Why Do Corporate Charters Waive Liability for Breach of the Duty of Care?

Holger Spamann

Harvard Law School

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Charters routinely waive monetary liability for bad business decisions by directors and managers (cf. DGCL 102(b)(7))

- if they didn’t, business judgment rule (BJR) would by default
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▶ Implications: desirability is context-specific (e.g., charities)
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- Simple cost-benefit argument
- Implications: desirability is context-specific (e.g., charities)
- Unified theory of duties of care & loyalty (continuum)
Argument in a nutshell

I always use free information
Known exceptions don't apply here
Courts (discovery) generate lots of information
E.g., alternative projections, negotiation notes
Use needs to be calibrated, but caps etc. can do that
But the cost-benefit tradeoff is (usually) unfavorable
Benefit of extra information low
Existing info good: stock price etc.
Extra info mediocre (courts = business experts)
Cost possibly high (opportunity costs of witnesses)
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  - but not harmful either
Basic Argument: Intuition

Two ways to think about additional signal:

- **Precision**: (weighted) average of two signals is more precise than either one of them
  - for same amount of information, less noise

- **Diversification**: two signals’ noises partially cancel out
Comments on the basic argument

Risk aversion

irrelevant: works with or without it

in particular, extra information allows exposing agent to less risk from equity volatility etc.

Risk-taking incentives

improved as well

liability for not taking risks (arguably, Smith v van Gorkom)

holds even if court intervention only triggered by bad outcomes

courts make mistakes (cf. perturbation argument)

Calibration

is crucial: outsized liability not good

cf. Engert & Goldlücke 2014: BJR possibly optimal if size of liability fixed
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Cost-Benefit Analysis: Overview

Basic argument leads to cost-benefit trade-off: using free signal is optimal, but

- signals aren't free (court costs)
- their benefits may be small
Benefits small: 1) little slack

The smaller the gap between principal and agent incentives, the lower the benefit from additional information.
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- Governance mechanisms further limit slack
  - elections
  - reputation
  - takeovers
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Contractual relationship!
Benefits small: 2) little information

More than elsewhere, courts in the dark.
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- Unlike in medicine etc., *no benchmark* for right decision
  - one-off nature of business decisions: running to stand still
  - cf. HBS: teaches “judgment” ...
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- Decision-making procedure
  - imperfect proxy
  - predicated liability on it invites window-dressing
Costs: nothing special?

- [Direct litigation costs]
- Indirect litigation costs: D/O time defending/preventing litigation
  - scales with firm size, but so do benefits!
NB: General arguments for/against litigation

- Many.
- Apply to all litigation.
- Including litigation in contractual relationships (med mal etc.).
- But corporate litigation provides a larger bounty – attracts more bad litigation?
  - i.e., perhaps nothing particularly bad about corporate litigation, but with more at stake, more important to curb it?
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