note 17, § 93 ¶ 11; Bachmann, supra note 9, at 21.
purpose of reducing the costs of risk-bearing because they can easily pass on these costs to their shareholders who are in turn well situated to diversify away the risk with the help of a diverse investment portfolio. As liability systems are expensive to operate, a rational shareholder would prefer the diversified investment portfolio over meticulous compensation of losses on a case-by-case basis.

The theoretical insight that compensation is less relevant for officers’ and directors’ liability is strongly reflected in corporate practice. As has been explained above, it is common practice in Germany that directors are insured against liability through a policy that is negotiated and paid for by the company. It is the only line of liability insurance where premiums are not paid by the potential wrongdoer but by the victim itself! Transposed to the familiar field of liability insurance for traffic accidents, an insurance scheme based on the principles of D&O insurance would imply that victims of traffic accidents buy protection against harm inflicted on them by a third party, and contingent on fault being found on the part of that third party. Disregarding the deductible and the rare cases in which the damages exceed the ceiling of the insurance cover, the company pays every cent of the expected costs of liability of its managers. In truth, D&O insurance is closer to first-party insurance than to liability insurance that involves coverage for the harm done to another. This practice has implemented, quite visibly, the theoretical hypothesis that the expected liability costs will ultimately be borne by the corporation and passed on to its owners through diminished dividends or lower share prices. Therefore, D&O liability cannot be explained or justified as a compensation mechanism.

B. Deterrence

If officers’ and directors’ liability is not about compensation, deterrence offers an alternative. While shareholders are disinterested in the redistributive aspect of officers’ and directors’ liability, they may be interested in its potential to guide human behavior, i.e., the behavior of the managers in fulfilling their duties. On this view, the liability system serves the function of aligning the behavior of executives with the interests of shareholders, rather than indirectly compensating shareholders for losses incurred by the corporation.84

83 D&O Insurance in principle works the same way in the United States, i.e., it is taken out and paid for by the company. Id. at 1745.

The deterrence function of officers’ and directors’ liability is based upon the fundamental principal/agent structure of corporate governance. While the shareholders own the corporation, they are neither interested in nor capable of leading the business and therefore hire managers to do the job for them.\(^85\) The self-interest of the managers is not automatically aligned with the interest of the shareholders. The shareholders as principals are unable to closely observe the behavior of the managers and to accurately react to self-dealing, i.e., violations of the duty of loyalty, and laxity, i.e., violations of the duty of care.

The liability system works as a remedy for this dilemma, as it enables the shareholders to sanction wrongful behavior of the managers \textit{ex post facto}, provided that the corporation incurred losses. If the liability system worked perfectly and at zero cost, the principal/agent-problem could be eliminated. Whenever an executive failed to behave honestly and diligently and caused a loss to the corporation or failed to secure a profit that was within reach, she would become liable in damages. In an ideal world, executives would anticipate this consequence and thus would always act with the necessary loyalty and diligence.

If deterrence is or should be the dominant or even the only function of officers’ and directors’ liability, it seems to follow that a liability system based on fault will eliminate the principal/agent problem if it works perfectly. Comparing directors’ liability to the familiar and basic field of liability for motor accidents, it should be expected that unlimited liability for the harm caused negligently or intentionally will provide the potential wrongdoer with the necessary incentives to take care.\(^86\) The same result could be obtained through a system of strict liability where it would not even be necessary to establish fault.\(^87\)

In contrast to liability for motor accidents, fault-based and strict liability regimes are not desirable in the area of officers’ and directors’ liability, at least not if wrongdoers are liable to compensate for the full harm. The reason is that managers — as opposed to motorists — do not internalize the full gains associated with their choices and thus should not be held liable for the full losses caused by decisions that were made without the necessary diligence. The gains generated from diligent decisions and other behavior of managers accrue to the company, and not to the responsible manager personally. While it is common to incentivize managers by allowing them to share in the gains that they help to generate through elements of contingent remuneration, these

\(^{85}\) See sources cited \textit{supra} note 64.

\(^{86}\) See \textit{Shavell, Accident Law}, \textit{supra} note 44, at 6-21.

\(^{87}\) \textit{Id.}
elements never come close to approaching the level of the gross gains to the company itself.

In this situation, full liability for losses coupled with partial and strictly limited sharing in gains would lead to asymmetric payoffs. If managers were held liable for any loss suffered by the company, as in a system of strict liability, they would be forced to internalize all the negative consequences of their negligent decisions but not enjoy the full benefits of diligent decisions. It appears that this conclusion does not hold with respect to liability systems based on fault as, in theory, potential wrongdoers would anticipate what the law requires and rationally choose a level of diligence that avoids liability. Therefore, under a negligence rule, negligent behavior should not occur at all. Obviously, this is not true, as there are many cases in which wrongdoers are in fact found to have acted negligently. Whether the occurrence of meritorious suits under negligence regimes is due to courts’ mistakes in setting the required level of care or to misapprehensions of potential wrongdoers is an interesting, albeit irrelevant, question. The essential point is that, also under a negligence rule, managers bear part of the downside risk of the business.

Managers who face such asymmetric payoffs will adapt their behavior accordingly. They will be careful to avoid decisions that may lead to losses, particularly losses large enough to threaten their personal wealth because they exceed the ceiling of the D&O insurance cover. At the other end of the spectrum, they will not care much about foregone opportunities to earn high profits, as these profits would accrue to the company and not to them personally.

---

90 Imagine a situation where a manager compares two investment projects. Project 1 yields a gain of 30 with a probability of 0.7, and a loss of 20 with a probability of 0.3. Project 2 yields a gain of 90 with a probability of 0.9, and a loss of 150 with a probability of 0.1. A risk-neutral decision maker with the goal of maximizing the return to the corporation would choose project 2 with an expected value of 66 (81-15) over project 1 with an expected value of 15 (21-6). A manager who shares asymmetrically in gains and losses generated by the company would look at these projects differently. She would focus on the downside only and compare a possible loss of 150 with a probability of 0.1 to a possible loss of 20 and a probability of 0.3. Obviously, she stands to lose much more of her wealth if she chooses project 2. Even if she disregards the absolute level of losses and engages in expected value analysis, the expected value of the losses associated
C. The Limits of Deterrence and the Design of the Liability System

The fundamental problem of D&O liability, i.e., the asymmetric sharing of executives in the gains reaped and losses incurred by the corporation they are leading, can be tackled from two different angles. One focuses on the gains side and allows the manager to share in the profits of the corporation, while the other concentrates on the downside and limits the participation of the manager in the losses incurred by the corporation.

The tendency to avoid losses through overly risk-averse decisions can be mitigated if the remuneration of the manager is tied to the earnings of the company. Contingent remuneration helps to align the measure to which managers participate in the downside — potential losses — with the measure to which they participate in the upside — potential profits. While this is true, the effect of such realignment of incentives will be very limited. The degree to which managers may be allowed to share in the profits of the company cannot approach one hundred percent, as full sharing in profits would have the effect of expropriating the shareholders. In a corporation in which managers reap all the profits, they have become the real owners of the business. In essence, full sharing in profits would eliminate the separation of ownership and control together with the principle of limited liability on which corporate law rests. It would turn managers into entrepreneurs who run a business in their own name and on their own account. On the assumption that the separation of ownership and control is an efficient institution, the asymmetry between the degrees to which managers share in gains made and losses incurred by the company that they lead cannot be eliminated by increasing the share to which they participate in gains.91

If full sharing of managers in the gains of the business they are leading is no valid option, the analysis must consider limiting their exposure to losses. This can be achieved by cutting back on quantum, i.e., by restricting the amount of damages in case that negligent behavior is found. Doing so would extend the principle that corporate law employs for the upside, i.e., gains, as a blueprint for allocating the costs of the downside, i.e., losses. In the same way that managers with contingent compensation packages share in the profits that arise from their decisions to a relatively small degree, they would share in the losses caused by their decisions to a small degree as well. In theory, it is possible to use the same multiplier, both for the sharing in gains — in the

91 See Michael Adams, Eigentum, Kontrolle und beschränkte Haftung [Property, Control and limited Liability] 47 (1991); Easterbrook & Fischel, supra note 64, at 40.
form of contingent remuneration — and for the sharing in losses — in the form of limited liability. Such a rule would downsize the several contingent outcomes available to the corporation proportionally so that the decision-maker would face the same choice as a single owner of the business would, only in smaller sizes.92

IV. REDESIGNING THE CURRENT SYSTEM

The conclusion reached above is that managers should bear a sanction if they fail to behave diligently and this failure causes a loss to the firm. Yet the size of the sanction should be proportionate to their share in the gains that would have accrued to the company if their decision had turned out right. The remainder of the Article will explore the question regarding how this principle could be brought to bear on the current system of officers’ and directors’ liability.

A. Strengthening Enforcement

Strengthening the enforcement of claims holding directors liable for the harm caused is no easily accomplished feat. The first institution to turn to in search of a ready enforcer would be the supervisory board. After all, it is an essential part of the supervisory board’s function to monitor and control management and to represent the company in its dealings with its executives.93 However, for the reasons explored above, the members of the supervisory board face strong incentives not to enforce claims against the management, as doing so inevitably digs up dirt that is prone to contaminate the hands of supervisors, as well.94 It is hard to imagine how the legal system could balance out the massive disincentive faced by the supervisory board that stands in the way of a more vigorous enforcement of damages claims against the management. It seems that more can be gained from looking elsewhere.

92 Assume that in the numeric example from supra note 90 management receives ten percent of the gains of the company in case things go well, but also has to cover ten percent of the losses if the decision turns out sour. In this case management could count on a net expected return of 1.5 from project 1 that compares to a net expected return of 6.6 from project 2. Thus, management would compare the exact same numbers as a single owner would or, what amounts to the same, a decision-maker that had to choose the option that is best for society as a whole. The only difference is that the figures are divided by 10.

93 See text accompanying supra note 59.

94 See supra Section II.C.
In theory, the shareholders’ assembly would be the natural enforcer of claims against management, as the shareholders are the ones who have to bear the consequences of wrongful decisions, not the members of the supervisory board. Again, the obstacles that stand in the way of incentivizing the shareholders’ assembly are high and difficult to overcome. It takes a considerable investment of time and money to participate in shareholder meetings, to explore the facts and the legal issues of a potential damages claim, and to convince other shareholders to join forces. Since the potential gains from successful suits are socialized while the costs remain private, the incentive to free-ride on the efforts of others remains strong.

As actors or entities with a sufficiently strong self-interest to enforce claims are missing, the obvious solution is to vest the right in individual shareholders. This proposal takes up the basic idea of the derivative suit, as it was developed in U.S. law and migrated to German law from there. However, the German lawmakers attached so many strings that rendered the German version of the derivative suit ineffective. These strings must be done away with if enforcement is to work better. In this regard, the most important step would be to abolish the bifurcation of the proceedings into a preliminary stage and a merits stage, and — even more pressing — to put an end to the situation where the substantive threshold for certification is much higher than the one for success on the merits. It is simply absurd that the claimant-shareholder must show disloyal behavior or gross violations of the law in order to win certification, while simple negligence suffices for prevailing on the merits.

Enabling shareholders to enforce claims of the corporation and in the name of the corporation is not enough to create an efficient enforcement mechanism, however. If the shareholder bears the risk of litigation but does not share in its outcomes at all as all damages go to the corporate purse, he has as little

95 There is another option that was proposed by German observers, namely public enforcement by governmental agencies or semi-public enforcement by quasi-administrative bodies such as the chamber of accountants. See Hans-Jürgen Hellwig, Die Finanzkrise — Fragen und Anmerkungen [The Financial Crisis — Questions and Comments], in Festschrift für Georg Maier-Reimer [Commemorative Publication for Georg Maier-Reimer] 201, 215 (Barbara Grunewald & Harm Peter Westermann eds., 2010) (Ger.); Lutter, supra note 58, at 763, 770; Martin Peltzer, Mehr Ausgewogenheit bei der Vorstandshaftung [A Plea for More Balance in D&O Liability], in Festschrift für Michael Hoffmann-Becking 861, 869 (Gerd Krieger, Marcus Lutter & Karsten Schmidt eds., 2013) (Ger.). Both of these options are fraught with many problems that cannot be explored here. This Article focuses on the private enforcement of damages claims against managers.

96 See supra Section II.C.
incentive to come forward with such claims. Within such an environment, derivative litigation is a sure loss for the active shareholder, willing to take on the labor and risk of bringing damages claims on behalf of his company. The individual shareholder who brings derivative suits in several cases and loses at least one of them will always incur a net loss. As a result, he will be reluctant to engage in this activity at all. Therefore, in order to work well in practice, the derivative suit needs some form of reward in cases of success in order to motivate individual shareholders to come forward and take the risk of litigation on them.97

Within the enforcement system of American law, the contingency fee plays the role of a reward for successful derivative suits. Even though the fee does not go to the shareholder who, nominally at least, instigated the suit, but to the attorney who represented him, it serves this function because it is the attorney — and not the shareholder — who is the true party in interest.98 In awarding the attorney a share of the award in case of success, American law provides a powerful incentive for attorneys to bring derivative suits even though the likelihood of success is less than 1 in any given case.

In Germany, the contingent fee cannot serve the same function as in the United States. It has been illegal for a long time and only recently been accepted, in reaction to a decision of the Constitutional Court that considered the flat ban on contingency fees to be untenable.99 Under current law, contingency fees remain relegated to a narrow niche, as they are permissible only where no other funding is available.100 One obvious substitute for the contingency fee would be to divert a fraction of the sum awarded upon a successful derivative suit away from the company and to allocate it to the shareholder who instigated the suit. In contrast to the contingency fee, this fraction would not go into the pockets of the attorney representing the shareholder, but into those of the shareholder-claimant himself. In this way, the same mechanism that incentivizes attorneys in the United States to bring derivative suits could

97 The bounty regime familiar from the law of whistleblowers is based on a similar idea. See David Freeman Engstrom, Whither Whistleblowing? Bounty Regimes, Regulatory Context, and the Challenge of Optimal Design, 15 THEORETICAL INQUIRIES L. 605 (2014).
98 See Coffee & Schwartz, supra note 70.
100 Rechtsanwaltsvergütungsgesetz [RVG] [Lawyer’s Remuneration Act], May 5, 2004, BGBl. I at 718, § 4a (Ger.).
be transposed to a European environment where contingency fees remain suspect and entrepreneurial lawyering is much less developed than in the United States.

The purpose of shareholders’ participation in the rewards of successful claims solely lies in incentivizing enforcement for its deterrent effect on human behavior. Therefore, the size of the share allocated to the successful shareholder should not reflect the amount of the initial claim or the size of the award made in favor of the corporation. Rather, its design must follow its purpose of compensating the claimant for the cost risk associated with the initiation of legal proceedings. Therefore, it needs to be tied to the size of the cost risk incurred by the shareholder who sues on behalf of the company that in turn is determined by the prospective total costs of litigation and the probability of success.

In a jurisdiction such as Germany, in which court and attorney’s fees are regulated by statute, it is comparatively easy to estimate the total costs of litigation for any given lawsuit. This sum then needs to be multiplied by a percentage figure that reflects the likelihood of failure. Picking the right multiplier involves an element of discretion, as higher multipliers generate more claims than lower ones. If the multiplier is set at 2, then potential claimants break even if they win one case and lose another. This may still be too little to incentivize shareholders to come forward and assume the risk of litigation. A multiplier of 5, on the other hand, would create incentives to sue if the likelihood of prevailing is greater than 20%, which is too low a threshold.

**B. Restricting D&O Liability Insurance**

Improving enforcement would be of little impact if insurance practice remained as it is today. The critical point about D&O insurance is that the practice of group policies forecloses access to the toolbox that insurers use for coping with moral hazard. In its current form, D&O insurance destroys whatever incentives are generated by the underlying tort law or other liability regimes.

The German lawmakers have implicitly recognized the detrimental effects of wholesale insurance with averaged premiums on incentives to take care and introduced a deductible in response. This was a step in the right direction, albeit one that does not go far enough. The door was left open for the managers to buy insurance cover for the deductible as well, and most have done so, with

---

101 For a full exposition of the German costs system, see Wagner, supra note 99.
102 Supra Section II.D.
103 Aktiengesetz [AktG] [Stock Company Act], Sept. 6, 1965, BGBI. I at 1089, last amendment in BGBI. I at 2586, July 23, 2013, § 93(2) cl. 2 (Ger.).
the result that officers and directors still do not feel the bite of liability at all.\textsuperscript{104} While the insurer of the deductible could, in theory, negotiate for the full set of contractual safeguards in order to control moral hazard, these will not be worth their substantial costs, given that the absolute size of personal liability remains limited. Under the current statute, the deductible must not be smaller than ten percent of the damages or the accumulated salary of one and a half years. Even managers earning top salaries of more than €10,000,000 per year will generate demand for an insurance cover of no more than €15,000,000-20,000,000 which is too small for applying sophisticated techniques of risk assessment and risk management. Things get worse if managers transact with the same company that they have employed as D&O insurer also for coverage of their personal share. In this situation, it is highly unlikely that insurers will bargain aggressively for instruments that safeguard incentives to take care because of fear of losing not only the business of the manager but also the much larger business of the company.

From the perspective of deterrence, the better solution would be to prohibit insurance of the deductible. It is self-contradictory to impose a mandatory deductible in the interest of preserving incentives to take care, and to then allow managers to shift this risk to insurers so that these incentives are again seriously impaired or even destroyed. A consistent policy requires that the threat of liability resulting from the mandatory deductible cannot be insured “a second time.”

A reform of the deductible would also have to rethink its dimensions. In its current form two features determine its size, i.e., a fraction of total damages, namely ten percent, together with the sum of the fixed annual salary multiplied by 1.5. The first factor, a fraction of total damages, is without alternatives, if the deductible shall apply to every case and be made proportional to total damages. It should be proportional to total damages, as this solution ensures that incentives to take care rise continuously and in parallel to the increase in the costs of harm. The second factor, i.e., the limitation by the fixed annual salary of a year and a half, is more critical. To be sure, it is adequate to use another limiting factor, as the benefits of D&O insurance would otherwise be lost where they are needed the most, namely in cases involving high damages. In corporate settings, it is by no means unusual that damages exceed one billion euros. In this example, if the ten percent of damages limit were the only one available, the manager would be personally liable for no less than €100,000,000. For most individuals in the trade, this would result in a loss of their total wealth. The problem with this prospect is not that managers

\textsuperscript{104} Supra Section II.D.; text accompanying supra note 75; Fleischer, supra note 43.
deserve our pity and compassion, but that it would cause them to make risk-averse decisions, which would not promote the interests of the shareholders and would be detrimental to society.105

The goal must therefore be to avoid the undesirable effects of unlimited liability for the decisions made by managers on the one hand, while preserving incentives to take care on the other. A deductible that is tied to the overall success of the company, as reflected in the remuneration earned by the individual manager, would offer a solution. From this perspective, the primary yardstick for the assessment of the deductible must be the contingent, rather than the fixed, part of executive compensation. The justification for contingent compensation is that it helps to incentivize managers to further the interest of the company as best they can.106 The downside of contingent compensation, particularly if it comes in the form of options, is that it distorts the manager’s incentives and induces excessive risk-taking. The reason is that remuneration in the form of stock options allows the executive to participate in the gains from risky strategies while isolating him or her from the potential losses.107

Making bonuses paid out in previous periods available for a claw-back by the corporation that incurred losses in subsequent periods would remedy this distortion of incentives. Holding executives personally liable in amounts equal to the bonuses earned earlier serves as a mechanism to this end. Inasmuch as personal liability is tied to the contingent part of executive compensation, it incentivizes managers to avoid overly risky decisions that are not in the best interest of the company.108

105 Supra Section III.C.


107 Bebchuck & Spamann, supra note 106, at 262.

108 The numerical example presented supra note 90 may once again be used to illustrate this point. It involved two projects, project 1 with a net expected value of 15 and project 2 with a net expected value of 66. If managers were receiving a 10 percent share of the gains realized by the company, but did not share in the losses, then their decisions would be distorted, as the risk of losses would simply be ignored. The decision maker would compare the gains from project 1 (30x0.7), multiplied by her personal share (21x0.1=2.1), with her personal share in the gains from project 2 (90x0.9x0.1=8.1). Thus an expected gain of
A symmetric sharing in the gains and losses of the corporation would thus provide the correct measure not only for assessing the size of contingent compensation of managers, but also for calibrating their personal liabilities. The exposure of an executive to damages claims brought by shareholders in the name of the corporation would be limited to a deductible to be applied to the D&O insurance policies made to their benefit. This deductible would not be separately insurable. The difficulties with this approach are that the size and the formula for calculating the contingent part of executive compensation are not written into law but subject to the choice of the competent committee or assembly of the corporation. As a result, there are many different forms of contingent compensation that cannot be reduced to a simple denominator.

The flexibility and diversity of contingent compensation schemes can be accommodated by tying the size of the deductible to the contingent part of executive compensation over a certain period of years, always in addition to the damages-based factor of the deductible. A possible solution would be to limit the personal exposure of executives to the contingent part of their remuneration over a period of three years. Such a solution would establish a nexus between sharing in corporate gains and sharing in losses to the corporation.

One problem raised by this approach is that it provides incentives to avoid contingent compensation and to revitalize fixed compensation instead. Such a shift back to traditional compensation models need not be detrimental to the interests of the corporation or its shareholders, as it would at least eliminate the distortion inherent in pure gains-based contingent compensation schemes that have become increasingly common throughout the economy.\textsuperscript{109} Shareholders may still do better under fixed salaries than under compensation packages that promise rewards for high gains but no penalties for high losses.

Still, the exclusive focus of the deductible on contingent compensation remains unsatisfactory. It allows a company to strategically circumvent the

\begin{itemize}
\item 2.1 from project 1 would be compared to an expected gain of 8.1 from project 2. If, however, managers shared equally in the gains and losses, then the choice to be made on behalf of the company would be sized down proportionally so that managers faced the right incentives to choose between the two projects. Here, a decision maker would compare the net gains from project 1 (30x0.7-20x0.3=15), multiplied by her personal share (15x0.1=1.5), with her personal share in the net gains from project 2 (90x0.9-150x0.1=66x0.1=6.6). Thus an expected net gain of 1.5 from project 1 would be compared to an expected net gain of 6.6 from project 2. In effect, the decision maker would face exactly the same options for his personal purse as the corporation for which she is making the decision, only divided by a factor of 10.
\end{itemize}

\textsuperscript{109} See the critics of contingent compensation cited supra note 106.
deductible by exclusively relying on fixed compensation. If the executive who caused the harm did not earn any bonuses, the pot for applying the deductible would be empty, and the executive would go scot-free. In order to foreclose strategic switches to fixed compensation, the deductible tied to a multiple of contingent compensation must be supplemented by a similar measure predicated on the fixed component of the annual salary. One plausible scenario could combine a deductible that reflects the value of the bonuses paid over a period of three years with another in the amount of fifty percent of total salaries, fixed and contingent, over the same period, whichever is more. Thus, the personal exposure of the executive would be at least in the amount of 1.5 times the annual salary and could be more than that where the executive received large bonuses that exceed this number.

C. Limiting Quantum

If enforcement were to be improved and D&O insurance cut down to its acceptable range, executive liability would look very different from what it does today. Damages claims would be much more frequent, and managers would be personally liable for sizable amounts, measured in multiples of their salaries. If this scenario were to become a reality, directors’ and officers’ liability would work efficiently most of the time, i.e., for cases involving comparatively small or ordinary amounts of damages. In the small group of cases that remain, damages are high, so high that they exceed the ceiling of the D&O insurance policy. Beyond that level, managers would remain personally liable for any harm suffered by the corporation due to their decisions. The question is whether this exposure to top damages can be tolerated.

In ordinary settings of liability in tort or contract, large amounts of damages do not pose normative problems. High damages indicate that the harm that was caused by the wrongdoer was large-scale. This in turn suggests that considerable or even exceptional effort should have been invested in precautions that could have prevented the large-scale harm. Incentives to take such costly precautions are generated only if the potential wrongdoer is confronted with the full costs of the harm caused, and not just a fraction of it. Therefore, in ordinary settings of liability in tort or contract, caps on damages are inadequate, as they destroy incentives to take precautions that could have prevented exceptionally large losses.

The question is whether the same considerations apply within the corporate setting. The answer is in the negative. The explanation is already familiar: if managers are held personally liable for the losses incurred by the corporation that they control, then their risk-aversion would lead them to make decisions
that are in the interest neither of the shareholders nor of society at large. Thus, it is necessary to think of ways to limit the exposure of managers within the top bracket of damages claims. One option, and a quite radical one at that, would be to limit the exposure of managers to the deductible as defined above. This would require transforming the current liability system into one that focuses exclusively on deterrence. Such a model would have no need for damages claims that go beyond the deductible, as such claims carry no incentive value anyway.

The proposal to do away with the liability of directors and officers completely, save for a deductible that has been remodeled in the interest of deterrence, sounds revolutionary but, in fact, it is not. The current system is much closer to it than the labels attached suggest. Given that the corporation pays the premiums on the D&O policies, the insurance scheme may more adequately be described as a special form of first-party insurance; special because the indemnity claim of the insured is contingent on the fact that another party — an executive — is found to have acted negligently or disloyally. It is difficult to see why a corporate entity would have a reasonable interest in such protection, always provided that deterrence is not the issue. A corporation that is risk-averse will want to protect its financials against any loss, regardless of whether it was caused by appropriate behavior of its executives or by their negligent or disloyal behavior. If the current form of D&O insurance were abolished, then the demand for such types of loss insurance would come to the fore. It would remain to be seen whether insurers find ways to meet this demand while at the same avoiding or curtailing the dangers of adverse selection and moral hazard.

The more moderate alternative would not abolish D&O insurance in its current form, but rather synchronize the damages claim of the corporation against its management with the terms of the insurance policy that the same entity has contracted for. The claim for damages would exist only in amounts up to the ceiling of the insurance policy. Damages beyond the ceiling would be capped so that neither the insurer nor the executives who caused the harm could be held responsible. In such a system, the decision as to the amount of the insurance coverage is for the corporation to make. Of course, this is precisely the state of affairs that exists today. After all, it is the corporation that buys insurance coverage and pays the premiums due under the policy. The only difference relative to the current system would be that damages claims that go beyond the insurance coverage would be extinguished. Given the limitations on attempts to recover substantial sums in damages from

---

110 Supra Section III.C.
111 Supra Section IV.B.
negligent management, the corporation does not stand to lose much if the personal liability of its executives is tied to the limit of coverage that was negotiated with the insurer.

**CONCLUSION**

The goal of this Article was to rethink executive liability from first principles. In doing so, the analysis committed to the view, possibly radical, that executive liability is about deterrence, and about nothing else. If the deterrence function of liability is the only concern worth caring about, then the scene can be cleared of remnants of the compensatory function. In their place, it is possible to devise a system of executive liability that is focused on generating the right incentives. In doing so, it is essential to put managers into a situation that is essentially similar to that of an individual (single) owner of the business, while coincidentally avoiding the drawbacks of risk-averse decision-making.

With a view to these goals, the analysis settles on a system that combines limited liability of managers with uninsurability. The amount of personal liability should be the mirror image of contingent compensation, i.e., it should be proportionate not to the gains, but to the losses associated with a particular decision. In a perfect world, both contingent compensation and executive liability would exist in identical shares of total gains and losses that accrue to or are suffered by the corporation. The second essential feature of limited personal liability is that it is uninsurable, i.e., cannot be insured, so that the damages hit executives personally, in their own wallets. It is this element that opens up the possibility for the liability system to be effective with comparatively small amounts. D&O insurance, in its current form, is no longer needed. To the extent that there is a true demand on the part of corporations to insure against losses incurred in the ordinary course of business, it can easily be satisfied in the market for first-party insurance. The shift away from third-party and into first-party insurance would free up executive liability from the constraints of the compensatory principle and make it possible to turn it into a tool for incentivizing executives to further the interests of the shareholders and of society at large.