

Summary

Making the executives pay

Empirical research on decisions about issuing director liability claims against (former) executives

Background and problem statement

Over the past few years, there have been several instances where national monitoring agencies or the Dutch government itself has had to step in to save or to restructure corporations or semi-state-controlled organisations on the brink of financial collapse as a result of mismanagement. One of the recurring issues in the ensuing parliamentary debate was how to take action against failing executives and internal or external monitors. In a letter to parliament, the then Minister of Justice, Hirsch Ballin, promised further investigation into the matter (*Kamerstukken II 2008/09*, 31 386, nr. 18). The present research is a direct result of this commitment. It focuses on the internal liability of executives, members of supervisory boards and/or internal monitors (ex Article 2:9/6:162 BW). We have examined cases in which organizations have held their own current or former executive officers and/or internal monitors liable for severe financial losses. Our problem statement is based on the assumption that there must be other cases in which there is sufficient evidence for holding executives or internal monitors liable for financial losses without legal action being taken.

The problem statement of the research is as follows:

What are the possible reasons for not holding current or former executives and internal monitors internally liable for the damage caused by the improper performance of duties in cases where there is sufficient ground to do so?

The above resulted in the following research questions:

- 1 What are the reasons for those authorised to hold executives and/or internal monitors liable to either bring legal action or to refrain from doing so? What are the considerations involved in deciding whether to institute liability proceedings?
- 2 Are there different considerations at play in semi-state-controlled companies compared to private companies when it comes to initiating liability proceedings?
- 3 What are the differences between cases where current or former executives and/or internal monitors were held internally liable and cases where this did not happen?

For the purposes of this report, ‘holding someone liable’ is defined as initiating civil court proceedings or submitting a case to arbitration with the aim of recovering the damage caused by the improper performance of duties on the part of executives or internal monitors. This means that civil claims that were abandoned or withdrawn before a final decision was reached are also included in this category.

Liability proceedings initiated by external parties (such as creditors) or individual employees or shareholders fall outside the scope of our research. The same applies to inquiry procedures initiated by the court as well as cases involving the death of companies as a consequence of bankruptcy.

Research methods

Case studies

This report is centred on our analysis of eleven cases: six involve companies that were prepared to initiate liability proceedings and five concern companies that decided against such a course of action. These cases represent both the private and the semi-state-controlled sector. Interviews were conducted with various individuals in order to analyse the considerations at play concerning the decision as to whether to file a liability claim. For instance, we interviewed persons involved in the decision-making process regarding such claims. These were mostly interim or permanent executives, members of the new or old supervisory board, and corporate lawyers. In addition, we interviewed a number of government officials and staff of government-related institutions. We also interviewed an executive who had been held liable. In all, 27 case-related interviews were conducted with 33 respondents.

Additional methods

In addition to case study analysis, a study of the literature was carried out, and meetings were held with experts and members of supervisory boards. The expert meeting took place at the start of the research project, and was attended by eight experts in the field of executive liability. The meeting with board members was organised in the concluding phase of the project, and was attended by six persons currently active as board members or internal monitors in various large private and semi-state-controlled companies. To make an assessment of the frequency of internal liability procedures being filed, we also examined existing case law. To this end, we searched two legal databases covering the past ten years for published court decisions on cases in which a legal entity filed an internal liability claim against a current or former executive and/or internal monitor.

Report

All information was provided on condition of anonymity. The present report mentions only examples and relevant circumstances that cannot be traced back to the cases we examined.

Findings

Number of internal liability procedures

It is difficult to estimate how often internal liability procedures are initiated in the Netherlands. Our inventory of published court decisions showed that, over the past ten years, sentence was passed in seventy different cases concerning the liability of current or former executives and internal monitors of companies that are still in existence. This number represents the lower limit, since not all judicial decisions are published and the number of arbitration awards is unknown. Questions as to whether this legal course of action should have been followed more often are of a normative nature, and can therefore not be answered in the present context.

We were able to identify several considerations behind the decision as to whether to start formal procedures based on Article 2:9 BW. The literature and the case studies, as well as our interviews, all show that there may be good reasons for companies to decide not to initiate internal liability procedures against executives or internal monitors for damage caused by their improper performance of duties. However, abandoning the option to hold someone personally liable in a formal procedure does not mean that no further action will be taken against the former executive.

From our study of the literature, four themes emerged that can play a role in the decision as to whether to institute liability proceedings. The findings of our research regarding each of these themes are described below.

The perception of legal possibilities and their limitations

In accordance with earlier studies, the ‘costs’ involved in a civil procedure – in terms of money, time, and effort – appear to be a major factor in almost all cases regarding the decision concerning legal action. The overwhelming majority of our respondents indicated that liability procedures are very costly and time-consuming and that the chances of winning a case and recovering the damages are low. This was also seen as a major drawback in those instances where liability proceedings had actually been initiated.

When they considered the ‘costs’ of liability claims, our respondents also mentioned several other ‘debit entries’. Firstly, they noted that instituting legal action based on Article 2:9 BW could result in a ‘disadvantageous confluence’ with other legal procedures. Secondly, they noted that current or former executives and/or internal monitors involved in instituting liability pro-

ceedings run the risk of being held liable themselves: for instance, for failure to exercise proper supervision.

The reputation of the company and the relations with business partners

As expected, the respondents also weigh the consequences for the reputation of the company when deciding whether to file a liability claim. This is consistent with earlier research, which suggested that reputation damage is a major consideration in the decision not to initiate legal proceedings (see e.g. Van Erp, 2009a). However, in our interviews with the respondents, potential reputation damage was not only cited as a reason for *not* filing a liability claim: legal proceedings are sometimes instituted precisely in order to avoid reputation damage to the company. By initiating liability proceedings against a former executive, a company can send a clear signal to employees and business partners. It was for this very reason that the stakeholders in a number of semi-state-controlled companies asked for legal action to be taken.

In some cases, fear of *personal* reputation damage was mentioned as a reason not to initiate legal proceedings. In other cases, personal reputations were mentioned as a reason for doing the opposite, because not taking legal action could result in reputation damage (Jensen, 2006).

In line with earlier findings (Macaulay, 1963; Jettinghof, 2001; Van Erp, 2009a), our respondents also pointed out that a mutually agreeable settlement of disputes is often preferable to initiating legal action: for example, for reasons of confidentiality.

Interpersonal relations within the company

Several authors (Westphal & Khanna, 2003; Dallas, 1997; Lorsch & MacIver, 1989) have pointed to the fact that the existence of social and interpersonal relations between the dominant actors within a company can have an effect on the decision not to initiate liability proceedings. It appears from the cases we examined that, in various ways, considerations of an interpersonal nature do indeed play a role in this type of decision.

Loyalty towards an executive may result in the decision not to file a claim against him. Some respondents took the view that the departure of an executive should be punishment enough, given the repercussions on his reputation and career prospects. Several statements made by our respondents pointed to a strong identification and/or close personal relationships.

The existence of an 'old boys' network' reportedly also stands in the way of liability claims. It is often said that the negative consequences of liability proceedings are reason enough to dissuade the relevant decision-makers from bringing matters to a head. However, most respondents and participants in the expert meeting and the meeting with board members dismissed the idea of an 'old boys' network'. It appears that the 'old boys' network' of executives and internal monitors protecting each other no longer plays a dominant role (Fennema & Heemskerk, 2008).

In a number of cases, a breach of confidence appeared to have had an effect on the decision to initiate proceedings. In these cases, the ‘deciders’ were offended by the idea that the executive had betrayed their trust or had lied to them. The fact that the two parties had once known each other well provided an added incentive to pursue legal action.

Moral considerations

Moral considerations in terms of ‘punishing’ the executives or achieving a preventive effect also influence the decision as to whether to file a liability claim (Eshuis, 2003; Bovens, 2010). In almost all cases in which legal proceedings were initiated, such considerations turned out to have played an important role in the decision. Many of the respondents who had instituted legal action considered their dispute with the former executive or internal monitor to be a *matter of principle*, and they were therefore quite willing to pay for the costs of legal proceedings. In the case of several semi-state-controlled companies, setting an example for the entire sector was a major reason to initiate liability claims.

Unlike the use of criminal sanctions, liability legislation is not intended to be punitive. Yet, surprisingly often, our respondents brought up the punitive aspect of liability proceedings, even though it was usually not the deciding factor. Moral indignation and the desire to punish were particularly prominent in cases of personal enrichment by executives.

Conclusion

In practice, there may be good reasons not to use Article 2:9 BW to institute liability claims proceedings in situations where it would be applicable. Sometimes, more is lost than is gained by initiating a procedure based on Article 2:9 BW. However, when companies decide not to bring civil liability claims, it does not mean that failing executives or internal monitors are being protected by their peers. The pros and cons of filing a liability claim are carefully weighed by the decision-makers, and the result may be that there are compelling grounds not to initiate legal proceedings, even in cases where the chances of success would have been high.