Preface

On 10th March 2017, Thy Pham was awarded a Ph.D. by the Erasmus University Rotterdam for her study on 'Directors' liability. A legal and empirical study', supervised by Professor B.F. Assink, Professor L. Timmerman and Dr. T.F.C. Fischer.

Directors' liability is a popular theme in Dutch legal literature, although often missing empirical research. In her thesis Pham makes a valuable contribution to the literature by focussing on directors' liability as a system of sanction and protection for corporate governance. As a result, the thesis provides new legal and empirical insights in the behavioural dimension of directors' liability.

The chief merit of the dissertation is the connection between doctrine and practice. Pham employs multiple methods to reach her conclusions: case study conducted among 54 senior directors, legal and social literature study, qualitative and quantitative analysis of (case) law and legal comparative analysis (Delaware and Dutch company law). Three areas of research are distinguished: 1) defensive behaviour among company directors, 2) serious reproach as the analytical framework for reviewing directors' liability in the context of art. 2:9, 6:162 and 2:138/248 DCC, and 3) directors' 'good faith' as a basic condition for valid discharge claims.

Pham shows that directors' liability may be a concern for bona fide directors. In particular, directors facing bankruptcy and corporate fraud may perceive liability risks as real, threatening and a source of defensive behaviour. Taking into account that in 85% of the court cases which were analysed in the research involved a company's bankruptcy, directors' liability threat perceptions are not unjustified. Interestingly, Pham shows in the present study that bankruptcy was not statistically a significant factor for courts to assign or reject directors' liability. From a corporate governance perspective, Pham therefore argues that courts have an important role in providing clear communications about the circumstances in which a director does and does not incur liability.

Using 'serious reproach' as the analytical framework, an extensive study of case law resulted in a model indicating the most influential factors for courts to judge a director personally liable. A substantive part of cases under study ended with a court finding a director personally liable due to 'subjective bad faith' action. In cases *not* involving directors' 'subjective bad faith', Pham shows that the lens of judicial review focuses mainly on two factors which appear to be

influential and form a strong basis for judgement. They are: violations of norms specifically addressed to the director and meant to protect the company or the company's creditors and shareholders, and directors' foreseeability of damage to the company or the company's creditors or shareholders.

Combining comparative and empirical insights, Pham identifies poor corporate governance in the area of discharge from directors' liability. Empirical findings show that there was not one Dutch case under study in which a director was not held liable for acting in 'subjective bad faith'. This finding stands in stark contrast with existing doctrine, which suggests that a director may be discharged of personal liability for intentional harmful actions towards the company as long as these litigious actions were 'known actions' to a company's general shareholders' meeting. By analysing Delaware's case law on section 102 (b)(7) DGCL and comparing it with Dutch case law, Pham argues that it is poor corporate governance for a legal system to communicate ex-ante that its court will respect discharge resolutions shielding directors' actions in 'subjective bad faith'. Pham instead advocates to demand directors' 'subjective good faith' as a basic condition for good corporate governance.

This dissertation is multidimensional, thorough and innovative. It is written in an accessible style and contains strong analysis and arguments. It is our great pleasure to introduce this dissertation in the series of the Institute for Corporate Law.

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Chapter 1. A window on the research

1.1 The motivational basis of the research

Willemsen Beheer v. NOM came at a critical time in Dutch corporate governance. At the forefront of the current global financial crisis, the Dutch Supreme Court held in a directors' liability case that: 'it is in the best interest of the company that directors are prevented from undesirable defensive considerations when they discharge their obligations.'[1] Underlying this court decision is the assumption that taking risks is warranted to better the profitability and continuity of a company. If this claim holds true, stakeholders should favour governance mechanisms that allow bona fide directors to undertake risky projects and accept a high directors' liability threshold.

I have taken the Supreme Court's assumption in *Willemsen Beheer v. NOM* as the starting point of this research to study directors' liability as a corporate governance instrument, an instrument to control directors' behaviour. The disposition of directors' liability within the context of corporate governance allows me to view directors' liability as a cohesive system of sanction *and* protection against directors' liability risks. I was greatly inspired by some of the socio-legal works elucidating the various dimensions of law and legal sanction as well as several empirical works at the intersection of sanction and trust. Indeed, I have considered these works as important stepping stones to undertake a legal and empirical research on the topic of directors' liability as a system of sanction and protection.

1. Supreme Court, 20 June 2008, ECLI:NL:HR:2008:BC4959, par. 5.3 (*Willemsen Beheer v. NOM*). The same rationale of posing a high liability standard – serious reproach – to establish directors' liability as a means to avert undue risk-aversion to the detriment of the company's stakeholders was expressed in Supreme Court, 9 May 2014, ECLI:NL:HR:2014:2628, par. 3.5.2 (*Hezemans Air v. Van der Meer*) and Supreme Court, 5 September 2014, ECLI:HR:2014:262, par. 4.2 (*RCI Financial Services v. Kastrop*); ditto with respect to directors' liability in the event of bankruptcy as was expressed in the parliamentary history (House of Representatives of the States General 1983-1984, p. 4).

1.1.1 To punish and not to punish

The impact of directors' liability is often measured by its enforcement capability and the effects of legal sanction. While some legal scholars have argued the limited effects of legal sanction on directorial behaviour,[2] others in contrast, have emphasised the need for legal sanction to hold directors accountable for adherence to their duties. 'Would-be offenders may be responsive to the reputational sanctions of social censure, embarrassment, and shame that often flow from legal sanctions'.[3] Indeed, Fairfax rather challenges those who stay aloof of recognising directors' liability as a means to accomplish that goal.[4] Others contend trust to be pivotal in encouraging directors to serve the interests of their companies responsibly and faithfully. For instance, Blair & Stout argued that legal sanction disrupts trust and prevents directors from activating 'other regarding behaviour'.[5] Ripstein discussed how legal sanction may decrease trust because it introduces grounds for distrust.[6] However, distrusting a director is preferred over mistrusting a director.[7] Legal sanction may reassure a potential trustor that it is relatively safe to trust and that even in the worst case scenario, he or she will not suffer intolerable high damage.[8]

In an experiment, Fehr & List[9] examined how Chief Executive Officers (CEO's) respond to the threat of sanction in situations requiring trust and trustworthiness. Interestingly, their research showed that the CEO's in the study responded in a less trustworthy manner if faced with an explicit threat of punishment. Trustworthiness was shown to be lowest if the threat of sanction was implemented. However, the availability of the sanction threat generated hidden returns: when an actor refrained from the sanction threat, the other person displayed a more trustworthy behaviour than in a situation in which there was no threat at all. Strikingly, trustworthiness was shown to be highest if the threat of sanction was available but not implemented.

The above-mentioned research results provide important insights. I have drawn the following lessons for my own research. First, it is pivotal to understand how directors *perceive* directors' liability risks and director protective shields to understand their potential responses to threats of personal liability. Second, the latent potential of legal sanction and the deliberate non-use of legal sanction seem to be of significance to reduce the possibility of opportunistic behaviour

2. Eisenberg 1999; Spier 2011, p. 14.
3. Baker & Griffith 2010.
4. Fairfax 2005, p. 393-456.
5. Blair & Stout 2001, p. 1735-1810. See also Sitkin & Roth 1993, p. 367-392.
6. Ribstein 2001, p. 553-590.
7. O'Neill 2002, p. 70.
8. Luhmann 1979, p. 36.
9. Fehr & List 2002.

on the part of a director. I have appreciated these research findings in their suggestion that directors' liability legislation, in its potential as a corporate governance instrument, should involve sufficient threat perception on the part of directors while allowing them to reduce excessive risks of litigation; the latter being equally critical to prevent directors from shirking their responsibilities out of fear of being sanctioned.

Defensive behaviour

I have interpreted the experiment and research finding of Fehr & Liszt as suggesting that one of the alternatives to control opportunistic behaviour may lie in the latent functioning of legal sanction − the availability of legal sanction and the non-use of it. The latent function of legal sanction may however be more accurately understood if directors' perceptions of and attitudes towards directors' liability risks are taken into consideration rather than the likelihood that those hazards will harm them. Accordingly, Chapter 2 is devoted to the study of defensive behaviour in relation to directors' personal liability threat perceptions and involves four main research issues. First, directors' perceptions of liability risks, second, directors' fear of liability risks and potential response with defensive behaviour, third, the (un)problematic nature of defensive behaviour, and fourth, directors' evaluation of director liability shields.

1.1.2 Recognising the dimensions of directors' liability legislation

Directors have a distinct position of authority involving power that occurs in institutionalised form.[10] Directors exercise of power rests in legal arrangements − collectively binding arrangements − which constrain opportunistic behaviour.[11] Directors' liability functions as a keystone within the institutionalised arrangement. Perhaps the most conventional concept of directors' liability is its potential to constrain and regularise behaviour. Sociologists have characterised this type of control as involving regulative control of behaviour.[12] In the attempt to influence directors' behaviour, directors' liability would involve specific rules which can monitor whether they were complied with, and can be enforced with sanctions. In a regulative understanding of directors' liability in which conformity to rules is emphasised, enforcing sanctions against deviant behaviour is pivotal.[13]

10. Gerven (1983, p.8) speaks of 'hierarchs' conferred with decision-making power which allows them to govern over interests that go beyond self-interest; Slagter & Assink (2013, p. 920-921).
11. Lane & Bachmann 1997, p. 226-254.
12. Scott 1995, p. 35; Beale & Dugdale 1975, p. 45-60.
13. Scott 1995, p. 50.

Director duties are typically open-ended, however. Timmerman has argued that director duties involve discretionary decision-making and cannot be 'regularised' or seized in specific rules.[14] Furthermore, Assink has argued that directors may be seen as role performers.[15] Their conduct is *ipso facto* susceptible to enforcement. Directors may face legal sanction by reason of failure to perform their role in its specific context, not merely because the director concerned had not complied with specific rules.[16] Accordingly, directors' liability legislation may not be accurately viewed as solely regulative and coercive, but may also be considered as involving normative and cognitive attributes.

The assumption described above may find empirical support. In a Cambridge study, over sixty firms in the mining machinery and kitchen furniture industries operating in Germany, Britain and Italy were randomly selected. Lengthy interviews were conducted to understand the institutional characteristics of the different business systems. The researchers found that norms and sanctions may have important normative and cognitive value in the sense that they may afford individuals reliable frameworks of appropriate behaviour on which to base their interactions with one another without having to overly resort to self-protection. The research revealed the informative source of legal norms and their ability to create shared knowledge about expected behaviour and their effectiveness to foster trust.[17]

I have regarded the Cambridge research as providing important insights for understanding the potential of directors' liability to control directors' behaviour. First, it is important to recognise the various dimensions of directors' liability in providing stable patterns of generally accepted behaviour. Directors' liability may exert control by prescribing norms of what directors are 'supposed to do', or should 'avoid doing' given their designated role and authority (also termed normative control).[18] In addition, directors' liability may involve frames describing routines, scripts, or 'ways in which things are or should be done' that would make sense in a given situation. Such common frames are informative and allow directors to relate specific behaviours to specific situations (also termed cognitive control).[19] Second, if normative and cognitive control are deemed important attributes of directors' liability, judges play a significant role

14. Timmerman 1992.
15. Assink (2010, p.1) emphasised the important function of company law to reduce complexity by prescribing expectations of directors' role performance.
16. See also Berger & Luckmann 1966, p. 74.
17. The research resulted in several papers, among others Arrighetti, Bachmann & Deakin 1997; Burchell & Wilkinson 1997; Deakin & Wilkinson 1998, p. 146-172.
18. Scott 1995, p. 38.
19. Zucker 1988, p. 23-52; Lord & Kernan 1987, p. 265-277; March & Olson 1989, p. 23 (March and Olson apply a broad concept of norms including guidelines, standards, routines, best practices and programmes).

in contributing to and communicating stable patterns of behaviour which are either beneficial, wasteful, or damaging, and should be avoided. As directors' liability is primarily shaped in case law, courts play an influential role in controlling directors by articulating acceptable and non-acceptable courses of action. Third, if courts are able to provide powerful structures explicating expectations of directors' responsibilities and liabilities in their respective roles in given situations, there may be less need for undue self-protection; of those exerting decision-making power and of those who make themselves vulnerable to directorial discretion.[20] In the end, the best protection a director may have, might be transparency and predictability in possible courses of action to stay aloof of liability risks.

The threshold of 'serious reproach'

Informing individuals about common understandings of directorial responsibilities and liabilities may reduce complexity and increase predictability. One way to do this may be to clearly communicate a threshold. Such a threshold may specify problematic and intolerable behaviour on the part of a director and direct orientation towards explicit consideration of legal sanction.[21] The liability standard of 'serious reproach' [ernstig verwijt] may embody such a threshold. Chapter 3 is therefore devoted to establishing the importance of courts in reducing uncertainty as regards the factors determining directors' personal liability. More specifically, I focused on studying case law involving directors' liability litigation qualitatively and quantitatively to discover the most significant factors for Dutch courts to hold a director personally liable and determined the consistency and predictability in legal decision-making.

1.1.3 The importance of legal sanction

In the Netherlands, the framework of directors' liability is based highly on trust in directors. First, boards of directors are trusted with the ultimate responsibility to manage or direct the management of the business and affairs of their companies. In managing and directing the company's business, they are trusted to

20. See also Zucker (1986, p. 54-111) who has argued that trust between social actors is more likely to occur where reliable norms of behaviour makes future behaviours more predictable than in situations where these rules do not exist or demonstrate deficiencies.
21. Luhmann 1979, p. 74 (the important function of centralizing sanction has been argued to break the circle of increasing distrust to turn into 'unmanageable cases. Sanction and distrust can be seen as internal controls of a legal system and prevents that a system may be immediately destroyed when trust is breached).

govern over the company's interests, which goes beyond self-interest.[22] Second, in the exercise of decision-making power and in balancing the interests of the company and its stakeholders, it is a prerogative that decisions made are not second-guessed by judges. As a principal, discretion is recognised and substantive judicial review is replaced with marginal judicial review.[23] Trust manifests in the belief that undertaking an enterprise requires a degree of autonomy of action: to act with prejudice to some stakeholders, or to the benefit of other stakeholders in a given situation, to take high risks and make erroneous decisions, sometimes with detrimental consequences. As long as these actions are within the boundaries of their discretion and involve due care considerations, directors are given the benefit of the doubt.[24] Hence, directorial discretion and marginal review may be assumed to imply trust in directors. This raises the question of how legal sanction relates to trust.

In an empirical research involving a study among employees in several European countries, Weibel et al. explored whether formal control was positively or negatively related to employees' trust in the organisation.[25] The researchers did not find evidence for the hypothesis that control was negatively related to trust. Interestingly, they did find that all forms of organisational control, output, behaviour control and sanctions, were significantly positively related to employees' assessment of the trust they have in their organisation.[26] Lack of control, having double standards and not sanctioning deceitful behaviours were seen to result in organisational untrustworthiness.[27] The research revealed how formal sanction was a central theme for the respondents. Respondents indicated that companies that fail to sanction deceitful behaviour or condone such behaviours, create significant problems across a business ('a cycle of deviant behaviour'). These findings were suggested to imply a 'sequence for organisational trust, with the behaviour of directors setting the scene for other employees and other groups.'[28]

I have regarded the above-mentioned research findings of considerable importance. It can be argued that in the context of directors' liability, actively implementing legal sanction may in certain situations be of great significance.

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22. Barber (1983) has also termed these responsibilities as involving fiduciary responsibilities. Although in the Netherlands the legal concept of fiduciary does not exist, directorial authority assumes trust in directors in the sense that directors are charged with acting and representing the interests of the company (Timmerman 2004, p. 11-12; Slagter & Assink 2013, p. 920-921; Dijk & van der Ploeg, 2007, par. 8.6.1 indicating a trust relationship between a director and the foundation).
23. See for a critical discussion on marginal judicial review Assink & Kroeze 2010, p. 11-32.
24. Timmerman 1992.
25. Weibel 2009.
26. Weibel et al. 2009, p. 26.
27. Weibel et al. 2009, p. 25.
28. Weibel et al. 2009, p. 26.

Directors' liability may not prevent directors from wrongdoing. It may, however, ascertain that if discovered and identified, these directors do not go scot-free. As was suggested by Weibel et al. implementing legal sanction against such directors may foster trust in business. Moreover, it may foster trust in the legal system as trust may not merely be placed in individual directors but in the functional elements of the legal system.[29]

Discharge from directors' liability

The suggestions made by Weibel et al. stand in stark contrast with the existing Dutch legal doctrine on discharge [décharge] from directors' liability for acts carried out in bad faith. Where their research findings indicate that directors' good faith is important to foster trust in and across businesses, standing case law in the Netherlands shows that a valid discharge granted by a company's general shareholders' meeting may shield directors from liability claims arising from serious reproachable conduct, including intentional harmful conduct, under the condition that the general shareholders' meeting was knowledgeable of the litigious action which can be traced from the company's annual accounts or other information provided to them.[30] Chapter 4 is therefore devoted to the study of the Dutch discharge in the light of good corporate governance and involves an exploration of directors' good faith as the baseline for courts to allow a discharge resolution to have legal effect.

1.2 What this book is (not) about

Traditionally, directors' liability legislation has been argued to serve two main functions: allocation of damage and control of behaviour.[31] The first function involves the question of who (the director or the injured party) will pay (for what part of) the damage.[32] Or more broadly, who will bear the financial risks of directors' actions – the director, the company, third parties of the company or insurers, in full or part?[33] Indisputably, this is an important question with lots of money involved. However, it was not the driver of this book. The driver

29. Luhmann 1979, p. 22 (identifying trust that extends beyond personal trust as involving system trust). See also Maas-de Waal, Dekker & Van der Meer 2004, p. 17-23 (distinguishing interpersonal and institutionalised trust).
30. Dutch Supreme Court, 10 January 1997, ECLI:NL:HR:1997:ZC2243, par. 3.4.1 (*Staleman v. Van de Ven*); Dutch Supreme Court, 20 October 1989, *NJ* 1990, 308, par. 3.2 (*Ellem v. De Bruin*); Dutch Supreme Court, 25 June 2010, ECLI:NL:HR:2010:BM2332, par. 4.2 (*De Rouw v. Dingemans*).
31. Baker & Griffith 2010 p. 6 (distinguishing two independent rationales, compensation and deterrence); Kroeze 2004, p. 226-233. See also Slagter & Assink 2013, p. 1003 (distinguishing between the function of allocating damages and influencing behaviour).
32. Van Schilfgaarde 1988, p. 264.
33. Baker & Griffith (2010, p. 6-8) speak of 'pocket shifting'.

of this book is the second function of directors' liability legislation, the control of directors' behaviour. In studying the potential of directors' liability legislation to control directors' behaviour, I went beyond the traditional legal view of directors' liability as predominantly regulative and coercive. This allowed me to understand directors' liability as an intricate system of sanction and protection and to consider the explicit and latent characteristics of directors' liability. The motivational basis of this book was discussed in paragraph 1.1.

I have mentioned that I have divided my research into three blocks. This book therefore consists of three pieces of research. Each piece of research is devoted to a specific research issue and can be read separately (Chapters 2, 3 and 4). Although I discuss the underlying research methodology in each of the chapters, it is important to note here that this book is in large a product of legal and empirical research. This has the important implication that while I studied positive law, legal doctrines and legal literature, and recognised the virtues that apply to traditional legal research, they were not the primer on which I based my findings nor the main method through which I reached my conclusions and propositions. Law in action and qualitative and quantitative empirical legal methods have provided me with important resources. Specifically, directors' perceptions and attitudes towards directors' liability risks (prevalent in Chapter 2) and the courts' perceptions and assumptions as represented in court decisions involving directors' liability litigation (prevalent in Chapters 3 and 4).

1.3 Structure

The perspective of this research lies in understanding directors' liability as a system of sanction and protection with regard to its addressee – the director. In the realm of Dutch company law, claimants are required to satisfy a high liability threshold to hold a director personally liable.

I have started the research from the assumption that bona fide directors should not fear directors' liability risks and resort to unnecessary defensive or protective measures. In the first part of the research it was found that bona fide directors may exaggerate the consequences of directors' liability risks and may respond defensively when faced with potential liability risks due to uncertainty as regards the norms that judges, ex-post, may apply when assessing directors' courses of action (Chapter 2).

In the second part of the research, I took the uncertainty of judicial decision-making as the point of departure and analysed case law qualitatively and quantitatively. The concept of 'subjective bad faith' was used to distinguish

'unproblematic' cases in which courts seem likely to adjudicate a director personally liable from more 'complex' cases involving uncertainty as regards courts' judgement. It was found that in the 'complex' cases (cases *not* involving directors' 'subjective bad faith'), courts nonetheless reached judgement fairly consistently. Moreover, it seems that only a few compelling legal case factors exhibited significant predictive value with regard to judgments involving a director's personal liability. Where a court, in a 'complex' case found that a director could be made a serious reproach and judged the director concerned personally liable, I have interpreted the director's action as conduct 'lacking good faith'. Where a court, in a 'complex' case had refused to hold a director personally liable, I have interpreted the director's conduct as involving 'good faith' (Chapter 3).

The third and final part of the research was focused on exploring court cases involving directors' 'bad faith' in connection with discharge provisions. In these specific court cases, directors have invoked the protection of a discharge in an attempt to shield their personal liability of 'bad faith' actions. In analysing these cases, I have distinguished directors' actions involving 'subjective bad faith' from those involving 'lack of good faith' in order to discover whether the difference in serious reproachable conduct may play a role in the outcome of a specific court case. The result of this research indicated that this was not the case. It was found that courts were unwilling to allow discharge provisions to cover 'bad faith' actions, regardless of the type of serious reproachable conduct. Where doctrine and empirical finding stand in contrast, I argued there should be a critical debate on the existing concept of discharge. Moreover, looking critically at the data, it was possible to distinguish between directors' 'subjective good faith' and 'objective good faith' as regard discharge. Directors' actions performed in 'objective good faith' do not amount in serious reproachable conduct. Therefore discharge was effectively not a problematic issue in these cases. Directors' actions performed in 'subjective good faith' may however be qualified a serious reproach. Discharge then also may raise legal debate. As an alternative to the existing doctrine, I finally suggested on the basis of *Ellem Beheer v. De Bruin* and *De Rouw v. Dingemans,*[34] that directors' 'subjective good faith' should be the baseline to review discharge claims. On the whole, whatever the legal motivation of the scope of discharge may be, this research brings the empirical insight that only bona fide directors are freed of personal liability (Chapter 4).

The research closes by providing reflections on how the research findings relate to some existing debates and developments in the domain of directors' liability (Chapter 5).

34. Supreme Court, 20 October 1989, *NJ* 1990, 308 (*Ellem v. De Bruin*); Supreme Court, 25 June 2010, ECLI:NL:HR:2010:BM2332 (*De Rouw v. Dingemans*).

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