Study on Directors' Duties and Liability

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Overview

The liability regime of executive and non-executive directors in companies constitutes a necessary corollary to control issues within a company. It is based on the determination of specific duties, it establishes the limits of management behaviour and it provides stakeholders and third parties dealing with the company with legislative protection against management misconduct. In that respect, directors' liability is an important and effective compliance and risk-allocation mechanism.

The European Commission has not, to date, considered directors' liability issues in a comprehensive way. It is the purpose of this study to provide the relevant information in a comprehensive manner, in order to support to European Commission to consider its future policy in this area. To this end, the analysis spans from national laws and case law to corporate practice in respect of companies' directors duties in all 27 EU Member States and Croatia.[1] The overarching goal is to provide for a better understanding of certain important drivers of directors' behaviour.

This study shows the extent to which the content and extent of duties and the corresponding liabilities, as well as the understanding of the persons to whom they are owed, fluctuate over the life of a company, i.e. during the "normal" phase of operation, and in the so called "twilight zone", i.e. shortly before insolvency. The study is mainly a stocktaking one. However, its comparative analysis also identifies similarities and differences between national regimes and identifies relevant cross-border implications.

Mapping directors' duties

Apart from taking stock of the national regimes in 28 detailed country reports (cf. Annex), this study provides a comprehensive comparison of those elements of the law that appear relevant to further policy decisions to be taken by the European Commission. The comparative-analytical part strives to identify similarities, differences and trends in the relevant national laws of Member States, and to aggregate that information in an accessible manner. The comparative-analytical part uses maps, allowing the user to easily grasp the core information on each of the relevant aspects. Extensive tables aggregating statutory and case law allow for quick reference and a critical discussion of the EU-wide treatment of each of the issues.

The findings in respect of the relevant issues are set out below, followed by an overall assessment of the current legal landscape governing directors' duties and liabilities in the EU.

Organisation and structure of boards in Europe

This study first analyses the differences in board structures used and available across the EU. Despite recent trends of regulatory convergence regarding board structures, there is still a significant degree of variation between the company laws of the EU Member States. The variation exists in the basic board structure (especially with regards to the distinction between one-tier and two-tier boards), as well as in relation to other aspects of company board make-up, such as election/nomination rights and the participation of employees. Differences in board structures can have a significant impact on both the extent and content of directors' duties and liabilities, as well as on the enforcement of these duties.

[1] In the following, the term 'Member States', for the present purpose, is understood to refer to the current 27 EU Member States and Croatia.

First, the structure of a company's board determines the main elements for the allocation of decision-making powers – and, consequently, responsibility for the decisions – within a company. Second, to the extent that a legal system (also) relies on enforcement of directors' duties through the company organs itself, a formal division of responsibilities between different types of board members may be seen as having the effect of creating incentives for holding managers to account.

Employee participation can play an important role in the effect that rules on directors' duties and liability have in practice. Twelve of the 28 countries examined grant employees some form of influence over the composition of the board. In most cases, employee representatives are not directly participating in the day-to-day management decisions, but rather in strategic planning and management supervision. There is a fair amount of variance among the systems of employee participation. The study finds that, throughout the examined countries, employee representatives on the board of directors are subject to essentially the same duties as other board members, although the practical application of such duties may somewhat differ across Member States. Also, this study finds that the participation of employee representatives in the managerial decision-making process strongly correlates with a less shareholder-centric understanding of the "interest of the company". This is of significance for the main subject of this Study, since the interests of the company, and the question whether or not board members have acted in the company's interest, plays a pivotal role in determining the accountability of board members across all jurisdictions examined by us.

Substantive law in respect of directors' duties

The comparison and analysis regarding the substantive law governing directors duties covers a wide range of material and procedural aspects, notably: (i) where and how directors' duties are addressed in the law – regulatory approach; (ii) who owes the duties and to whom – addressees of duties; (iii) how the interest of the company is defined; (iv) what represents the material content of the directors' duties – duty of care, duty of loyalty; (v) the nature of liability, covering in particular the extent to which an individual director is liable for decisions taken by the board; (vi) further, it describes the type of liability flowing from breaches of the duties, and limitations to the liability.

Regulatory approach. Member States' laws differ both with respect to the general approach to the regulation of directors' duties – based on a system of statutory rules or general principles of law (e.g., fiduciary principles or the law of agency) that are elaborated and amplified by the courts – and the level of detail with which the duties are laid down. Obviously, the first point relates to the well-known distinction between common law and civil law countries, although this distinction has lost much of its meaning in the context of directors' duties. As far as the second point is concerned, some jurisdictions provide for a largely exhaustive list of specifically defined duties, others rely on a general clause that defines the behavioural expectations of directors in broad terms. However, the two points are not parallel. Directors' duties may be uncodified but nevertheless distinguish between specific duties and attempt to regulate all relevant conflicts exhaustively. Or, the duties might be codified, however in the form of a very broad general clause. All legal systems draw on principles of general contract law, tort law, or fiduciary principles to supplement the company law-specific rules where necessary. Nowadays, in almost all countries, directors' duties are predominantly codified.

Notwithstanding a country's general regulatory approach, the analysis suggests that the law in most legal systems is elastic enough to allow the courts to derive solutions for novel conflicts that are not addressed by the statute. Furthermore, irrespective of the paucity or indeterminacy of the statutory sources of directors' duties, the content of the duties is nuanced and applicable to a variety of conflicts, provided that the courts have had the opportunity to build on the codified rules and develop the legal principles. As a consequence, the analysis concludes that, first, a fragmentary codification of directors' duties as such does not necessarily lead to an insufficient level of investor protection. Second, fragmentation and/or paucity may, however, suggest a higher level of legal uncertainty, at least until judicially developed rules are well established, which, in turn, may require time and the existence of procedural rules that facilitate access to justice.

Addressees of directors' duties. In all Member States the main addressees of directors' duties are the validly appointed members of the relevant company bodies, i.e. the de jure directors. However, the vast majority of Member States recognise that the duties owed by de jure directors should, under certain circumstances, also apply to other persons with a comparable relationship to the company and its stakeholders.

The first category concerns, in general terms, persons who act as if they were de jure directors, despite not having been validly appointed as such. This category can be further divided into, first, the rather uncontroversial cases of defective appointment: even the jurisdictions that do not formally recognise the application of directors' duties to such de facto directors typically resolve the matter by providing that any defects that may have attached to the process of appointment can be "healed" at a later point in time. Second, persons might simply *behave* as if they had been validly appointed, without such appointment ever being attempted. Most Member States also extend at least *some* of the duties to this type of director.

The most problematic category concerns persons who do not act as if they were de jure directors, nor purport to be directors. Rather, they exercise a certain degree of influence over the company's affairs that affords them a level of factual control comparable to the power that is typically vested in the board. This issue typically arises where a parent company, or its directors, take strategy decisions at group level. None of the Member States answers the question of whether the parent can be held liable in the same manner as the de jure directors of the legal entities they control with an unqualified "yes", not least because doing so would call into question the very concept of limited liability. Where Member States do provide for liability of legal or natural persons wielding significant influence over the company, the rules differ significantly in the degree of control and influence that may lead to the imposition of director-like duties on the parent company or its management.

Directors' duties are owed primarily to the company, i.e. to the legal entity and not to its shareholders. This basic principle is universally accepted and undisputed. However, in exceptional circumstances duties may be owed directly to shareholders, creditors, or other stakeholders.

Notably in the common law countries the rule is that directors owe their duties directly to the shareholders if a 'special factual relationship' exists between the director and the shareholders, for example where directors make direct approaches to the shareholders in order to induce them to enter into a specific transaction. In any case, this jurisprudence is restricted to the relationship between the director and the shareholders. Duties owed to creditors or to other constituencies, such as the employees, are not accepted in any of the common law jurisdictions, although the focus of the company's interests may shift from the shareholders to the creditors in the vicinity of insolvency.

Theoretically, in civil law jurisdictions, a direct legal relationship between directors, shareholders, and other constituencies may arise from an application of general principles of law, particularly tort law. The general tort law clauses that can be found in a number of jurisdictions may open that possibility as they provide for liability for any damage caused by intentional or negligent conduct. However, the courts restrict the use of the general clause, and in some of the jurisdictions general principles do not seem to play an important role in practice. In jurisdictions where legal tradition is usually characterised by narrower provisions these cannot be relied on as complements of the company law duties capturing general directorial misconduct, but they afford additional protection to shareholders and some other constituencies in particularly severe cases of wrongdoing like criminal offences. A third group of civil law jurisdictions distinguish laws between internal liability of the director to the company and external liability to shareholders or third parties. External liability usually requires conduct that goes beyond mere mismanagement or conflicts of interest and is triggered by a breach of specific legal requirements of the companies legislation or the articles of association, conduct that affects exclusively the rights of the shareholders, or the drawing up of misleading accounts.

Duty of care. The duty of care ensures that directors devote sufficient time, care, and diligence to managing the company, act only on an informed basis, possess the necessary skills and experience to make sound business decisions, and consider the likely outcome of their decisions carefully.

However, legal systems differ with regard to the precise behavioural expectations towards directors in this respect. At the same time, most jurisdictions recognise that directors may become risk averse if the liability risk faced by them is too high, thus forgoing investment opportunities with a positive net present value in favour of less risky alternatives. They try to counter this phenomenon with rules capable of avoiding hindsight bias, in particular by introducing business judgement rules or similar mechanisms. Yet, this response is not uniform.

As regards the first aspect, the behavioural expectations towards directors with a view to avoiding any deficient performance of management functions, the analysis splits into two aspects: the determination of the required standard of care and the allocation of the burden of proof for showing that the standard was met or, respectively, not met.

Three approaches are used in defining the required standard of care, the objective/subjective standard (strictest), objective standard (intermediate), and reduced standard (less strict). All but four EU jurisdictions provides either for the objective/subjective or the objective standard. In addition, the differences between the strictest and intermediate standards are small, and even the four jurisdictions using the reduced standard may move fully or in part to a stricter standard. Therefore, there is significant convergence in respect of this issue throughout the EU. However, this study finds that in spite of the theoretical convergence the perception of how the standard of care applies in practice differs widely in the Member States.

Regarding the burden of proof, the analysis focuses on whom it is imposed in relation to the most important aspect, notably the care taken by the director in making the business decision. While the burden of proof for other elements, for example the requirement that the company has suffered a loss, is often on the plaintiff, the level of care employed by the director is a function of processes that relate to board proceedings and the director's state of mind. Accordingly, they cannot easily be reviewed by the claimant, especially if the claim is enforced by the shareholders. The allocation of the burden of proof consequently assumes particular importance. However, the relevant laws of EU Member States differ: about half of them imposes the burden of proof on the director (i.e., that he or she acted with due care), whereas the other half imposes it on the plaintiff (i.e., that he or she has failed to do so).

The Member States show relatively little variation with respect to the questions of whether the applicable standard of care differs depending on the role and position of the director and the type of company. The statutory definition of the standard of care usually does not distinguish between directors depending on the role they perform and the position they occupy in the company. However, it is recognised in virtually all jurisdictions that even where the law contains only a general reference to the prudent businessman, it seems natural to require more of directors who work full-time and hold an important position in the company, such as chief executive or chairman of the audit committee, since the understanding of what constitutes 'prudent' or 'diligent' behaviour depends on the context. Yet, while the general approach to taking account of differences in the directors' professional experience, knowledge of, and familiarity with, the company is fairly similar, the study observes nuanced differences in the Member States. A topical example is the responsibility of a non-executive director who holds a key position in the company, for example chairman of the board or of the audit committee.

Member states' laws also show relatively little variation as far as monitoring duties of the directors and the consequences of a delegation of functions on the standard of care are concerned. Virtually all jurisdictions hold, either in the statute, in case law, or in the literature, that the delegation of tasks does not lead to an exculpation of the delegating director. The Member States differ, however, in the specificity and comprehensiveness with which they regulate the problem. This latter aspect of the duty of care has become particularly relevant in financial institutions, where the financial crisis exposed significant risk management failures in some institutions.

A further aspect in respect of the duty of care analysed in detail in this study is whether institutions comparable to the business judgment rule (originally adopted from US case law) have been implemented in Member States. The rule consists of a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. If this presumption is not rebutted by the claimant, the courts will generally respect the directors' business judgment. If the presumption is rebutted by the claimant, the burden of proof shifts to the directors to demonstrate that the transaction was 'entirely fair' to the corporation. The study first asks whether an express, codified business judgment rule exists or the courts accord directors an implied margin of discretion, within which business decisions are not subjected to full review. If an express or implied business judgment rule can be found, the study examines the threshold requirements, the burden of proof for these requirements, and the remaining standard of review if the protections apply.

The business judgment rule or an equivalent rule as a codified legal institution has spread over the last six or seven years to five European jurisdictions. The majority of legal systems in the EU, however, do not contain an explicit formulation of a business judgment rule. In that case, the margin of discretion accorded to the directors depends on the interpretation of the duty of care's behavioural expectations by the courts. Often, clear definitions and bright-line rules are missing, with the consequence that the limits of the implied protection of business judgments are shifting and not easy to identify. Still, in most jurisdictions, there is evidence that the courts appreciate that a review of decisions taken under conditions of uncertainty has to acknowledge that the decision-maker has to rely *ex ante* on expectations and probabilities, and that a full *ex post* review may suffer from hindsight bias. Nevertheless, differences remain. At the other end of the spectrum are the countries that have codified a business judgment rule and thus explicitly provide for an area of managerial decision-making that will not be reviewed by the courts. However, this does not mean that directors face the lowest risk of liability for breaches of the duty of care in these countries. Given that the level of protection afforded by a business judgment rule is a function of several factors, the advantage of recognising a protected margin of discretion by statute may be offset by rules that shift the burden of proof to the directors. This is in fact the case in most of the countries that have codified a business judgment rule.

Duty of loyalty. The duty of loyalty, broadly understood, addresses conflicts of interest between the director and the company. Particularly in common law, it has a long tradition as a distinct and comprehensive duty that encompasses a variety of situations where the interests of the director are, or may potentially be, in conflict with the interests of the company. In other legal traditions, a fiduciary position of directors is less accentuated and the duty to avoid conflicts of interest and not to profit from the position on the board of companies is less pronounced. Nevertheless, the social conflicts that the common law duty of loyalty is intended to address are identical and are recognised in most jurisdictions as in need of regulatory intervention. The most important such conflicts are: (1) related-party transactions (self-dealing), i.e. transactions between the company and the director, either directly or indirectly; and, (2) corporate opportunities, i.e. the exploitation of information that 'belongs' to the company, in particular information that is of commercial interest to the company. Most other aspects associated with the expectation that the director act loyal towards the company (e.g., not to compete with the company, not to accept benefits from third parties that are granted because of the directorship, or not to abuse the powers vested in the directors for ulterior purposes) can be related to these two main applications of the duty of loyalty.

While the duty of care is pervasive in the Member States and the formulation of the directors' behavioural expectations does not differ widely between jurisdictions, the regulatory techniques employed to address conflicts of interest are markedly different. What is called duty of loyalty in the common law terminology, is in most jurisdictions a compilation of functionally comparable legal instruments. While no one approach is *per se* superior to another, it seems that the effectiveness of the respective rules depends on the flexibility that they allow and that some approaches lend themselves more to an application sensitive to the particularities of the individual case than others.

The study analyses the status quo in relation to the most relevant behavioural expectations, notably the treatment of related party transactions as well as of the exploitation of corporate opportunities.

In respect of the treatment of related party transactions the study identifies three main approaches: (i) jurisdictions applying a broad rule that makes such transactions conditional upon disclosure and a decision by a disinterested organ; (ii) jurisdictions using the two-tier board system, allocating decision-making power for transactions between the company and the director to the supervisory board; and, (iii) jurisdictions making such transactions conditional upon disclosure, but the interested director can participate in the decision that authorises the interested transaction.

As regards corporate opportunities the assessment depends on two factors. First, is the exploitation of corporate opportunities by the directors for their own account restricted and, if yes, under which conditions (disclosure, disinterested approval, etc.) are the directors free to pursue a business opportunity that belongs to the corporation? Second, how is it determined when a business opportunity 'belongs' to the corporation? With respect to both dimensions, the law may adopt a narrow approach (i.e., the regulation is applicable to a narrowly defined set of cases) or a broad approach (applicable to a wide range of directors' activities). Accordingly, one group of countries (in particular, those belonging to the common law group) impose a fairly broad duty on directors not to exploit any information or opportunity of the company, as this would constitute a case of prohibited conflict of interest, and a second, larger group relies on the duty not to compete with the company. No country establishes an absolute prohibition. All jurisdictions allow directors to exploit corporate opportunities after authorisation by the board of directors, supervisory board, or general meeting of shareholders, as applicable.

Furthermore, in most jurisdictions the rules apply both to direct conflict cases (the director him- or herself takes advantage of the opportunity) and indirect conflicts (the director is involved in a business that engages in activities that are potentially or actually of economic interest to the company). The legal systems differ in details, for example with respect to the question of when the interest of the director in a competing business is significant enough to trigger the prohibitions of the no-conflict or non-compete rule or when the activities of a person affiliated with the director implicate the director him- or herself. But all legal systems that regulate these conflicts (which is not the case for all jurisdictions analysed) provide for *some* mechanism that goes beyond the purely formal director-company relationship and includes affiliates that are economically identical or closely related to the director. The Member States differ systematically with regard to the second dimension, i.e. the definition of the necessary link between the business opportunity and the company.

On the basis of the foregoing considerations, the study divides the Member States into the following groups. (i) The broad approach is based on what can be called the 'no-conflict rule': directors are required to avoid any type of conflict of interest with the company, which means in this context that they must refrain from exploiting business opportunities. (ii) The narrow approach relies on the duty not to compete with the company. The director is generally only required to refrain from pursuing economic activity in the company's line of business. (iii) Finally, the third group comprises jurisdictions that do not contain any binding regulation of corporate opportunities, either by way of a statutory no-conflict or non-compete provision or case law. However, the analysis shows that the jurisdictions in the third group do not, *per se*, exhibit regulatory gaps compared with the legal systems in the other two groups, as the law seems elastic enough to be able to address conflicts where regulatory intervention is deemed expedient. The main difference with regard to outcomes seems to be the increased legal uncertainty due to the lack of clearly specified rules addressing different conflict situations.

An important aspect in this context is the treatment of resigning directors. The resignation may invite regulatory intervention if the director resigns for the purpose of establishing a competing business and he or she makes use of information, business contacts, or general skills and expertise acquired while serving on the board of the company. Often this issue will be addressed in the service contract with the director, which will contain a non-compete agreement imposing the obligation on the director not to compete with the company for a number of years. Outside the scope of the contractual solution, the law in many Member States is not settled. The difficulty is that the codified law in many countries does not deal with the problem of resigning directors explicitly and case law is scarce. In that case, the situation is characterised by a great degree of uncertainty and the general rule is that directors' duties no longer apply after the director ceases to hold office.

Nature of liability. The board of directors is a collegiate body, but liability is in all Member States personal; it does not attach to the board as a corporate organ (which does not have legal personality), but to the individual director. This gives rise to the question how collegiate decisions that constitute a breach of duty translate into liability of the directors who participated in the decision by voting in favour or against it, and directors who were absent but were later involved in the implementation of the decision or could have prevented its implementation. These questions have not been addressed in all Member States. In particular in those jurisdictions where case law on directors' duties is rare it may not always be clear which steps a board member should take in order to exculpate himself. In general, however, the principles developed by the legal systems that have dealt with this question show a high degree of coherence. This is in particular of relevance for jurisdictions where the burden of proof is normally with the plaintiff.

Limitation of liability. The study identifies five methods to limit or exclude the liability of directors for breach of duty commonly used in the Member States: Exclusion of liability in the articles; *ex ante* authorisation of certain types of conduct by the shareholders, i.e. before the conduct that gives rise to liability occurs; *ex post* ratification of breaches of duty or waiver of the company's claim; indemnification of the director against liability incurred not to the company, but to a third party, or against the costs of third party lawsuits; and directors and officers liability insurance (D&O insurance).

Enforcement of the duties

In order to ensure effective investor protection, enforcement of directors' duties is a necessary complement to the substantive rules on directors' duties and liability. While enforcement of personal claims, i.e. actions brought by shareholders or third parties in their own name for the infringement of individual rights owed directly to them generally does not pose significant problems, enforcement of the company's claims against its directors faces two major difficulties: the organ authorised to act on behalf of the company may be conflicted, in particular, in the one-tier system. Second, enforcement of the company's claims through shareholders by means of a derivative action faces a collective action problem: the costs are borne by the shareholders who bring the action, while the passive shareholders benefit from the claimant's efforts. Consequently, the study focuses on, first, who has authority to act on behalf of the company in enforcing the company's claim, and, second, under which conditions (minority) shareholders can bring a derivative action if the authorised organ does not act. As far as the second issue is concerned, the study quantifies the ease with which shareholders can bring a minority action.

Standing to sue. As regards the first issues, there is significant variation between the Member States. In a number of one-tier board systems the board of directors has the authority to instigate proceedings on behalf of the company. A second group of such countries provide that the general meeting shall have the power to decide whether or not to enforce the claim. A third group of one-tier board model countries accord the right to bring an action to both the board of directors and the shareholders in general meeting. In the group of jurisdictions with two-tier board structures, several of them stipulate that the supervisory board has the authority to instigate legal proceedings and represent the company; in others the supervisory board is required to do so upon the request by the general meeting. Alternatively, some jurisdictions allocate the power to decide on an enforcement action to the general meeting, the managing director, the board of directors, or either the management board or the supervisory board. It is difficult to assess which of these arrangements is the most effective in order to address the conflict of interest problem mentioned above and the data indicates that enforcement levels are low in all Member States.

Derivative action. The study assesses the ease of derivative actions from the point of view of, first, standing, second, the conditions for bringing an action, and, third, the cost rules and combines the findings into a minority shareholder enforcement index in order to facilitate cross-country comparison and to allow an appreciation of the overall ease with which shareholders can enforce breaches of directors' duties in each Member State if the authorised organ of the company fails to do so. The index assumes that the three components are of equal importance. Further, it must be noted that a high or low score in the enforcement index should not be equated with a high or low level of minority shareholder protection in the respective jurisdiction. The jurisdiction may have developed substitute mechanisms that supplement private enforcement and give minority shareholders other avenues to complain of an alleged breach of duty, as in particular judicial investigation procedures, disqualification of directors as a sanction, as well as other administrative or criminal sanctions.

Directors' duties and liability in the vicinity of insolvency

All Member States employ one of two main legal strategies to ensure that creditors' interests are properly taken into account in near-insolvent companies. First, the vast majority of Member States provide for a duty on the part of a company's directors to timely file for insolvency. Typically, this strategy is then buttressed by a consequential liability of directors for any depletion of the company's assets resulting from the delayed insolvency filing. In most Member States employing this strategy, this liability can only be enforced by the liquidator, and thus results in a proportional satisfaction of all creditors' claims.

The second main strategy we have identified is very similar in nature. Instead of setting a legal requirement for the insolvency filing, some Member States provide for a duty to cease trading at a particular point in time where creditors' interests are at risk. The first regulatory strategy is clearly more widely spread. It is triggered by the insolvency of the company, rather than by merely a threat of insolvency. The "wrongful trading" strategy, on the other hand, differs in so far as it does allow companies, for at least a limited time, to continue trading in a state of (balance sheet) insolvency. At the same time, the wrongful trading remedy can – at least in theory – be triggered even before the company is formally insolvent. The remedy is based on a realistic assessment of a company's prospects. Thus, directors of a formally insolvent company that has a realistic chance to trade its way out of its situation may be justified in continuing the business, while directors in a not-yet insolvent company may be obliged to cease its operations where the avoidance of a (future) insolvency seems highly unlikely. The two legal strategies seem to have at least similar effects on the behaviour expectations towards of directors in pre-insolvency situations.

Important differences exist, however. In practice, courts mainly tend to enforce the wrongful trading prohibition in relation to companies that are already insolvent. This may suggests that, in practice, the wrongful trading prohibition tends to be triggered at a later stage than duties to immediately file for insolvency once the relevant triggering event has occurred. At the same time, however, empirical research suggests that recovery rates in jurisdictions relying on the wrongful trading prohibition – are higher than in jurisdictions adopting the "duty to file"-strategy.

An additional regulatory strategy which at least indirectly affects the duties in the vicinity of insolvency is the so-called "re-capitalise or liquidate" rule. Throughout the European Union, public companies are obliged to call a general meeting where the (cumulated) losses of a company exceed 50% of the subscribed capital. While Art 17 of the Second Directive requires the calling of a general meeting in these circumstances, it does not require companies to take any specific action. A majority of the Member States have implemented the Second Directive as a mere duty to call a meeting. A third of the Member States, however, goes beyond this minimum requirement. These Member States require companies to choose, upon loss of half of their subscribed share capital, between either re-capitalising the company or winding down its operations and liquidating the company. The effect of the "re-capitalise or liquidate" rule on near-insolvency trading is twofold. First, it aims at making it less likely for companies with significant nominal share capital to trade in a state of capital depletion. Second, duty-related enforcement mechanisms are directly linked to this strategy, as failure to ensure that appropriate capital measures are taken at this very early stage lead to the liability of board members. The findings suggest that enforcement of duties related to the "re-capitalise or liquidate" rule mainly happens once insolvency proceedings have been opened, but the existence of the rule may have a significant impact on directors' incentives as the company approaches insolvency.

Cross-border issues

The differences in respect of substantive law and enforcement set out above may have cross-jurisdictional significance. In particular, they may create challenges as a consequence of cross-border operation or administration of companies.

Centros decision. The Court of Justice, with its decisions in Centros and subsequent cases, has significantly increased the availability of foreign company law forms to incorporators across Europe. As a result, a growing number of companies headquartered – and sometimes exclusively operating – in a particular jurisdiction will be subject to the company laws of another Member State. At its core, the jurisprudence of the Court of Justice ensures that companies formed in accordance with the law of one Member State (home state) will not be subjected to the substantive company law provisions of another Member State (host state) merely because of the location of the company's headquarters or central management.

The exclusive application of the home Member States' company law mandated by the Centros line of cases also applies, in principle, to the regulation of both duties and liability of board members. This primarily means that incorporators, when choosing between the available company laws, also choose the legal framework for directors' duties and liabilities. Host Member States would not be allowed to apply to companies incorporated in another Member State their domestic legal rules about directors' liability, as this would potentially subject the directors to claims under multiple substantive laws and, as such, be 'liable to hinder or make less attractive' the exercise of freedom of establishment. The study outlines the main private international law "connectors" used by various jurisdictions. As the Court of Justice has held in Cartesio, Member States are effectively free to restrict the availability of their company laws to businesses that mainly, or at least exclusively, operate outside their territory. Traditionally, the ability of a company to have its centre of operations outside the jurisdiction it is incorporated in, depended on the private international law framework adopted by the relevant jurisdiction. Countries following the incorporation doctrine generally allowed companies to incorporate in their jurisdictions, even though no substantial link existed between the operations of the company and this jurisdiction. Countries following the real seat doctrine, on the other hand, traditionally required from their own companies that they maintain their central administration within their jurisdiction.

However, as shown in the study, the relationship between the two approaches (i.e. private international law in relation to foreign-incorporated companies and company law requirement to maintain the "real seat" of a domestic company within a jurisdiction) can now be seen as relatively weak. The consequence of the above is twofold. First, the jurisprudence of the Court of Justice effectively requires all Member States, irrespective of their private international law approach, to accept foreign incorporated companies to establish their central administration within their territory. Second, a large variety of different company laws, including company laws of Member States still applying a real seat approach to foreign companies, are available to businesses across Europe. As mentioned above, this also includes the legal frameworks dealing with directors' duties and liabilities.

Potential conflicts. We identify a number of potential conflicts that can arise between different national rules in the area of directors' duties and liability.

Directors' duties and general civil liability. As discussed before, the study finds a significant degree of variance among Member States regarding the legal mechanisms for subjecting directors to liability. Not all Member States exclusively rely on company law mechanisms in this regard. Thus, rules which in a national context merely operate as functional substitutes for company law-based liability provisions can have the effect of subjecting directors to multiple and conflicting obligations. Where a Member State, for example, contains provisions regarding the liability for harming creditors' interests in its general civil law, such rules may expose the director to liability under both, the applicable company law and the “foreign” general civil law. This problem may potentially affect all companies with cross-border operations.

Duties in the vicinity of insolvency. Particular problems arise as a consequence of differences in insolvency law. As described before, Member States rely on different legal mechanisms to dis-incentivise directors from trying to “gamble” their way out of insolvency. Some of these mechanisms are situated outside traditional company law. In the jurisdictions examined, the application of Member States’ conflict of law rules differ significantly in relation to such duties. In a large number of Member States, no clear consensus exists in legal practice or academia regarding the qualification of duties to file for insolvency. Such duties are sometimes qualified as company law rules, leading to the application of the company’s home Member State. In other circumstances, such rules are qualified as falling within the area of tort law or insolvency law, which leads to the application of the law of the Member State where the company has its centre of main interest (COMI). In some Member States, a number of different interlocking legal strategies are classified, for private international law purposes, as belonging to different areas of law, leading to the application of such rules to foreign-incorporated companies.

A further complication stems from the fact that the COMI will not necessarily coincide with the “real seat”. The study highlights the different approaches taken by the Member States analysed. In some countries, the exact classification of the rules that are functionally equivalent to insolvency-related duties is unclear and/or the classification differs within the class of legal remedies relating to near-insolvency situations. In addition, other countries rely mainly or exclusively on company law mechanisms. This results in the inapplicability of the relevant legal remedies in relation to foreign-incorporated companies and may thus lead to a significant degree of under-enforcement of the relevant duties.

Conclusion of the Study

Lack of enforcement. This study concludes that gaps and deficiencies exist less with regard to the substantive rules on directors’ duties, and more in relation to enforcement. In the vast majority of Member States, breaches of directors’ duties do not normally lead to judicial enforcement of claims against directors as long as the company continues to operate as a going concern. There are several factors that contribute to what may be seen as under-enforcement of directors’ duties. We find that the most important of these factors cannot easily be addressed by changes to the national law rules concerning directors’ duties; rather, the relevant obstacles are of a structural nature.

First, in most jurisdictions the most important business decisions are taken by, or with the formal or informal approval of, the controlling shareholders. Consequently, it may be said that the issue in need of regulatory intervention is not so much wrongdoing by the directors that affects the shareholders as a class, but rather the minority/majority shareholder conflict.

Second, the rules on standing do not seem to be working well. If the board of directors in companies with a one-tier board structure has authority to instigate proceedings on behalf of the company, the conflict of interest is apparent, in particular where incumbents are sued. However, data indicates that the problem is not alleviated by allocating the power to enforce the company’s claims to another organ, for example the general meeting or, in companies following the two-tier board model, the supervisory board.

Third, the institutional preconditions may not always be conducive to enforcement. Even where the law on the books seems to be, in principle, satisfactory, enforcement is perceived in some Member States as being lengthy, expensive, and fraught with uncertainties. In addition, the perception of the competence and efficacy of the judicial system does not seem to be unreservedly positive in all Member States. Shareholders may prefer to remove the incumbent directors and appoint new ones, rather than applying to the courts.

As a consequence of these factors, enforcement in most jurisdictions is confined to cases of fraudulent conduct and particularly grave breaches of directors' duties. In some cases, claims against directors are also brought following a change of control, although such claims are often excluded in the relevant agreements leading to the change of control. Enforcement activity also occurs where the duty of loyalty is implicated and directors have engaged in self-dealing or misappropriated corporate assets. It should be noted, that the findings do not, in itself, call into question the effectiveness of the relevant legal rules. The level of compliance with directors' duties, particularly in larger companies, is perceived to be very high in some of the Member States that do not exhibit high levels of litigation activity.

Incentive problems in relation to enforcement by (minority) shareholders. Derivative actions are rare in Europe. An explanation may be that virtually all Member States exhibit deficiencies with respect to one or more of the three dimensions along which this study tests the effectiveness of the shareholder suit, as the ease of enforcement index shows. A particularly important issue are cost rules. A rule that requires the shareholders to advance the costs of the proceedings and imposes the litigation risk on them aggravates the collective action problem mentioned above. Therefore, this study submits that for an effective regulation of derivative actions all three elements analysed, standing, admission conditions and cost rules, should be conducive to minority shareholder enforcement. Absent that, private enforcement is unlikely to act as a meaningful deterrent against breaches of directors' duties.

Incentive problems with enforcement of claims against directors of insolvent companies. In most Member States, judicial enforcement of directors' duties mainly or almost exclusively takes place after the company has filed for insolvency. Nevertheless, the feedback received from both the interviewed practitioners and Country Experts suggests that in most Member States only a small fraction of claims against an insolvent company's directors are enforced in practice.

The study identifies the following three problems in relation to enforcement of directors' duties after the company has entered insolvency proceedings. First, liquidators may often not be properly incentivised to bring claims against directors. Secondly, most companies that enter insolvent liquidation are small or medium-sized businesses. In most of these companies, the directors are at the same time major shareholders of the company. This typically means that a significant part of the director's personal assets will have been tied up in the company, and hence lost in its insolvency. Third, practitioners from a number of Member States emphasised the problems relating to the costs and duration of court proceedings. In addition, and more relevant to this study, practitioners highlighted the legal uncertainties resulting from the scarce case law on directors' duties in most jurisdictions. This situation may well be a self-perpetuating and inefficient equilibrium that may be attributed to the public good-nature of litigation of that sort.

Gaps relating to companies with cross-border operations. In all Member States directors' duties consist of a mix of traditional company law duties, i.e. in particular the duty of care and the duty of loyalty, and additional duties that apply in the vicinity of insolvency, notably the duty to file for the opening of insolvency proceedings. As far as the latter are concerned, in most Member States some uncertainty exists as to their classification for purposes of private international law. Often there is no coherent view in the legal literature and in case law whether to classify an instrument as company law, insolvency law, or tort law. It is also possible that functionally related instruments are classified differently under private international law and, accordingly, are subject to different connecting factors. The consequence is that a coherent set of interconnected rules of substantive national company law may be dissected by virtue of the private international law and allocated to different legal systems. If foreign law is applicable to some aspects of the case and no substitute legal mechanism is available under that country's substantive company law, parts of the case may be left unregulated. Finally, if companies and directors are subject to other regulatory regimes in addition to the state of incorporation, which of course determines liability of the directors under the general rules on directors' duties, they may be dissuaded from exercising their free movement rights under the Treaty.

The likely disadvantages of the current legal situation in many Member States are as follows:

(1) The uncertain scope of the private international law rules and the criteria for classification of the substantive provisions on directors' duties in the vicinity of insolvency creates legal uncertainty.

(2) Where two or more legal instruments function as legal complements in a jurisdiction, but these instruments are subject to different connecting factors and these connecting factors lead to the application of different national laws, the lack of coordination in the conflict of law rules may result in regulatory gaps.

(3) It is unclear whether, and under what conditions, the application of additional duties and liability provisions, for example pursuant to the *lex loci delicti commissi* to directors of companies incorporated under a different jurisdiction is compatible with Arts. 49, 54 TFEU.

Such gaps may invite regulatory arbitrage. While we have not found any evidence in practice that regulatory arbitrage takes place, the theoretical possibility exists and may warrant a modification of the applicable rules on private international law so that the weak selection of multiple regimes is avoided.

Gaps relating to director disqualification. Director disqualification as an administrative law substitute for private enforcement of directors' duties creates similar cross-border frictions due to the unaligned nature of the respective private international law rules as those discussed in the previous section. Director disqualification requires some connection of the director's company with the territory where the disqualification order is issued. Such rules give rise to two concerns. First, in case of foreign companies they may lead to strong selection as outlined above, since they apply in addition to any sanctions that may be applicable under the law of the company's home Member State. In general, they are foreign elements that may disturb the balance of the domestic system of sanctions and liability. Second, and maybe more importantly, disqualification orders do not apply on an EU wide basis, but only capture companies that have the necessary connection to the territory where the disqualification order is issued. Even where a member State extends the applicability of its disqualification statute, this extension will not prevent the valid appointment of a director in another jurisdiction. Partly due to the case law of the European Court of Justice, Member States may find it difficult to enforce their national law rules against disqualified directors who are then appointed by foreign-incorporated companies, even where the relevant foreign-incorporated company operates within its territory.

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INTRODUCTION

The European Commission DG Internal Market and Services has commissioned the three authors of The London School of Economics and Political Science to undertake a study on directors' duties and liability across the EU. Work on the study commenced mid-January 2012 and ended 15 December 2012. The work basically consists of two strands, notably the relevant research in 28 jurisdictions (EU-27 plus Croatia[2]) on the one hand, and the comparative analytical work on the other hand.

In performing the task of local research in the 28 jurisdictions, in a first phase of the work, the three authors drew on a Europe-wide network of more than 60 local research assistants and renowned company law experts.[3]

During the second phase of the work, the comparative-analytical part was developed in-house at LSE with additional input by a steering group of eminent experts and supplementary fact finding in the Member States where needed.

The process of producing the 28 'country reports' and the comparative analytical part is described in greater detail in the section on methodology below.

Overview

The structure of the finalised study is as follows.

In this **introductory part**, the purpose of the study, history of the Commission's work on directors' duties, the scope of the study and the main methodological elements employed in preparing the study are presented. Further, it sets out a number of difficulties we encountered in preparing it.

The **comparative-analytical** part is the core of this study, as it summarises as well as analyses the information gathered by us in the first phase of the project. Seven topics are covered:

- The organisation and structure of boards, covering the choice between one tier and two tier structures, the roles of employee representatives and the appointment and dismissal process.
- The substantive provisions on directors' duties. This is the main part of the analysis, comprising the issues of who owes the duties and to whom; which are the interests of the company; and the content of the duty of care and the duty of loyalty. Further, it describes the type of liability flowing from breaches of the duties, and limitations to the liability.
- Questions of enforcement, i.e. who has the standing to sue and whether a derivative action is possible.
- Duties in the vicinity of insolvency, in particular to file for insolvency and the prohibition to engage in wrongful trading. Further, whether there are other changes to directors' duties in the vicinity of insolvency, and whether there is a duty to recapitalise or a mere duty to call a meeting.
- Cross-border issues, notably the influence of the real seat or the incorporation theories on the law applicable to directors' duties.

For each of these topics, we first identify the main legal strategies used throughout the Member States to address the common practical problems in the respective sphere. We then "map" the regulatory approaches in the areas we identified as most relevant, in order to provide an overview of the legal landscape throughout Europe. In the subsequent analysis we take a functional approach, comparing

[2] For ease of reference hereinafter simply referred to as 'Member States' or '28 jurisdictions'.
[3] The list of all contributors is set out on pp. v *et seq.*

different legal strategies based on their intended purposes and their function within a given jurisdiction, rather than focussing on similar legal techniques. We then discuss the comparability of the strategies we identified and highlight potential problems where appropriate.

The findings of the comparative-analytical part are supported by information extracted from our local experts' answers to a number of hypothetical scenarios. The use of this tool allowed us to uncover hidden uncertainties, differences and practices which would not have been easy to spot based purely on a description of the law, however elaborate.

Lastly, the second part will draw conclusions from the legal landscape and will try to identify the relevant legal issues and gaps in the legal framework.

The **Annex** contains 28 country reports setting out the law of the Member States underlying directors' duties and liability. All country reports follow, to the extent possible, the following template in order to facilitate orientation and comparison.

- Overview of the regulatory regime and ownership structure of local companies.
- Who is considered director under the local law (eligibility, de facto/shadow directors).
- Content of directors' duties under local law (duties of care, loyalty, etc).
- Which are directors' duties in the vicinity of insolvency (file for insolvency, wrongful trading).
- Which types of liabilities directors incur and in relation to whom (company, third parties)
- How claims based on breach of liability are enforced, by the company, by shareholders or by creditors.
- Relevant conflict of laws rules, depending on the type of claim (company law rule, tort law, contract law, or insolvency law)

The country reports strive to depict the local law currently in force comprehensively, adding necessary information on its historical and dogmatic background. They are entirely descriptive and refrain from assessing the legal framework in terms of completeness or efficiency.

Purpose of this study

This study is designed to assist the European Commission in assessing the EU approach to and policy on corporate law. It focuses on the issues of company directors' duties and liability. It strives to enable policy makers to obtain a clearer picture of Member States' statutory law, case law and supervisory and corporate practices in respect of directors' duties and liability. Further, it identifies gaps and incompatibilities of the legal frameworks of Member States that may materialise in cross-jurisdictional situations.

History of the Commission's work on directors' duties and liability

The High Level Group of Company Law Experts, which was set up by the Commission with a view to making recommendations on company law modernisation has recommended, in its 2002 report, amongst other things, the strengthening of the accountability of directors when the company is threatened by insolvency by introducing a rule on "wrongful trading" at EU level.[4] Such a rule should hold company directors (including shadow directors) accountable for letting the company continue to do business when it can be foreseen that the company will not be able to pay its debts as they fall

[4] Report of the high level group of company law experts on a modern regulatory framework for company law in Europe, Brussels (2002), available at: http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf.

due. The group emphasised the usefulness of such a rule while adding that there was no need to harmonise the whole body of directors' liability rules in all Member States.

The Commission included this idea in its 2003 Communication on Modernising Company Law. It stated however that concrete proposals would need further analysis before they are made. The proposal to introduce focussed harmonising legislation was then tested by the Commission in the context of its 2006 public consultation on future priorities for the 2003 Action Plan on Company law and Corporate Governance. The majority of respondents opposed any EU initiative in this regard. Amongst other things, it was argued that there were no current substantial cross-border problems requiring a common EU solution. Nonetheless, there was much support for preparing a study focusing on the different systems of directors' responsibilities and liability. The study should establish the existence of a basis for common EU standards on some major principles and issues.

In its 2010 Green Paper on Corporate Governance for Financial Institutions, the Commission raised the wider question of whether civil and/or criminal liability of directors needs to be strengthened. The invitation for comments was mainly designed as an information gathering exercise; there were no developed arguments in support or against the proposition, while it was expressly stated that additional in-depth work would be necessary.

Just recently, in its December 2012 Action Plan on European Company Law and Corporate Governance, the European Commission announced to take up a number of initiatives intended to modernise company law and corporate governance in the EU. Amongst the measure envisaged is the strengthening of shareholder oversight over related party transactions of company directors. This study, in the context of analysing the duty of loyalty, already provides an analysis of the current state of play in Member States.

Scope

This study covers both duties and the consequential liability of directors. Directors' liability is the corollary of a number of diverse duties imposed on them, either individually or as a group. For this reason, the application of laws addressing directors' duties and liability is closely related to and interacts with other legal rules and statutory provisions on corporate governance.

However, the legal framework regarding directors' duties and corresponding liability is not well explored at the EU level. This is also due to the level of complexity of the matter, as different jurisdictions may have differing rules on

- the character and variety of duties;
- the changes of duties when a company comes close to or enters insolvency;
- the exact circle of persons bound by these duties;
- the exact circle of persons to whom these duties are owed;
- the kind of liability entailed;
- the procedures for enforcing duties and liability related claims; and,
- the treatment of cross-jurisdictional situations.

Unsurprisingly, the rules governing the above and other related issues are widely spread over the different areas of law, such as company law, civil law, insolvency law, tort law and criminal law.

Further, the sources vary considerably, from statutory law to case law but also including other regulatory instruments like stock exchange rules and rules promulgated by self-regulatory organisations. Any assessment of duties and corresponding liability of directors requires an aggregation of these sources.

Therefore, in its fact-finding part, this study is a mapping exercise. The country reports contained in the Annex set out a comprehensive local picture regarding content, sources and practice in respect of directors' duties and liability for each of the 28 jurisdictions. The comparative part aggregates this information so as to produce an overarching, bigger image in relation to the EU as a whole, identifying similarities, gaps, and difficulties between the various domestic regimes.

There are, however, two restrictions to the scope.

- First, the study is generally limited to pre-insolvency situations. In other words, it will not cover duties and corresponding liability arising on insolvency. Yet, it covers duties and corresponding liability in the vicinity of insolvency, i.e., the "twilight zone" period. This restriction to the scope is slightly blurred in certain cases as the borderline between pre-insolvency and insolvency situations differs between the laws of Member States.
- Second, though generally all companies are covered, regardless of their business (in particular: financial and non-financial ones), the study is primarily focussed on public companies, i.e. those subject to the Second Company Law Directive,[5] such as the 'plc', 'AG' or 'SA'.

Main methodological elements

Multi-tier scrutiny of research

This study organised the relevant research activity in several layers in order to guarantee accurateness and completeness.

- Country reports were drafted by local researchers. A template and prototype report were used as basis so as to guarantee the same level of awareness of the relevant problems of all researchers involved in the drafting.
- Each country report was scrutinised by an eminent local company law expert who provided additional input and gave a second view on the substance. At the same time, the authors of this study were closely involved in the revision of the country reports, ensuring completeness and comparability.
- The authors of the study aggregated the findings of all country reports and prepared the relevant conclusions from the comparative analysis.
- At an early stage, preliminary conclusions were submitted to a high-level steering committee made up of leading legal scholars for review and additional input. The comparative-analytical part was refined on that basis and again submitted to the steering committee for comments.
- Throughout the process of drafting the comparative-analytical part, the authors conducted additional fact finding, notably by way of interviewing eminent local experts that had not been

[5] See now Directive 77/91/EEC of 13 December 19762012/30/EU, OJ 2012 L 315/74.

involved in the drafting process so far. In particular in respect of practical enforcement of directors' duties the authors sought this input from leading local practitioners.

Functionality

It is important to obtain pristine and unaltered information on each jurisdiction's legal framework regarding directors' duties and liability. However, there is a general risk of obtaining biased or incomplete information as local authors tend to view legal problems through the lens of the relevant national legal discourse. To tackle problems relating to this phenomenon, the comparative-analytical part of the study has been prepared with a strictly functional approach in mind.

That is, practical problems are described and concrete questions are asked without reference to any specific legal rules and without employing terminology 'borrowed' from one of the jurisdictions. Only this method allows aggregating sensibly information gathered in the country reports. General and specific legal concepts in Member States are not necessarily the same and an attempt to work along legal classification would bear the risk of comparing what is not necessarily comparable.

In order to assess not only the law on the books, but also the law in practice, we conducted a number of interviews with practitioners from leading law firms in all Member States. We asked questions regarding the practical role that directors' duties play in the respective jurisdiction, the risk of liability that directors face, the likelihood of enforcement before insolvency and in insolvency, the relevance of the derivative action, and generally potential obstacles to an efficient enforcement. The answers to these questions allowed us to draw tentative conclusions regarding perceptions of the effectiveness of the regulatory regime. In the comparative part, we refer to these answers where appropriate. It should be noted that our conclusions are not based on a representative survey. In addition, they relate to the perceived effectiveness of the regulation of directors' duties, rather than quantifiable indicators of enforcement output. We are grateful to all practitioners who have contributed to the study and made time available to answer our questions.

Hypothetical scenarios

Experience shows that any comparative legal study that exclusively focuses on abstract questions and generic description and comparison of the local laws is not only hardly vivid but first and foremost prone to be incorrect or incomplete. This is because only a concrete testing of the abstract and generic findings against concrete cases regularly reveals the full range of intricacies and interdependencies. Further, local laws (and local jurists) tend to see the law in purely national categories, generally neglecting the potentially distorting effect flowing from the involvement of cross-jurisdictional elements.

Consequently, we have included in respect of most countries the likely solutions to hypothetical scenarios, drafted by local experts, which cover a broad range of pertinent problems connected to directors' duties and liability. The concrete answers given under the relevant local law were factored into our comparative analysis in order to support its accurateness and functionality.

Cross-jurisdictional aspects

National legislators tend to consider legislation from a purely domestic angle, often neglecting any potential distortion stemming from cross-jurisdictional incompatibilities. Consequently, national law often contains no or little guidance as to the comprehensive solution of such situations. Therefore, this study pays particular attention to the issue of cross-jurisdictional incompatibilities.

Difficulties

The most significant difficulties in preparing this Study consisted in the following.

- Member states' legal frameworks in respect of a specific question, here directors' duties and liability, often differ considerably, in terms of concepts, content, sources, *etc.* However, in order to keep this study manageable, country reports should follow the same structure and deal with exactly the same questions. Researchers and country experts have found it difficult to transpose their thinking into the standard structure of thought we asked them to follow. We have consequently invested a great deal of work with a view make findings comparable and manageable so as to guarantee a consistently structured and easily accessible final product.
- The degree of sophistication of the legal literature and the case law in respect of the relevant questions varies enormously. This is not a surprise given that a number of Member States have smaller markets and some have also re-entered the market economy only about 20 years ago. Obviously, one cannot expect the same degree of guidance from courts and academic writing across Europe, and our experience so far shows that legal problems discussed in detail for several decades in some jurisdictions have hardly been addressed in others. As a consequence of these differences, authors and reviewers from a number of countries are unable to provide us with authoritative and specific answers to some of our more detailed questions. Therefore, as a consequence, our discussion and analysis of some of the more complicated legal concepts tends to rely more on a subset of European jurisdictions.
- Equally a typical phenomenon in comparative studies of the present kind, the cross-jurisdictional aspect is not prominently addressed in most Member States. In other words, it is extremely difficult extracting the relevant information, also because guidance from courts and literature is scarce. This issue is further addressed in the comparative-analytical part, below.

COMPARATIVE-ANALYTICAL PART

Introduction – Mapping Directors' Duties

The following part of the report contains the summary findings of the study. We This part has been designed drawing on the results of our stocktaking exercise, relying in particular on the country reports and the additional input received from our Country Experts and Country Researchers,[1] as well as the input received by the Steering Committee, the discussions during our Steering Committee Conference and our discussions with the Commission.

Our primary goal is to highlight common features as well as the difference between the approaches taken by EU Member States in regulating directors' duties. Given the substantial differences in legal traditions and regulatory techniques between Member States on the one hand, and the similarities of the legal and economic problems this central part of company law tries to address on the other, we adopt a functional approach in our analysis.[2]

In light of the aims of this study and having regard to its usefulness for assessing the necessity for, and the viability of, any potential future harmonisation in this area of law, we take the view that it is essential to identify functional equivalents across jurisdictions, and analyse their real-life effect on the operation of national company law.

This part thus goes beyond describing different regulatory approaches relating to the accountability of directors; the aim is to compare both the legal techniques used, and their outcomes. The value of this approach is underlined by the fact that we find both – close similarities in outcomes despite fundamental differences in regulatory techniques, as well as significant differences in the effect of seemingly similar rules.

Mapping director's duties and liabilities

This part is organised as follows. Part 1 sets the scene by providing an overview of the board structures used across the EU, including the role of employee representatives on corporate boards.

Part 2 describes the substantive provisions on directors' duties, including the different regulatory approaches relating to directors' duties and the addressees of the duties. This part also provides information of how different Member States define the "interests of the company", a concept that often serves as the central reference point for defining the behavioural expectations towards company directors. Furthermore it describes in detail how Member States define and enforce the duty of care and the duty of loyalty for company directors, and to what extent director liability can be excluded or limited.

Part 3 contains a summary of the relevant enforcement mechanisms, and attempts to identify relevant legal factors for what is widely perceived as under-enforcement of directors' duties. To complement our stocktaking exercise, which mainly focussed on obtaining information on the legal rules in place

[1] See the lists of contributors in Part I. of this report.

[2] For a discussion of the merits of, and the problems connected with, the "functional method", see e.g. R Michaels, "The Functional Method of Comparative Law" in: Law M Reimann and R Zimmermann (eds), *The Oxford Handbook of Comparative Law* (Oxford: Oxford University Press 2006) 339-382.

across Europe, we conducted a number of interviews with corporate law practitioners from a number of Member States. The additional information obtained through these interviews is also described in Part 3.

Part 4 deals with directors' duties once the company approaches insolvency. The main findings of this part of the study, however, have been used in Part 5, which highlights the main problems arising from the establishment and operation of companies across frontiers.

Each of the following sections starts by summarising the findings from our stocktaking exercise by categorising the legal approaches according to their main regulatory aims and their likely effect. The results are then visualised – necessarily in simplified form – by literally "mapping" the most significant regulatory groups. After that, we provide a short interpretation and analysis of our findings.

To complement our presentation of the data collected in our stocktaking exercise, we circulated a number of hypothetical cases among our country experts, and where relevant reference is made to the answers we received to these hypotheticals.

1. The Organisation and Structure of Boards

1.1 Relevance of board structure

As part of our stocktaking exercise, we looked at the differences in board structures available and in use across the EU. These structures can have an important impact on the functioning and performance of a board,[3] including a board's attitude towards risk.[4] The structure and composition of boards has also been shown to be related to a number of firm characteristics.[5] Despite recent trends of regulatory convergence regarding board structures,[6] we still find a significant degree of variation between the company laws of the EU Member States. The variation exists in the basic board structure (especially with regards to the distinction between one-tier and two-tier boards), as well as in relation to other aspects of company board makeup, such as election/nomination rights and the participation of employees.

Differences in board structures can have a significant impact on both the extent and content of directors' duties and liabilities, as well as on the enforcement of these duties.[7] First, the structure of a company's board determines the main elements for the allocation of decision-making powers – and, consequently, responsibility for the decisions – within a company. Second, to the extent that a legal system also relies on enforcement of directors' duties through the company organs itself, a formal division of responsibilities between different types of board members may be seen as having the effect of creating incentives for holding managers to account.[8]

The same is true for corporate ownership structure,[9] which – for listed companies – also differs significantly across Europe.[10] Indeed, the vast majority of corporate law practitioners we interviewed as part of our fact-finding mission stressed the fact that concentrated shareholder structures are an important factor explaining perceived low levels of enforcement of directors' duties.[11] In particular, the direct or indirect involvement in the managerial decision-making process by controlling shareholders of both listed and non-listed firms seems to act as a powerful disincentive for the enforcement of directors' duties outside insolvency.

[3] See e.g. KJ Hopt, 'Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron' in: J Armour and JA McCahery (eds.), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and The U.S.* (Hart: Oxford 2006) 445, 453; PL Davies "Board Structure in the UK and Germany: Convergence or Continuing Divergence?" (2001) 2 *International and Comparative Corporate Law Journal* 435; C Jungmann, 'The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems: Evidence from the UK and Germany' (2006) 4 *European Company and Financial Law Review* 426; RB Adams and D Ferreira, 'A Theory of Friendly Boards' (2007) 62 *Journal of Finance* 217.

[4] See e.g. AB Gillette, TH Noe and MJ Rebello, "Board Structures Around the World: an Experimental Investigation" (2008) 12 *Review of Finance* 93-140.

[5] See e.g. A Boone, L Field, J Karpoff, and C Raheja, 'The Determinants of Corporate Board Size and Composition: An Empirical Analysis' (2007) 85 Journal of Financial Economics 66.

[6] See e.g. PL Davies "Board Structure in the UK and Germany: Convergence or Continuing Divergence?" (2001) 2 *International and Comparative Corporate Law Journal* 435; KJ Hopt and PC Leyens, "Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy" (2004) 1 *European Company and Financial Law Review* 135.

[7] See e.g. KJ Hopt and PC Leyens, ibid.

[8] But see KJ Hopt and PC Leyens, ibid 142, pointing towards the reluctance of supervisory board members in a two-tier system to bring actions against management board members, as this would often entail admittance of a breach of the supervisory boards' duty to exercise control over the management. See also Adams and Ferreira, n 3 above.

[9] See e.g. S Thomsen, 'Conflicts of Interest or Aligned Incentives? Blockholder Ownership, Dividends and Firm Value in the US and the EU' (2005) 6 *European Business Organization Law Review* 201; CG Holderness, 'A survey of blockholders and corporate control' (2003) *FRBNY Economic Policy Review* 51.

[10] See e.g. M Faccio and LHP Lang, 'The ultimate ownership of Western European corporations' (2002) 65 *Journal of Financial Economics* 365; F Barca and M Becht (eds.), *The control of corporate Europe* (Oxford: Oxford University Press 2001); T Kirchmaier and J Grant, 'Corporate ownership structure and performance in Europe' (2005) 2 *European Management Review*, 231.

[11] "Closely-held companies"" are private or public limited companies with a small number of shareholders and, consequently, relatively high ownership concentration.

1.2 Mapping board structures I: The choice between one-tier and two-tier boards

Summary of the country reports in tabulated form

Table 1.2.a: board structures in Europe

Country	*one-tier or two-tier board structure (public companies)*
Austria	mandatory two-tier board structure
Belgium	one-tier board or mixed structure[12]
Bulgaria	choice between one-tier and two-tier board structure
Croatia	choice between one-tier and two-tier board structure
Cyprus	one-tier board structure[13]
Czech Republic	mandatory two-tier board structure
Denmark	choice between "Nordic model"[14] and German-type two-tier board structure
Estonia	mandatory two-tier board structure
Finland	choice between "Nordic model" and German-type two-tier board structure
France	choice between one-tier and two-tier board structure in addition, in the one-tier structure the company may choose between the PDG model[15]
Germany	mandatory two-tier board structure
Greece	one-tier board structure
Hungary	choice between one-tier and two-tier board structure
Ireland	one-tier board structure[16]
Italy	choice between three different board structures[17]

[12] Under Belgian law, the board of directors may transfer some of its power to a "direction committee", which consists of both directors and non-directors.
[13] Cypriot company law is based on the UK Companies Act 1948. As under the law of the United Kingdom, the argument can be made that a degree of choice exists in relation to board structures. See also n. 25 below.
[14] See the description of the "Nordic Model" below.
[15] The PDG or "président-directeur general"-model combines the offices of the CEO and the chairman of the board, which in turn has consequences on removal rights; see below Section 1.5.
[16] Irish company law is similar to the law of the United Kingdom; hence, a degree of choice may exist in relation to board structures. As a matter of fact, Irish companies do, however, invariably adopt a one-tier board structure; see also n. 25 below.

Country	one-tier or two-tier board structure (public companies)
Latvia	mandatory two-tier board structure
Lithuania	choice: supervisory board and/or board of directors are optional under Lithuanian law
Luxembourg	choice between one-tier and two-tier board structure
Malta	one-tier board structure
Netherlands	choice between one-tier and two-tier board structure[18]
Poland	mandatory two-tier board structure
Portugal	choice between three different board structures[19]
Romania	choice between one-tier and two-tier board structure
Slovakia	mandatory two-tier board structure
Slovenia	choice between one-tier and two-tier board structure
Spain	one-tier board structure
Sweden	"Nordic model"[20]
United Kingdom	one-tier board structure[21]

[17] Italian company law allows companies to choose between the "traditional" model with a board of directors and a board of statutory auditors, as well as a typical two-tier and a typical one-tier system. The prevalent choice, i.e. the traditional system, can probably best be described as a special form of a one-tier board structure. See the Italian report, Annex, Section 1.3, for details on the three board structures.

[18] While companies may generally adopt either structure, after exceeding certain size-related thresholds, companies are obliged to adopt a two-tier board.

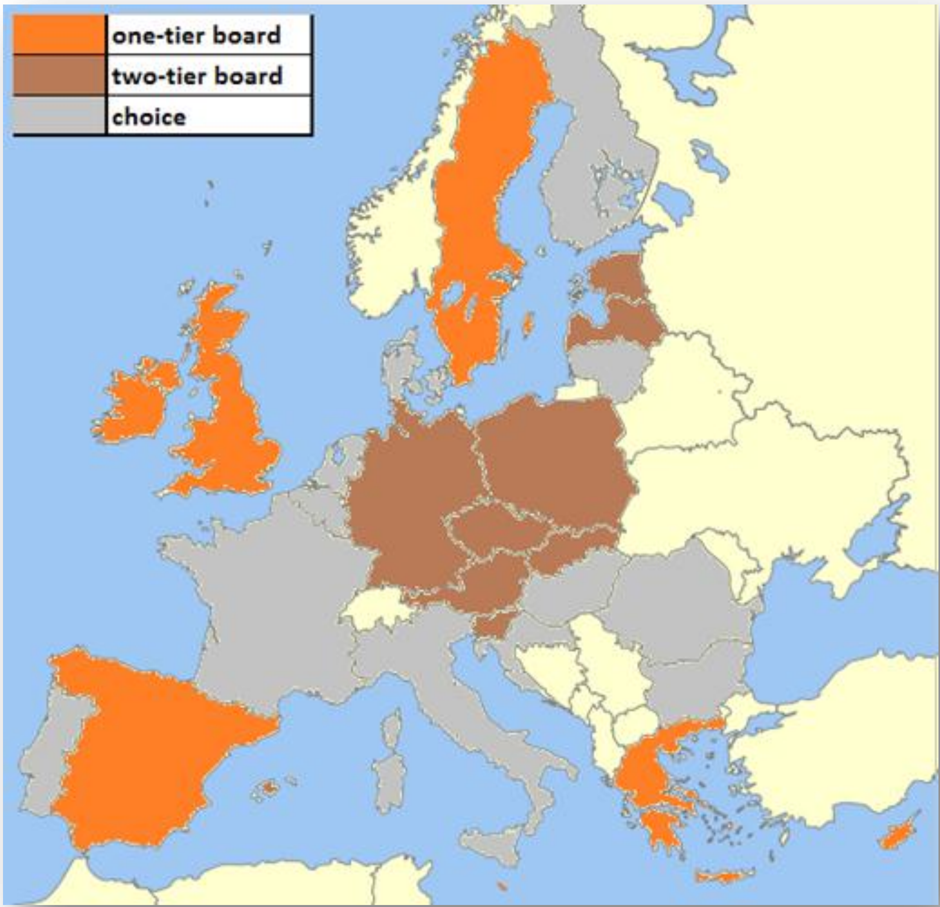
[19] Portuguese company law allows companies to choose between the a structure with a board of directors and an audit board, as well as a typical two-tier and a typical one-tier system. The prevalent choice is best described as a special form of a one-tier board structure, in our view. See the Portuguese report, Annex, Section 1.3, for details regarding the available board structures.

[20] See the description of the "Nordic Model" below.

[21] UK company law does not contain mandatory rules as to a company's board structure, arguably allowing shareholders to adopt a structure that resembles a typical two-tier board; see PL Davies and S Worthington, *Gower and Davies' Principles of Modern Company Law* (9th ed., London: Sweet & Maxwell 2012) 14-65; PL Davies "Board Structure in the UK and Germany: Convergence or Continuing Divergence?" (2001) 2 *International and Comparative Corporate Law Journal* 435.

Discussion

Map 1.2.a: Board structures in Europe



Legend	Countries
Mandatory two-tier board	AT, CZ, EE, DE, LV, PL, SK
One-tier board	CY, EL, IE, MT, ES, SE, UK
Choice	BE, BG, HR, DK, FI, FR, HU, IT, LT, LU, NL, PT, RO, SI

Board structures are usually classified into one-tier and two-tier structures, and it is this divide that has received most of the attention in comparative corporate governance debate. We find that a significant number of Member States provide national companies with a choice between the two systems. This "choice" approach has increased in its importance since the introduction of the *Societas Europea* (*"SE"*),[22] which effectively enables incorporators across the EU to choose between one- or two-tier boards.[23] Research relating to SE incorporations suggests that the added flexibility of governance (board) systems offered by the SE has been an important driver for the creations of SEs across

[22] Council Regulation (EC) No 2157/2001 on the Statute for a European Company (Societas Europaea – SE).
[23] See Art 38(b) of the SE Regulation. J Rickford, 'Current Developments in European Law on the Restructuring of Companies: An Introduction' (2004) 15 *European Business Law Review* 1225, 1240.

Europe.[24] It seems plausible that the recent trends of making available a choice of board structures for all public companies is related to these findings.

As of 2012, thirteen Member States permit companies to choose between one- and two-tier boards. These are Bulgaria, Croatia, Denmark, Finland, France, Hungary, Italy, Lithuania, Luxembourg, Portugal, Romania, Slovenia and, with some limitations, the Netherlands.

Only seven Member States (Austria, the Czech Republic, Estonia, Germany, Latvia, Poland, and Slovakia) *require a* two-tiered board, while eight Member States (Belgium, Cyprus, Greece, Ireland, Malta, Spain, Sweden, and the United Kingdom[25]) provide for one-tiered board structures.

There exists one important caveat in relation to our findings as reported above. While it is tempting to assume that the only significant divide between the board structures in different Member States' is reflected in their choice between one-tier or two tier boards, a closer examination shows a more complex set of board structures in Europe. Under the typical "dualistic" model, a company has two distinct boards, one with purely supervisory functions and a management board responsible for the day-to-day management. Under the "monistic" model, on the other hand, the two functions are exercised by a unified board, such as typically the case under UK law.

However, the board structures in a number of Member States cannot easily be classified according to the "monistic" / "dualistic" divide. For example, Swedish company law prescribes a structure that we classify, in our description above, as being closer to a "one-tier structure".[26] However, the executive team (including the CEO) of Swedish companies are, in effect, not typically elected by the shareholders, but rather by the shareholder-elected board, which in turn monitors the executive team. Although there is no formally distinct *"management board"*, the Swedish structure can probably best be described as a hybrid form, incorporating elements of both the one-tier and the two tier system,[27] although it still seems closer to the "monistic" model, given that the board has functions that go beyond purely supervisory tasks.[28] This is reflected in the table above by classifying the Swedish board system as "Nordic Model". Denmark and Finland also apply this "Nordic Model", but in both jurisdictions public companies can choose to adopt a German-type two-tier structure instead.

Similarly, Italian law offers not two but, three separate forms of organisation for corporate boards. For companies adopting the "traditional model",[29] the board of directors is accompanied by a *"board of auditors"*, which has only parts of the responsibilities that are typically associated with a supervisory board. Apart from the "traditional model", Italian law also allows for the adoption of "typical" one- and two-tier board structures. Portugal adopts a very similar approach, also offering the choice between these three forms.[30]

1.3 Mapping board structures II: Prevalent choices

It should be noted, however, that in most of the Member States allowing for choice between different board structures, and particularly in the Member States that introduced such choice relatively recently, only few companies make use of the flexibility the law offers. The table below summarises the prevalent choices made by public companies in Member States classified as "choice"-countries above.

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[24] See e.g. H Eidenmüller, A Engert, and L Hornuf, 'Incorporating under European Law: The Societas Europaea as a Vehicle for Legal Arbitrage' (2009) 10 *European Business Organization Law Review* (EBOR) 1-33.

[25] In relation to the UK the argument can be (and has been) made that nothing in its national company law prohibits the adoption of a board structure that comes very close to the traditional two-tier board; see PL Davies "Board Structure in the UK and Germany: Convergence or Continuing Divergence?" (2001) 2 *International and Comparative Corporate Law Journal* 435. See also n 21 above. A similar argument can be made in relation to Cyprus and Ireland.

[26] See also D Johanson and K Østergren, 'The Movement Toward Independent Directors on Boards: A Comparative Analysis of Sweden and the UK' (2010) 18 *Corporate Governance: An International Review* 527, 530.

[27] See the Swedish report in the Annex; see also B Kristiansson, "Directors' Remuneration in Listed Companies – Sweden" (2008), (available at www.ecgi.org/remuneration/questionnaire/sweden_update_2008.pdf) 2.

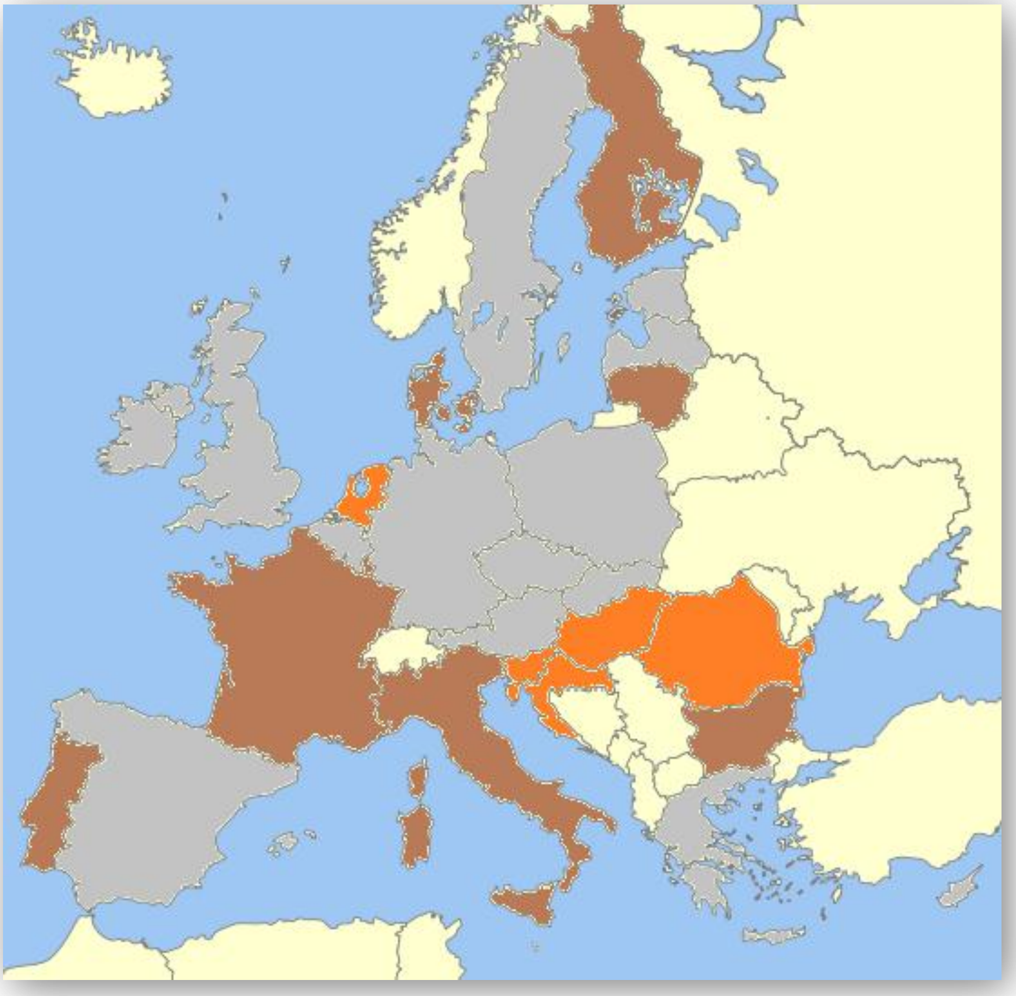
[28] Rolf Dotevall, Bolagsledningens skadeståndsansvar (Norstedts Juridik 2008) p. 31.

[29] See the Italian report in Annex I. See also F Ghezzi and C Malberti, "The Two-Tier Model and the One-Tier Model of Corporate Governance in the Italian Reform of Corporate Law" (2008) 5 *European Company and Financial Law Review* (ECFR) 1, 11.

[30] See Portuguese Report in Annex I, p 7-8.

Based on our analysis of the real-life divisions between the different company organs, we decided to classify the system predominantly adopted by Italian and Portuguese companies as "one-tier", although it is clearly possible to arrive at the opposite conclusion.

Map 1.3.b: Choices between one-tier and two-tier boards in countries providing a choice of different board structures



Legend	Countries
Predominant structure: one-tier	BG, DK, FI, FR, IT, LT, LU, PT
Predominant structure: two-tier	HR, HU, NL, RO, SI

1.4 Mapping board structures III: The roles of employee representatives

The table below summarises our findings regarding the roles of employee representatives on the board of (large) public limited companies throughout the European Union.

Table 2.3.a: Employee participation in Europe

Country	*employee participation (if mandatory, board-level and independent of current/former state ownership)*	*Details*
Austria	Yes	employees appoint one third of the members of the supervisory board
Belgium	No	Only applies in certain state-controlled companies
Bulgaria	No	-
Croatia	Yes	One member of the supervisory board
Cyprus	No	-
Czech Republic	Yes	In companies with at least 50 employees, employees appoint one third of the members of the supervisory board
Denmark	Yes	Two members of the board when adopting the “Nordic Model” of corporate governance Up to a third of the members of the supervisory board in companies adopting the two-tier model
Estonia	No	-
Finland	Yes	Employee participation subject to negotiation between company and employees
France	No	Only in state-owned or certain privatised companies For all other companies, employee participation is voluntary and depends on agreement with employees
Germany	Yes	Between one third and half of the supervisory board seats are allocated to employees (one third for companies with more than 500 and up to 2,000 employees; one half for companies with more than 2,000 employees) In companies with more than 2,000 employees, trade unions may also nominate representatives to the board
Greece	No	Only in state-owned companies
Hungary	Yes	one third of members of supervisory board, provided that company has more than 200 employees
Ireland	No	-
Italy	No	-
Latvia	No	-
Lithuania	No	-
Luxembourg	Yes	In companies with more than 1000 employees, one third of the board members are employee representatives
Malta	No	-
Netherlands	Nomination only	Works council has nomination rights for up to a third of the board seats, but may not nominate employees of the company. The board members nominated by the employees still have to be elected by the shareholders.

Country	employee participation (if mandatory, board-level and independent of current/former state ownership)	Details
Poland	No	Only for (formerly) state-owned companies
Portugal	No	-
Romania	No	-
Slovakia	Yes	One third of supervisory board members in companies with more than 50 employees
Slovenia	Yes	One third of supervisory board members (two-tier structure) One to three members, depending on board size (one-tier structure)
Spain	No	Only in state-owned companies
Sweden	Yes	Two to three members of the board
United Kingdom	No	-

Discussion

Map 1.4.c: Board-level employee participation in Europe

Legend[31]		Country
	No mandatory board-level employee participation	BE, BG, CY, EE, EL, ES, FR, IE, IT, LT, MT, PL, PT, RO, UK, LV
	Mandatory board-level employee participation	AT, CZ, DE, DK, FI, LU, HR, HU, SE, SI, SK
	Nomination/opposition rights only	NL

[31] Henceforth, we use the official two-letter country code to identify the Member States (and Croatia). These codes are as follows:

Belgium	(BE)	Lithuania	(LT)
Bulgaria	(BG)	Hungary	(HU)
Czech Republic	(CZ)	Malta	(MT)
Denmark	(DK)	Netherlands	(NL)
Germany	(DE)	Austria	(AT)
Estonia	(EE)	Poland	(PL)
Ireland	(IE)	Portugal	(PT)
Greece	(EL)	Romania	(RO)
Spain	(ES)	Slovenia	(SI)
France	(FR)	Slovakia	(SK)
Italy	(IT)	Finland	(FI)
Cyprus	(CY)	Sweden	(SE)
Latvia	(LV)	United Kingdom	(UK)
Luxembourg	(LU)	Croatia	(HR)

Our classification above is based on mandatory rules applicable to public companies with large domestic business operations. We do not report here special rules applicable only to companies operating in special industry sectors and/or to companies that are, or formerly were, (part-)owned by the state or another public body.

Employee participation can play an important role in the practical effect rules on directors' duties and liability have in practice. Twelve of the 28 countries examined by us grant employees *some form* of influence over the composition of the board. These countries are Austria, Croatia, the Czech Republic, Germany, Denmark, Finland, Hungary, Luxembourg, the Netherland, Slovenia, Sweden, and Slovakia. Of these countries, only Sweden has been classified as providing for a one-tier board,[32] while all other countries either mandate, or at least allow the adoption of a two-tiered board structure. There exists a fair amount of variance among the systems of employee participation; the spectrum ranges from the German system, where employee representatives[33] populate 50% of the supervisory board in large[34] companies, to the Dutch system of *nomination and opposition* rights, where employees are in effect restricted to make recommendations for the appointment of particular candidates, but shareholders can in turn oppose such nominations.[35] In addition, the employee representatives must not themselves be employees of the company.[36]

We find that, throughout the examined countries, employee representatives on the board of directors are subject to essentially the same duties as other board members, although the practical application of such duties may somewhat differ across Member States.

The decision to mandate board-level employee participation also relates to the focus and scope of directors' duties more generally. We find that the participation of employee representatives in the managerial decision-making process strongly correlates with a less shareholder-centric understanding of the "interest of the company". This is of significance for the main subject of this Report, since the interests of the company, and the question whether or not board members acted in the company's interest plays a pivotal role in determining the accountability of board members across all jurisdictions examined by us.

1.5 Appointment and dismissal of directors

Summary of the country reports in tabulated form

Table 2.3.a: Shareholder appointment and removal rights

Country	*Rights of shareholders to appoint directors*	*Rights of shareholders to remove directors*[37]	*Comments*
Austria	Shareholders may appoint members of supervisory board Management board members are appointed by	Shareholders may remove members of supervisory board, but need supermajority to do so without cause (subject to articles, which can provide for	Two-tier board structure mandatory

[32] But see the qualification as regards this classification above (text to n 27).
[33] In Germany, some of the employee representatives are nominated by the relevant trade union, rather than the employees of the company; see s.7 of the German Co-Determination Law ("*Mitbestimmungsgesetz*"); see in more detail the German Report in Annex I.
[34] i.e. companies with more than 2,000 employees. See s.7 of the German Co-Determination Law and, in more detail, the German Report in Annex I.
[35] See e.g. G Jackson, "Employee Representation in the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism and Political Institutions" (2005) 12 (3) *Industrielle Beziehungen* 1, as well as the Dutch Report in Annex I.
[36] See the Dutch Report in Annex I for more detail.
[37] The data presented here only refers to without cause removal rights, i.e. the right to remove a director without proving a breach of duties on the part of the director.

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	supervisory board	simple majority). Management board members can only be removed by supervisory board and only for good cause. A vote of no confidence by the shareholders may constitute a good cause unless passed for unjustified reasons.	
Belgium	All directors are appointed by the general meeting of shareholders	All directors may be removed by the general meeting of shareholders without cause at any time	One-tier structure; simple majority suffices for removal of directors
Bulgaria	*One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	*One-tier system:* Shareholders may remove members of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause management board members may be removed by the supervisory board without cause	- Choice of board structures - simple majority suffices for removal of directors
Croatia	*One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	*One-tier system:* Shareholders may remove members of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause management board members may be removed by the supervisory board only for good cause	- Choice of board structures - in the more common two-tier system, the management board enjoys a higher degree of "insulation" as its members cannot be removed without cause (even by the supervisory board)
Cyprus	All directors are appointed by general meeting of shareholders	Mandatory removal right in relation to all board members	Mandatory removal right of shareholders (simple majority) Shareholders may vest power to appoint directors in board, but removal rights still

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
			apply mandatorily
Czech Republic	*One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	*One-tier system:* Shareholders may remove members of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause Shareholders' removal rights in relation to management board members is subject to provision in articles	Removal rights can be exercised by simple majority of the votes (where available), but articles may provide for higher threshold or additional requirements
Denmark	*"Nordic Model":* Shareholders appoint all members of the board of directors Executives are appointed by board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management (executive) board	*"Nordic Model":* Shareholders may remove members of the board of directors at any time without cause Executives can be removed by board of directors without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause Only supervisory board members can remove management (executive) board members; removal without cause	- Nordic Model still by far the prevalent choice - Although the two-tier structure was modelled on German law, the supervisory board members can remove the management board members at their discretion
Estonia	Shareholders appoint members of supervisory board Management board members are appointed by supervisory board	Shareholders may remove members of supervisory board without cause Management board members can only be removed by supervisory board and only for good cause.	Two-tier board structure mandatory
Finland	*"Nordic Model":* Shareholders appoint all members of the board of directors Executives are appointed by board of directors	*"Nordic Model":* Shareholders may remove members of the board of directors at any time without cause Executives can be removed by board of directors without cause	- Nordic Model is the prevalent choice; few companies with supervisory boards

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	Two-tier system: Shareholders appoint members of the supervisory board; supervisory board appoints members of the management (executive) board	*Two-tier system:* Shareholders may remove members of the supervisory board without cause Only supervisory board members can remove management (executive) board members; removal without cause	
France	*One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	*One-tier system with PDG:*[38] Shareholders may remove all members of the board of directors without cause *One-tier system without PDG:* Shareholders may remove all members of the board of directors without cause, but need good cause to remove the general manager/CEO *Two-tier system:* Only supervisory board may remove members of the management board	One-tier model by far the most popular choice
Germany	Shareholders may appoint members of supervisory board Management board members are appointed by supervisory board	Shareholders may remove members of supervisory board, but need supermajority to do so without cause (subject to articles, which can provide for simple majority). Management board members can only be removed by supervisory board and only for good cause. A vote of no confidence by the shareholders may constitute a good cause unless passed for unjustified reasons.	Two-tier board structure mandatory
Greece	Shareholders appoint all	Shareholders may remove any member of	one-tier board structure is mandatory in Greece

[38] The PDG or "président-directeur general" model combines the offices of the CEO and the chairman of the board.

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	members of the board of directors	the board of directors at any time without cause	
Hungary	*One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	*One-tier system:* Shareholders may remove members of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause Management board members may be removed by supervisory board only (subject to articles)	
Ireland	All directors elected by shareholders	Any director may be removed without cause by shareholder meeting with simple majority of votes cast	Mandatory removal right of shareholders (simple majority) Shareholders may vest power to appoint directors in board, but removal rights still apply mandatorily
Italy	*Traditional system:* Shareholders appoint all members of the board of directors and the board of statutory auditors *One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	*Traditional system:* Shareholders may remove members of the board of directors at any time without cause Members of the board of statutory auditors can only be removed with cause and following court approval *One-tier system:* Shareholders may remove any member of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause Only supervisory board may remove members of the management board without cause	Traditional system still by far the most popular choice External auditors may only be removed without cause irrespective of the board structure
Latvia	Shareholders appoint members of the supervisory	Shareholders may remove members of the supervisory board	Mandatory two-tier structure

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	board; supervisory board appoints members of the management board	without cause Only supervisory board may remove members of the management board, and only with cause	
Lithuania	<u>Where supervisory board is established:</u> General meeting appoints supervisory board supervisory board appoints board of directors <u>Where no supervisory board is established:</u> General meeting appoints members of the board of directors	<u>Where supervisory board is established:</u> General meeting may remove supervisory board members without cause supervisory board may remove members of the board of directors and the company manager without cause <u>Where no supervisory board is established:</u> General meeting may remove supervisory board members and company manager without cause	Both, board of directors and supervisory board are optional in Lithuania
Luxembourg	<u>*One-tier system:*</u> Shareholders appoint all members of the board of directors <u>*Two-tier system:*</u> Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	<u>*One-tier system:*</u> Shareholders may remove members of the board of directors at any time without cause <u>*Two-tier system:*</u> Shareholders may only remove members of the supervisory board without cause management board members may be removed by the supervisory board without cause Where the articles provide so, management board members may also be removed by the general meeting	- Removal rights are exercised with simple majority, unless otherwise stated in the articles of association - Articles of association can be changed by shareholders to gain right to remove management board members without cause
Malta	Shareholders appoint all members of the board of directors	Shareholders may remove any member of the board of directors without cause	One-tier structure Simple majority suffices for removal of directors
Netherlands	<u>*One-tier system:*</u> Shareholders	<u>*One-tier system:*</u> Shareholders may	Employees have the right to nominate, and under certain

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	remove members of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause supervisory board may remove management board members without cause, but an obligation to consult the general meeting applies	circumstances oppose, the appointment of supervisory board members
Poland	Shareholders may appoint members of supervisory board Management board members are appointed by supervisory board	Shareholders may remove members of supervisory board without cause Management board members can only be removed by supervisory board and only for good cause.	Two-tier board structure mandatory
Portugal	"Latin board structure": Shareholders appoint members of the board of directors and the audit board One-tier board structure: Shareholders appoint members of the board of directors Two-tier board structure: Shareholders appoint members of the supervisory board Supervisory board appoints management board members	Shareholders may remove board members at any time without cause	The removal rights are subject to the limitations in the articles of association
Romania	*One-tier system:* Shareholders appoint all members of the	*One-tier system:* Shareholders may remove members of the board of directors at any	- Removal rights are exercised with simple majority, unless otherwise stated in the articles of

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board	time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause Management board members may be removed by the supervisory board without cause Where the articles provide so, management board members may also be removed by the general meeting	association - Articles of association can be changed by shareholders to gain right to remove management board members without cause
Slovakia	*One-tier system:* Shareholders appoint all members of the board of directors *Two-tier system:* Shareholders appoint members of the supervisory board; supervisory board appoints members of the management board (subject to articles of association)	*One-tier system:* Shareholders may remove members of the board of directors at any time without cause *Two-tier system:* Shareholders may remove members of the supervisory board without cause Management board members may be removed by the supervisory board without cause (subject to articles of association)	Co-optation right (i.e. board appointing additional directors) can be provided for by articles, but appointment only valid until following general meeting and subject to limitations
Slovenia	Shareholders may appoint members of supervisory board Management board members are appointed by supervisory board	Shareholders may remove members of supervisory board, but need supermajority to do so without cause (subject to articles, which can provide for simple majority). Management board members can only be removed by supervisory board and only for good cause. A vote of no confidence by the shareholders may constitute a good cause unless passed for unjustified reasons.	Two-tier board structure mandatory
Spain	All directors elected by	Any director may be removed without cause	In case a director breaches his or her duties, any

Country	Rights of shareholders to appoint directors	Rights of shareholders to remove directors[37]	Comments
	shareholders	by shareholder meeting with simple majority of votes cast	shareholder can demand immediate removal of such director
Sweden	All directors elected by shareholders, but managing director is not typically member of the board	Any directors can be removed at any time without cause	Nordic Model The chief executive officer is typically not a member of the board of directors
United Kingdom	All directors elected by shareholders	Any director may be removed without cause by shareholder meeting with simple majority of votes cast	Mandatory removal right of shareholders (simple majority) Shareholders may vest power to appoint directors in board, but removal rights still apply mandatorily

To enable us to assess the real-life effect of the legally defined duties of directors more fully, we have analysed the effective distribution of powers within the corporate entity. In this context, we first focus on the appointment and dismissal rights of shareholders in relation to board members. Significant differences exist across different Member States in relation to shareholders' rights to remove directors *without cause*, i.e. without any proof of improper conduct on the part of the director.

One must tread carefully in interpreting this data, however. Where ownership is concentrated, the legal allocation of appointment and removal rights does not typically have a significant effect on the accountability of directors or the influence shareholders have over a company's affairs. High ownership concentration is still the norm in most Member States, including, to a certain extent for listed companies.

The data summarised above is thus of particular importance for listed companies with a relevant level of share ownership dispersion.

Although the company laws of all European jurisdictions enable a well-coordinated shareholder body to ultimately decide on the composition of the board of directors, the degree to which law "insulates" managers from immediate shareholder influence can have an important impact on directors' behaviour. Even where a jurisdiction mandates the management of the company in the interest of *all* stakeholders, a credible threat of being removed by one of the constituencies (i.e. the shareholders) should be expected to influence the relative weight a director will assign to the different stakeholders' interests when making business decisions. The effects of such decision rights can, for instance, play an important role in a board's reaction to a hostile takeover offer.

1.6 Shareholder power

1.6.1 Managerial insulation

Based on the data collected in relation to the factors mentioned above, one can group the jurisdictions covered by this report according to the influence shareholders have with regard to the composition of a company's board of directors.

The influence over the composition of a company's board can have an important influence on how the company's business will be managed in practice. The ability to change the board composition "*ad hoc*" also has important implications for the exposure of boards – and, hence, companies – to outside pressures,[39] including pressures by activist shareholders with a short-term investment horizon. Likewise, these rights also affect the accountability of managers to shareholders.[40]

In categorising the company laws of the Member States, we focus in particular on factors such as the rights of shareholders to dismiss directors without cause, the majority requirements for dismissal, and the presence of employee representatives on the board. Where a two-tier board structure also requires management board members to be appointed *and dismissed* by supervisory board members,[41] the resulting mediatisation of shareholder power is also taken into account. Likewise, we also take into account how the "interests of the company" are defined under national company law. We would expect that where the interests of the company are defined in a way that includes multiple constituencies, this multi-interest model will result, at the margin, in a higher degree of managerial discretion.[42] Overall, our categorisation can best be interpreted as focussing on "managerial insulation" – i.e. the degree to which managers can, at least in the short- and medium-term, withstand pressure from shareholders as to the corporate and business strategy pursued by the company.

The relevance of our categorisation does, of course, also depend on a number of structural factors that cannot be regarded as direct consequences of the legal rules examined. Most importantly, a highly concentrated ownership structure may well render limitations of shareholder rights meaningless.[43] Thus, the three categories may be most relevant in situations where share ownership is dispersed or at least no single shareholder, and no (coordinated) group of shareholders, has *de facto* control over the company.

[39] See the discussion Ferreira et al as to the possible impact of ad hoc removal rights on corporate risk taking (D Ferreira, D Kershaw, T Kirchmaier, EP Schuster, 'Shareholder Empowerment and Bank Bailouts' (2012) ECGI - Finance Working Paper No. 345/2013, available at http://ssrn.com/abstract=2170392).

[40] The impact of managerial "entrenchment" has received particular attention in US legal and economic research; see e.g. LA Bebchuk and A Cohen, 'The cost of entrenched boards', 78 *Journal of Financial Economics* 409; PA Gompers, JL Ishii, and A Metrick, 'Corporate governance and equity prices' (2003) 118 *Quarterly Journal of Economics* 107.

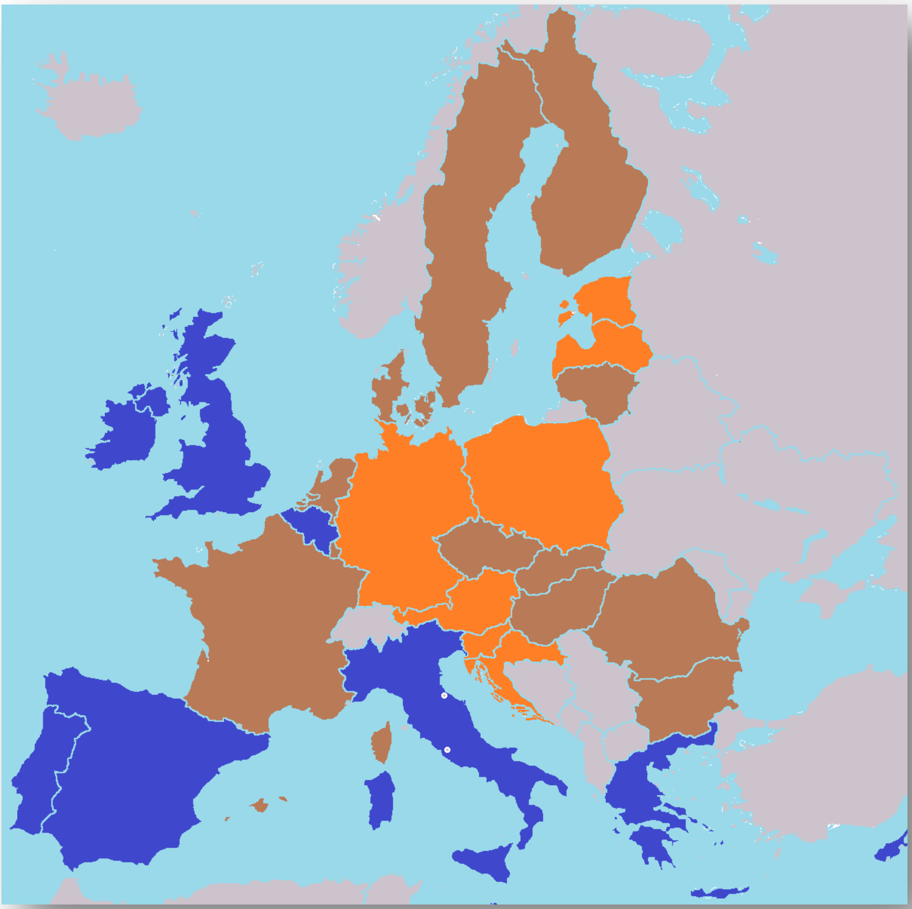
[41] Which is not the case in all jurisdictions, as can be seen above, Section 1.5.

[42] See e.g. the discussion in M Gelter, 'Taming or Protecting the Modern Corporation - Shareholder-Stakeholder Debates in a Comparative Light' (2011) 7 *NYU Journal of Law & Business* 641. See also the "Varieties of Capitalism" approach (PA Hall and D Soskice (eds.) *Varieties of Capitalism* [Oxford: Oxford University Press 2001]); see also MC Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (2001) 14 *Journal of Applied Corporate Finance* 8, for a very critical view of multi-dimensional approaches to defining the objectives managers should pursue.

[43] See above, text to n 9.

1.6.2 Classification of national company laws on the basis of “managerial insulation”

Map 1.6.2.a: Classification of national company laws on the basis of “managerial insulation”



Legend	Country
Group I	AT, DE, EE, HR, LV, PL, SI
Group II	BG, CZ, DK, FI, FR, HU, LT, LU, NL, RO, SK, SE
Group III	BE, HR, CY, EL, IE, IT, MT, PT, ES, UK

Rather than attaching an “index value” to each examined jurisdiction, we form three groups of countries, with each group assigning, in our view, a similar set of rights to shareholders of national companies. The reason we do not attach exact numerical index values to national company laws is that we want to avoid the wrong impression of precision. The effectiveness of shareholder rights is the result of a plethora of factors, only few of which are within the scope of this report. The possible interactions between the legal rules assessed and the diverse social, cultural, institutional and economic factors render a precise “ranking” of company law unfeasible, in our view. Also, the differences between the described legal systems should not be exaggerated, as – even in the absence of controlling shareholders – a number of other factors may lead to convergence in firm behaviour.[44] For example, economic pressures stemming from executive compensation or from the product markets certainly play an important role not reflected in our description below. Nevertheless, we believe that the grouping of jurisdictions may make it easier to compare the different legal systems covered by our study.

We form three distinct groups of company laws, based on the factors mentioned above. As mentioned above, the rights we focus on will typically only be relevant in companies with at least modestly dispersed ownership structures. We thus restrict the analysis on rules applicable to public limited companies. Where shareholders may choose between several board structures, we focus on the prevalent choice made in the relevant jurisdiction to avoid focussing on governance structures that have little or no relevance in practice.

Below is a description of the three groups we formed, as well as an explanation for the assignments we have made in relation to each jurisdiction covered.

Description of the three "Groups"

Group I

Group I contains the company laws that offer the highest degree of managerial insulation to company directors. The Member States assigned to Group I prevent shareholders from directly removing the executive directors (managers) of a company before the end of their respective terms, except for cause.[45]

Group III

Group III contains the jurisdictions whose company laws offer shareholders the highest degree of power over management. The Member States assigned to Group III allow shareholders to (almost) immediately remove the managers of a company without cause before the end of their respective terms. In addition, company laws assigned to this group also lack additional features that may dilute the shareholder-centric orientation of the company, such as board level employee participation or a clear multi-interest approach in relation to the "interests of the company".

Group II

This group contains the "intermediate cases" – jurisdictions that cannot easily be assigned to either of the two aforementioned categories, with managerial insulation between what we find for Groups I and III.

Table 1.6.2.a: Classification of national company laws on the basis of "managerial insulation"

Country	*Classification (Group)*	*Explanation of assignment to group*
Austria	**Group I**	Austria's company law is assigned to Group I because the management board members cannot be removed without cause by the shareholders. In addition, even the supervisory board cannot remove members of the management board, except for cause. While a vote of no confidence by the shareholders may constitute good cause for dismissal by the supervisory board, this is not the case where shareholders pass the

[44] See also M Gelter, 'The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance' (2009) 50 *Harvard International Law Journal* 129, who describes differences in shareholder influence as only "variations in degree".
[45] Removal "for cause", in this context, typically requires proving a breach of directors' duties.

Country	Classification (Group)	Explanation of assignment to group
		relevant resolution for unjustified reasons. Even where a cause for dismissal exists, the supervisory board still has discretion as to the exercise of the right (subject to the supervisory board members' duties). Additional factors we considered are the "inclusive" definition of the interest of the company,[46] the mandatory rules on employee representation, and the inability of shareholders to give binding directions to management
Belgium	**Group III**	Belgium is classified as Group III-country, since all directors, including the executive directors, may be removed by the general meeting of shareholders without cause at any time. An additional factor we considered was the absence of mandatory rules on employee representation.[47]
Bulgaria	**Group II**	Bulgaria is classified as Group II-country for the following reasons: members of the management board may only be removed by the supervisory board, but the supervisory board may remove members of the management board without cause at any time. In effect, shareholders cannot exercise removal rights *directly* in the two-tier structure, but since without cause removal rights are available to the supervisory board, the insulation of management is not as high as in the typical company subject to a law we classify as Group III. Additional factors we took into account are the absence of mandatory rules on employee representation as well as a shareholder-focussed definition of the interests of the company.
Croatia	**Group I**	In the prevalent two-tier system, shareholders do not have the right to remove management board members directly. In addition, even the supervisory board cannot remove members of the management board without cause. Additional factors we considered are the definition of the interest of the company,[48] the mandatory rules on employee representation,[49] and the inability of shareholders as well as the supervisory board to give binding directions to management.
Cyprus	**Group III**	Cyprus is classified as Group III-country, since all directors may be removed by the general meeting of shareholders without cause at any time. This right can be exercised with a simple majority of the votes cast. Additional factors we took into account are the absence of mandatory rules on employee representation, the shareholder-focussed definition of the interests of the company, as well as the right of shareholders to give

[46] See also Section 2.2.2 below.
[47] The classification is based on the prevalent one-tier structure. See K Geens and M Wyckaert, 'Het gebruik van het facultatief duaal systeem in Belgische beursgenoteerde vennootschappen: enkele facts and figures' (2010) 7 *TRV* 527.
[48] See also Section 2.2.2 below. Croatian law does seem to attach a higher weight to shareholder interests than other stakeholder interest, but shareholder interests are not assigned over-riding priority.
[49] Note that the Croatian system of employee participation mandates only one employee representative on the supervisory board.

Country	*Classification (Group)*	*Explanation of assignment to group*
		binding directions to shareholders.
Czech Republic	**Group II**	We assigned Czech company law to Group II for the following reasons: In the prevalent two-tier system, shareholders may reserve the right to remove management board members without cause in the articles of association. However, the default rule is that only the supervisory board may remove members of the management board. The articles may also make the removal right subject to additional conditions.
Denmark	**Group II**	Denmark is categorised as Group II company law for the following reasons: Under the prevalent "Nordic Model", shareholders may remove members of the board of directors at any time without cause, typically with simple majority. However, the CEO is not necessarily or typically a member of the board. In addition, Denmark adopts a mandatory system of employee participation.
Estonia	**Group I**	Estonia's company law is assigned to Group I because the management board members cannot be removed without cause by the shareholders, and even the supervisory board can only remove members of the management board with cause. An additional factor we considered is the "inclusive" definition of the interest of the company. Board-level employee participation is not, however, mandatory in Estonia.
Finland	**Group II**	Finland is categorised as Group II company law for the following reasons: Under the "Nordic Model", shareholders may remove members of the board of directors at any time without cause, typically with simple majority. However, the CEO is not necessarily or typically a member of the board. In addition, Finland adopts a mandatory system of employee participation, albeit subject to company level negotiations between the company and the employees.
France	**Group II**	French company law is categorised as Group II. While shareholders may remove members of the board of directors without cause, they can only do so with cause in relation to the CEO in companies not adopting the PDG-model.[50] In addition, the interests of the company seem to include interests other than those of the shareholder body as a whole.
Germany	**Group I**	German company law is assigned to Group I because the management board members cannot be removed without cause by the shareholders. In addition, even the supervisory board cannot remove members of the management board, except for cause.

[50] One may argue that France is a Group III company law, depending on the importance one attaches to employee participation (which is absent in France), and depending on the adoption of the PDG system.

Country	*Classification (Group)*	*Explanation of assignment to group*
		While a vote of no confidence by the shareholders may constitute good cause for dismissal by the supervisory board, this is not the case where shareholders pass the relevant resolution for unjustified reasons. Even where a cause for dismissal exists, the supervisory board still has discretion as to the exercise of the right (subject to the supervisory board members' duties). Additional factors we considered are the "inclusive", stakeholder oriented definition of the interests of the company, the mandatory rules on employee representation, and the inability of shareholders to give binding directions to management
Greece	**Group III**	Greek company law is categorised as belonging to Group III, since shareholders can remove any member of the board of directors at any time without cause, and they can do so with simple majority (mandatory law). Additional factors we took into account in our classification are the rather shareholder centric understanding of the interests of the company, the absence of mandatory rules on employee representation, and the right of shareholders to give binding directions to management
Hungary	**Group II**	In the prevalent two-tier structure, the supervisory board typically appoints the management board members. However, shareholders may preserve the right to appoint the members of both boards. Additional factors we took into account in our classification are the mandatory board-level employee participation system and the lack of a clear shareholder-centred definition of the interests of the company. The case could, however, be made that Hungary properly belongs to Group III, not least because of a right of shareholders to give binding directions to management.
Ireland	**Group III**	Ireland clearly belongs into Group III. Shareholders can remove directors without cause with a simple majority of the votes cast (mandatory rule), and they may give binding directions (albeit with qualified majority). Shareholder interests are clearly given overriding priority in case they conflict with the interests of another constituency. Moreover, no system of mandatory employee participation applies.
Italy	**Group III**	We classify Italy as belonging to Group III for the following reasons. Under the traditional system, shareholders have the right to remove directors at any time without cause. A mandatory simple majority requirement applies. The interests of the companies are defined with a clear shareholder focus, and no system of board-level employee participation applies in Italy.
Latvia	**Group I**	Latvian company law is assigned to Group I because the management board members cannot be removed without cause by the shareholders, and even the supervisory

Country	Classification (Group)	Explanation of assignment to group
		board can only remove members of the management board with cause. An additional factor we considered is the lack of a clear shareholder-centric definition of the interest of the company. Board-level employee participation is not, however, mandatory in Latvia.
Lithuania	**Group II**	Lithuanian company law is assigned to Group II. Although members of the management board cannot be removed without cause by the shareholders *directly* as a default position, such right can be provided for in or added to the articles of association. In addition, the supervisory board can remove members of the management board without cause. An additional factor we considered is the lack of a mandatory board-level employee participation system and a shareholder-centric definition of the interests of the company. Indeed, Lithuania may also be assigned to Group III.
Luxembourg	**Group II**	Under the two-tier system, shareholders may not *directly* remove the members of the management board without cause, unless the articles provide for this right. The supervisory board does not need to show cause to remove management board members. Where the articles say so, the general meeting may also remove management board members directly and without cause, providing for a lower level of insulation than in companies in Group I. Mandatory board-level participation applies to (relatively few) large companies.
Malta	**Group III**	Malta belongs into Group III, since shareholders can remove directors without cause with a simple majority of the votes cast (mandatory rule), and they may give binding directions to the company's directors. Shareholder interests are given overriding priority in case they conflict with the interests of other constituencies. Moreover, no system of mandatory employee participation applies.
Netherlands	**Group II**	Under the prevalent two-tier system, shareholders may not directly remove members of the management board without cause. The supervisory board can, however, exercise a without cause removal right, and its members are themselves subject to a without cause removal right exercisable by the general meeting. This leads to a lower degree of insulation than in our Group III company laws. However, a multi-interest approach to the interests of the company as well, the mediatisation of shareholder rights through the prevalent two-tiered structure, and the involvement of employees in the nomination of directors result in shareholders of Dutch companies having less power to effect immediate changes to the company's management than can be observed in company laws we

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Country	Classification (Group)	Explanation of assignment to group
		classified as belonging to Group III.
Poland	**Group I**	Polish company law is assigned to Group I because the management board members cannot be removed without cause by the shareholders. In addition, even the supervisory board cannot remove members of the management board, except for cause. Additional factors we considered are the lack of a clearly shareholder focussed definition of the interest of the company and the inability of shareholders or the supervisory board to give binding directions to management. Polish law does not, however, mandate board-level employee participation.
Portugal	**Group III**	We consider Portuguese law to belong to Group III because under the prevalent board model, shareholders have a mandatory without cause removal right in relation to all directors. This right may be exercised by the general meeting with a simple majority of the votes cast (although this is a default rule). Portuguese law does not mandate board-level employee participation. The definition of the interests of the company seem to give priority to shareholder interests, but less clearly so than other members in this group.
Romania	**Group II**	Romanian company law is assigned to Group II. Although members of the management board cannot be removed without cause by the shareholders *directly* as a default position, such right can be provided for in or added to the articles of association. In addition, the supervisory board can remove members of the management board without cause and its members are themselves subject to a mandatory without cause removal right. An additional factor we considered is the lack of a mandatory board-level employee participation system and a shareholder-centric definition of the interests of the company. In the case of Romania, the decision whether the better assignment is to Group II or Group III is not entirely clear.
Slovakia	**Group II**	Slovak company law is assigned to Group II. Members of the management board can be removed without cause by the shareholders, but this power is often assigned to the supervisory board, leading to a certain degree of mediatisation of shareholder power. An additional factor we considered is the mandatory board-level employee participation system and the lack of a clearly shareholder-centric definition of the interests of the company. It may also be argued that Slovak company law should rather be assigned to Group III.
Slovenia	**Group I**	Slovenian company law is assigned to Group I because the management board members cannot be removed without cause by the shareholders and even the supervisory board cannot remove members of the management board, except for cause. Additional factors we considered are the lack of a clearly

Country	Classification (Group)	Explanation of assignment to group
		shareholder-centric definition of the interest of the company, the mandatory rules on employee representation irrespective of the adopted governance structure, and the inability of shareholders to give binding directions to management.
Spain	**Group III**	We classify Spain as belonging to Group III for the following reasons. Shareholders have the right to remove directors at any time without cause (mandatory rule). The interests of the companies are defined with a clear shareholder focus, and no system of board-level employee participation applies in Spain.
Sweden	**Group II**	Sweden is categorised as Group II company law for the following reasons: Under the "Nordic Model", shareholders may remove members of the board of directors at any time without cause, typically with simple majority. However, the CEO is not necessarily or typically a member of the board. In addition, Sweden adopts a mandatory system of employee participation, with employee representatives appointing members to the (quasi-unitary) board.
United Kingdom	**Group III**	The UK clearly belongs into Group III. Shareholders can remove directors without cause with a simple majority of the votes cast (mandatory rule), and they may give binding directions (albeit with qualified majority). Shareholder interests are clearly given overriding priority in case they conflict with the interests of another constituency. Moreover, no system of mandatory employee participation applies.

2. Substantive provisions on directors' duties

2.1. Regulatory approach to directors' duties

Summary of the country reports

Table 2.1.a: Regulatory approach to directors' duties

Country	*Case law or statutory law?*	*General clause or different types of duty?*	*If statutory law: exhaustive enumeration of duties or also common law ones?*
Austria	Statutory law	1) Company law: 4 duties explicitly regulated in the AktG: a) duty to act in the best interests of the company, s. 70 b) duty of non-competition, s. 79 c) duty of care, s. 84(1) d) duty of confidentiality, s. 84(1) last sentence 2) Tort law and various other acts	Exhaustive enumeration, but case law important in shaping the exact scope of duties
Belgium	Mixture of statutory law and case law: - Strictly speaking, duties are not codified in company law, but derived from the general duty to act in good faith (art. 1134, 3 Civil Code), as well as the sections of the Companies Code providing for liability of directors - Substantial clarification has been given by case law (e.g. conditions of liability, co-existence of liability, content of civil law duty to act in good faith)	1) Liability to the company based on company law or contract law: a) Liability for faults committed in the exercise of the directors' management according to general law (i.e. law of contract), Art. 527 CC. This duty includes cases where the director acts against the company's interests. Several more specific duties flow from the company's interests (see right). b) Liability for breaches of the CC and the articles, Art. 528 CC c) Liability for non-compliance with the regulation on related-party transactions (as laid down in Art. 523), Art. 529 CC d) Liability in bankruptcy if the assets of the	- Art. 527 CC refers to general principles of contract law, in particular the obligation to act in good faith (art. 1134, 3 Civil Code). This provision is interpreted as the basis of the duty to act in the company's interest. The duty to act in the company's interest gives rise to a general duty of loyalty from which, in turn, a duty not to compete, a duty of confidentiality, and a duty to avoid conflicts of interest derive - Art. 1382 Civil Code is an open-ended liability provision → these provisions capture all cases that do not fall within a specific duty

		company are not sufficient to meet all debts, Art. 530 CC (requires serious fault, i.e. 'inexcusable recklessness verging on fraud) → comblement de passif 2) Liability to third parties based on tort law: general liability provision for negligent acts causing damage, Art. 1382 Civil Code	
Bulgaria	Statutory law	1) Commercial Act: specific duties: a) duty of care, s. 237(2) b) disclosure of conflicts of interest: s. 237(3) c) non-competition: s. 237(4) d) confidentiality: s. 237(5) e) regulation of related party transactions, s. 240b 2) Public Offering of Securities Act: s. 116b(1) lays down duties for directors of listed companies 3) Director's mandate: s. 280 Obligations and Contracts Act	The director's mandate under s. 280 Obligations and Contracts Act is interpreted as giving rise to the general duties of loyalty and to manage the company; s. 237(3)-(5) are specific expressions of the general duty of loyalty; when interpreting the specific duties, the courts do so in conjunction with the respective principles of general private law regarding the mandate
Croatia	Statutory law	Companies Act specifies duties: 1) Duty of care, s. 252(1) 2) Confidentiality, s. 252(1) 4) Prohibition of competition, s. 248 5) Other duties in ss. 193, 251, 526	Duty of loyalty not provided for in the statute, but its existence is commonly accepted
Cyprus	Partly case law, partly statutory	Companies Act: 1) Duty to avoid conflicts of interest, s. 191 2) Other specific duties, such as particular disclosure obligations	Not codified: 1) Duty of skill and care 2) Duties of loyalty: a) to act in good faith for the benefit of the company; b) to exercise powers for purposes for which they

			were conferred c) to make independent judgments d) to avoid conflicts of interest
Czech Republic	Statutory law	Commercial Code: 1) Follow instructions of the general meeting, s. 194(4) 2) Duty of care, s. 194(5) 3) Confidentiality, s. 194(5) 4) Non-competition, s. 196 5) Conflict of interests, s. 196a	Exhaustive enumeration of duties in the Commercial Code, no common law duties
Denmark	Statutory law	Companies Act: 1) General provision for liability: s. 361(1) → directors who, in the performance of their duties, have intentionally or negligently caused damage to the company, shareholder, or third parties, are liable to pay damages 2) Risk management, internal control, and information duties, s. 115 3) Duty of loyalty only fragmentarily regulated: a) related party transactions, s. 131 b) duty of confidentiality, s. 132	Duties are found throughout the Companies Act and vary in degree in light of the pertinent company. Furthermore, the duties can be derived from the company's articles of association, the company's rules of procedure and the Danish corporate governance recommendations.
Estonia	Statutory law	1) Duty to act in good faith, Civil Code, § 32 Comprises: a) duty to share information b) equal treatment c) duty not to exercise voting rights in a way that is detrimental to the company or its members 2) Duty of care, Civil Code, § 35; Commercial Code, § 315(1) Comprises:	Exhaustive

		a) duty to be diligent b) duty to be sufficiently informed for making decisions c) duty to restrain from taking unnecessary risks 3) Duty of loyalty, Civil Code, § 35	
Finland	Statutory law (case law is used as a reference in the literature and in private practice when interpreting the law)	1) Companies Act: a) Chapter 1, s. 8: general clause; duty of care and duty to promote the interests of the company (includes loyalty to the company and shareholders); b) Chapter 1, s. 7: equal treatment of shareholders, typically but not exclusively applied in the context of the distribution of assets c) Chapter 6, s. 2: duty to see to the administration and organisation of the company d) basis of liability: - to the company for breaches of the duty of care: Ch. 22, s. 1(1) - to the company, shareholders or third parties for breaches of other provisions of the Companies Act: Ch. 22, s. 1(2) 2) Non-competition and confidentiality are not specifically mentioned in the law, but are typically included in the agreements with directors	Ch. 1, s. 8 is interpreted as including an unwritten duty of loyalty
France	Partly statutory law, partly general principles	Commercial Code: Art. 225-251 for the one-tier SA, 225-256, 257 for the two-tier SA According to 225-251 and 256, directors are liable for: 1) infringements of laws 2) breaches of the articles	Also common law duties, in particular with respect to the duty of loyalty

		3) mismanagement 225-257: members of the supervisory board are liable for negligence in the discharge of their duties	
Germany	Statutory law	1) Duty of care, s. 93(1), sentence 1 Stock Corporation Act 2) Duty of confidentiality, s. 93(1), sentence 3 3) Duty of non-competition, s. 88	General duty of loyalty not explicitly regulated, but accepted by the courts
Greece	Statutory Law	Law 2190/1920: 1) General provision encompassing the duty of loyalty and duty of care, Art. 22a (dual nature: to achieve the objectives of the corporation with the due diligence of a prudent businessman and not to use the position of director for personal benefits to the company's detriment) 2) Duty of confidentiality, Art. 22a(3) 3) Duty of non-competition, Art. 23 4) Regulation of related party transactions, Art. 23a	Non-exhaustive enumeration: general fiduciary duty derived from the agency-relationship between the director and the company and the principle of good faith stemming from the Civil Code. All agents have the responsibility to promote the company's performance and maximise its market value.
Hungary	Statutory law	1) General rules of the Civil Code apply to the liability of directors for breach of duty. 2) The Companies Act specifies: a) certain cases of conflicts of interests b) duty not to disclose business secrets c) duty of non-competition	No exhaustive enumeration of duties. The general fiduciary principles of the Civil Code apply to define the duties of care and loyalty.
Ireland	Mainly case law, supplemented by statutory rules on conflicts of interest	1) Different types of common law and equitable duties equivalent to those under English law: a) duty of care b) duty to act in the best	-

		interest of the company c) duty to act for proper purposes d) duty to avoid conflicts of interests and secret profits 2) Companies Act 1990: additional rules in relation to loans to directors and substantial property transactions involving directors 3) Companies Act 1963: rules on reckless trading and fraudulent trading	
Italy	Statutory law	1) General clause from the Civil Code, Arts. 1175, 1375 (law of obligations): duty to act in good faith when fulfilling contractual obligations 2) Self-dealing, Art. 2391 Civil Code 3) Corporate opportunities, Art. 2391(5) Civil Code 4) Duty of non-competition, Art. 2390 Civil Code 5) Duty of care, Art. 2392(1) Civil Code	Exhaustive enumeration, but the courts take an active role in interpreting the existing law and filling gaps
Latvia	Statutory law	1) The general duty to act as a prudent and careful manager is laid down in Commercial Law 2000, s 169(1). Case law and the legal literature interpret the general principle to give rise to: a) the duty to obey the law, the articles of association and decisions of the general meeting b) the duty of care elements (developed by case law and the legal literature): - duty to employ an adequate level of skill and care - risks must be reasonable given the market circumstances	The duty of loyalty is not explicitly regulated in company law; it follows from the law of agency (Civil Code, s. 2304) and the fiduciary nature of the director's role as an agent. Elements: 1) Duty to act in the best interests of the company 2) Duty to act loyal towards the shareholders as an aggregate

		- duty not to delay decision-making - duty to make well-informed decisions with an aim to reduce possible risks - duty to act independently 2) Duty of non-competition, Commercial Law, s. 171 3) Duty to disclose conflicts of interest, Commercial Law, s. 309(3) 4) Duty of confidentiality, Commercial Law, s. 19	
Lithuania	Statutory law	Civil Code, Art. 2.87: 1) Duty of care 2) Duty to act in good faith 3) Duty of loyalty 4) Duty to avoid conflicts of interest 5) Duty to avoid commingling the property of the company and private property 6) Duty to declare interest in proposed transactions	-
Luxembourg	Statutory law	1) Art. 1382 Civil Code: general tort law provision 2) Companies Act: a) Art. 57: duty to declare conflict of interest b) Art. 59(1) (one-tier board), Art. 60bis-10(1), 60bis-18(1) (two-tier board): liability for contractual breaches or management mistakes (breaches of the duty of care) c) Art. 59(2) (one-tier board), Art. 60*bis*-10(1), 60*bis*-18(2) (two-tier board): liability for breach of the articles or the Companies Act d) Art. 66: duty of confidentiality	General duty of loyalty, which derives from the position of the director, the agency relationship between the director and the company, Art. 59 Companies Act (general liability provision, see left), and Art. 1134 Civil Code (duty of parties to a contract to execute their obligations under the contract in good faith): duty to exercise powers in the best interest of the company

		e) Arts. 72-75: general information duties NOTE: Art. 59 constitutes the legal basis for liability for breaches of *all* duties	
Malta	Mainly statutory law	Companies Act: 1) Duty to act honestly and in good faith in the best interests of the company, Art. 136A(1) 2) Duty of care, Art. 136A(3)(a) 3) Duty not to make profits from the position of director, Art. 136A(3)(b) 4) Duty to ensure that their personal interests do not conflict with the interests of the company, Art. 136A(3)(c) 5) Duty not to use any property, information or opportunity of the company for their own benefit, Art. 136A(3)(d) 6) Duty to exercise the powers they have for the purposes for which the powers were conferred, Art. 136A(3)(e) 7) Duty not to compete with the company, Art. 143(1) 8) Prohibition of making loans or payments for loss of office to directors, Art. 144	Directors' duties are also derived from general principles of law, in particular the provisions of the Civil Code on agency relationships and the fiduciary duties laid down in the Civil Code
Netherlands	Mainly statutory law	1) Internal responsibilities: a) s. 2:8(1): the corporate organs must behave towards each other in accordance with what is required by standards of reasonableness and fairness b) s. 2:9: directors are responsible towards the legal person for a proper performance of the tasks assigned to them 2) External liability (to the	Liability derives from the statute, but the detailed requirements have been developed by case law

		shareholders or creditors): based on tort law and applied by the courts to hold directors liable, *inter alia*, in the following situations: - entering into obligations with a third party, whilst the director knew or should have known that the company would not be able to fulfil them - knowingly frustrating creditors' claims - selective payment, frustrating a single creditor's claim and benefiting another 3) s. 2:138 Civil Code: liability in case of insolvency (*lex specialis* to general tort law) 4) s. 2:139 Civil Code (*lex specialis* to general tort law): if the interim figures or the annual accounts misrepresent the condition of the company, the directors shall be liable to the shareholders or third parties for any loss suffered by them as a result thereof NOTE: while the statute distinguishes between liability according to s. 2:9, s. 2:138, or tort law, it is increasingly argued in the literature that the three grounds have converged into the same standard of assessment	
Poland	Partly statutory law, partly case law	1) Code of Commercial Companies: a) duty to abstain from deciding on conflicted transactions, Art. 377 b) duty of non-competition, Art. 380 c) duty of care, Art. 483 d) loan agreements and other transactions with	Duty of loyalty not codified, but its existence is commonly accepted; it derives from the fiduciary relationship between the company and the director and provisions in the Code of Commercial Companies prohibiting specific types of action, e.g. the duty not to

		the directors require the consent of the GM, Art. 15 2) General tort law, Art. 415 Civil Code: 'whoever by his fault caused a damage to another person shall be obliged to redress it'	compete with the company
Portugal	Statutory law	Code of Commercial Companies: 1) Duty of care, Art. 64(1)(a) 2) Duty of loyalty, Art. 64(1)(b) Liability for a violation of both duties exists pursuant to the rules laid down in Art. 72 3) Duty to disclose related party transactions, Art. 397(2) 4) Duty of non-competition, Art. 398(3)	Some duties that are not expressly regulated in the statute are recognised by the courts as deriving from the general duty of loyalty. Directors are prohibited from: 1) enjoying advantages from transactions between the company and third parties 2) using means or information of the company to their own benefit 3) revealing confidential information about the company
Romania	Statutory law	1) Art. 72 Companies Act: the duties and liability of directors are governed by general agency law (i.e. the law on the mandate under the New Civil Code) and the rules specifically provided for in the Companies Act 2) Companies Act, Art. 73: duty to fulfil all obligations prescribed by law and the articles of association (e.g., duty to observe the capital maintenance provisions, to keep company records, etc.) 3) Formerly fiduciary duties arising from the agency relationship (mandate) between the director and the company, but since 2006 codified in the Companies Act: a) duty of loyalty, Art.	- Where the Companies Act does not contain any regulation, the rules under the New Civil Code on agency (the mandate) can be used to fill gaps (see left). In accordance with the nature of the mandate as a fiduciary relationship, the rules arising under the mandate are described as fiduciary duties. These include: a) duty to act in good faith, Art. 14 (this duty is considered as the essence of the duty of loyalty) b) general duty of loyalty (Art. 803(2)), encompassing the duties of disclosure and of confidentiality - Dogmatically, breach of the mandate leads to contractual liability.

		144(1), encompassing: - duty to treat the business of the company fairly and honestly - to act intra vires - to promote exclusively the interests of the company - to avoid conflicts of interest - to refrain from using corporate opportunities b) duty not to compete with the company, Art. 153[11] c) duty of care, Art. 144(1)	
Slovakia	Statutory law	Commercial Code, ss. 191-196a 1) s. 194(5): a) duty of care b) duty to exercise powers in accordance with the interests of the company / duty of loyalty c) duty of confidentiality 2) Duty to act in good faith, s. 194(7) 3) Duty of non-competition, s. 196 4) Prohibition of certain transactions (regarding loans, credit, property etc.) with the director, s. 196a	Directors' duties are not exhaustively regulated in ss. 191-196a Commercial Code; in order to fill gaps, the rules on agency law (ss. 566-576 Commercial Code) apply pursuant to s. 66(3)
Slovenia	Statutory law	1) Companies Act (ZGD-1): a) duty of care, Art. 263(1) b) confidentiality, Art. 263(1) c) regulation of related party transactions and general duty to avoid conflicts of interest, Art. 38a d) duty of non-competition, Art. 41 2) Directors' duties with respect to the financial operations of the	High Court of Ljubljana: directors may not only be liable on the basis of ZGD-1 rules on liability, but also because of a breach of the agency agreement that exists between the company and the director

		company are additionally regulated in the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (ZFPPIPP) (applicable to all companies outside insolvency): When managing the company's operations, the management shall act with the professional due diligence of the corporate finance profession, endeavouring to ensure that the company is at all times liquid and solvent (Art. 28(2)). 3) Heightened standards exist for banks and other financial institutions in specific legislation	
Spain	Statutory law	LSC: 1) Duty of care, s. 225 2) Loyalty, s. 226 3) Prohibition to use the company name, s. 227 4) Prohibition to take advantage of business opportunities, s. 228 5) Conflict of interest, s. 229 6) Duty of non-competition, s. 230 7) Confidentiality, s. 232	Exhaustive regulation in the LSC
Sweden	Statutory law	Companies Act: 1) Duty to monitor, Ch. 8, § 4(3) 2) Conflict of interest regulation, Ch. 7, § 46 (shareholders), Ch. 8, § 23 (directors), Ch. 8, § 34 (managing director) 3) General basis for liability: Ch. 29, § 1: a director who in the performance of his or her duties, intentionally or negligently causes damage to the company shall compensate such damage.	Duty of loyalty and duty of care are not explicitly regulated, but can be derived from the directors' specific duties in the Companies Act. Duties can also be derived from the company's articles of association.

United Kingdom	Now statutory law, prior to 2006 common law	1) Duty to act within powers, s. 171 2) Duty to promote the success of the company, s. 172 3) Duty to exercise independent judgment, s. 173 4) Duty of care, s. 174 5) Duty to avoid conflicts of interest, s. 175 6) Duty not to accept benefits from third parties, s. 176 7) Duty to declare interest in proposed transaction, s. 177	Common law duties codified

Discussion

Member states differ both with respect to the general approach to the regulation of directors' duties – based on a system of statutory rules or general principles of law (e.g., fiduciary principles or the law of agency[51]) that are elaborated and amplified by the courts – and the level of detail with which the duties are laid down in statute. The first point relates to the well-known distinction between common law and civil law countries, although we will see that this distinction has lost much of its meaning in the context of directors' duties. As far as the second point is concerned, we can distinguish between jurisdictions that provide for a largely exhaustive list of specifically defined duties and jurisdictions that rely on a general clause that defines the behavioural expectations of directors in broad terms. The two points are not parallel. Directors' duties may be uncodified but nevertheless distinguish between specific duties and attempt to regulate all relevant conflicts exhaustively. This is the case with Cyprus, Ireland, and (until the company law reforms of 2006) the United Kingdom. On the other hand, civil law jurisdictions may simply contain a broad formulation of the directors' responsibilities, which we observe in particular in the case of Belgium, France, Luxembourg, and the Netherlands (but no longer in other countries influenced by French commercial law, notably Spain and Portugal, which have recently moved towards a system of specific and express duties), and in the Nordic and Baltic countries (Denmark, Estonia, Finland, Latvia, and Sweden). Either way, we note that all legal systems draw on principles of general contract law, tort law, or fiduciary principles to supplement the company law-specific rules where necessary. For example, French, Belgian, and Dutch law utilise the general liability provisions of the law of tort and negligence;[52] many jurisdictions, among them Bulgaria,

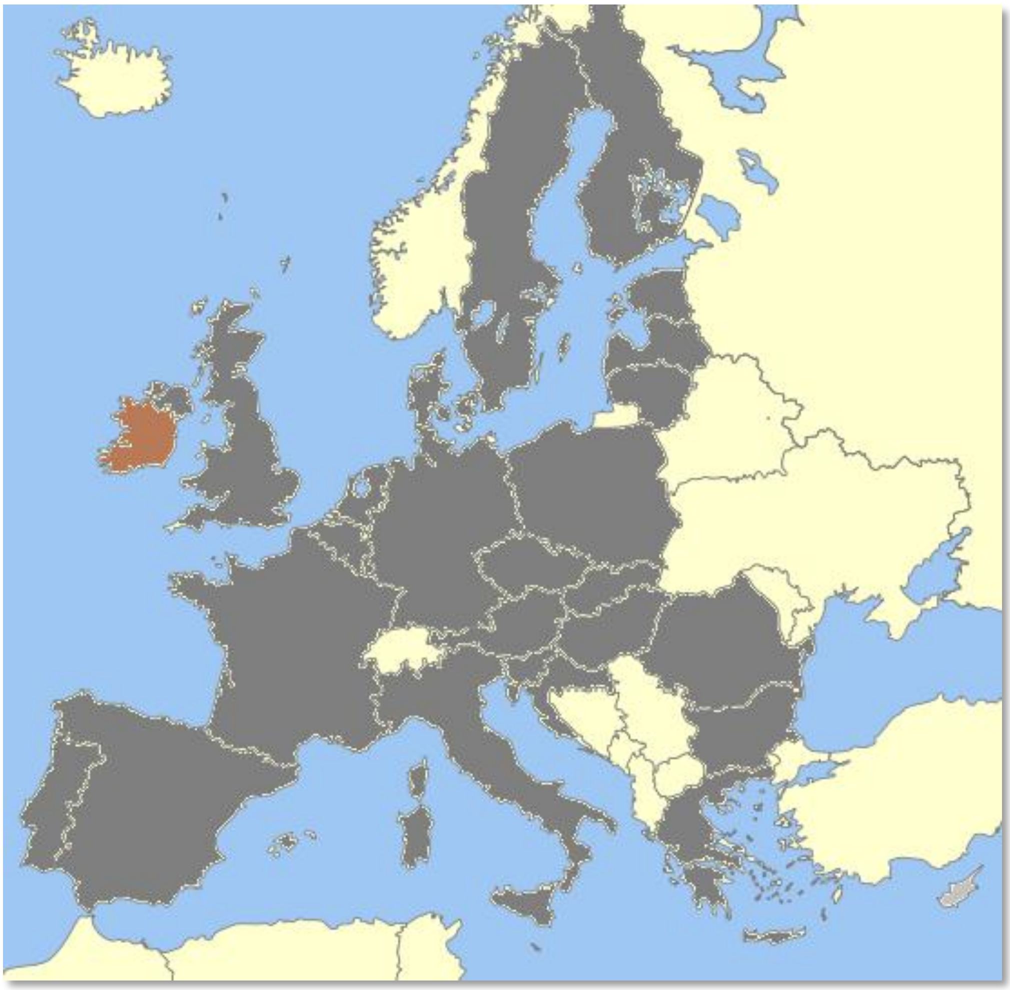
[51] Fiduciary principles are trust law based in common law jurisdictions, i.e. directors are seen as having to act exclusively for the benefit of the beneficiaries (the shareholders). Agency (sometimes called 'mandate'), on the other hand, refers to the contractual relationship by means of which the principal confers authority on the agent to act on the principal's behalf within a specified area of business or to carry out a particular transaction. From the common law point of view, these two concepts are to be distinguished. The law imposes more demanding expectations on trustees than on agents: 'Directors are not only agents, but to a certain extent trustees. . . . The duty of directors to shareholders is so to conduct the business of the company, as to obtain for the benefit of the shareholders the greatest advantages that can be obtained consistently with the trust reposed in them by the shareholders and with honesty to other people; and although it is true that the directors have more power, both for good and for evil, than is possessed by the shareholders individually, still that power is limited and accompanied by at trust, and is to be exercised bona fide for the purposes for which it was given, and in the manner contemplated by those who gave it.' N. Lindley, *A Treatise on the Law of Partnerships, Including its Application to Companies* (Callaghan & Company 1878), 364. Civil law jurisdictions are less familiar with the concept of the trustee; they have not developed a clear distinction between trust and agency. Rather, they generally assume that certain principles of good faith and honesty underlie all contractual or commercial relationships (see, for example, s. 242 of the German Civil Code, requiring debtors to act in good faith and take account of customary practice).

[52] Belgian Civil Code, Arts. 1382, 1383; French Civil Code, Arts. 1382, 1383; Dutch Civil Code, s. 6:162.

Greece, Latvia, Romania, Slovakia, and Slovenia, explicitly refer to the law on agency to complement directors' liability.

In *Map 2.1.a*, we classify the Member States according to the divide between codified and common law duties. The directors' duties of virtually all countries derive, at least to some extent, from case law, even if the company law is largely codified. The distinction between codified and common law countries is not so much one of a strict dichotomy as of a gradual difference or change in emphasis. The jurisdictions are located on a continuum and the importance accorded to case law or statutory law, respectively, changes incrementally, without a clear dividing line between the two regulatory approaches. With this caveat in mind, we assign the jurisdictions to three groups: (1) Countries with *predominantly* codified systems of directors' duties; (2) jurisdictions where some of the main duties (e.g., duty of skill and care, duty not to enter into related-party transactions, etc.) are codified, but a significant number of duties are not; and (3) countries with *predominantly* case-law based duties.

Map 2.1.a: Regulatory approach to directors' duties



Legend	Country
Predominantly codified duties	AT, BE, BG, HR, CZ, DK, EE, FI, FR, DE, EL, HU, IT, LV, LT, LU, MT, NL, PL, PT, RO, SK, SI, ES, SE, UK

	Partly statutory law, partly case-law[53]	CY
	Case law	IE

In almost all countries, directors' duties are predominantly codified. The only exceptions are Ireland, where directors' duties are derived from case law, similar to the situation in the United Kingdom before the company law reform that led to the adoption of the Companies Act 2006, and Cyprus, where the main duties (duty of skill and care, duty to act in good faith for the benefit of the company, and duty to exercise powers for purposes for which they were conferred) are not codified. The codification (or lack thereof) of directors' duties exemplifies well the affiliation of countries to different legal families. The countries belonging to the common law (Cyprus, Ireland, and UK) have, or have had until recently (UK pre-2006) largely or exclusively case-law derived directors' duties. Therefore, they conform to the type of law-making and legal sources that we would expect from that legal family. This no longer applies to the United Kingdom, of course, but the UK's common law heritage continues to be generally determinative of directors' duties because the Companies Act 2006 aims to a large extent to codify the existing common law principles, rather than rewrite the law.[54] In addition, the Companies Act 2006 expressly stipulates that 'regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying' the statutory duties.[55]

As far as countries belonging to the first category are concerned (predominantly codified duties), a more detailed analysis shows that all jurisdictions rely to varying degrees on case law to define and amplify directors' duties. Case law is, first of all, important in interpreting and clarifying the content of the codified duties. In addition, we can observe that, where the codified rules are insufficient, the courts and/or the legal literature may take recourse to the legal relationship between the company and the director, which is commonly held to be of a fiduciary nature and, accordingly, give rise to fiduciary duties, or to other general principles of law.[56] Good examples of this interplay between statutory rules and case-law influences are France, Germany, and some of the Nordic and Baltic countries (Denmark, Finland, Latvia, and Sweden). The French Code de Commerce expressly provides for liability in case of infringements of the law or the articles of association or management mistakes (*faute de gestion*).[57] It does not, however, mention the duty of loyalty, which has been developed by the courts and whose dogmatic basis remains controversial.[58] Similarly, the German Stock Corporation Act contains only one provision regarding directors' liability, which is structured around the duty of care,[59] and a number of norms specifically tailored to situations that would fall within the remit of the duty of loyalty, using common law terminology, notably the duty not to compete with the company[60] and the duty of confidentiality.[61] Nevertheless, it is well established under German law that directors are bound by a general duty of loyalty developed by the courts and derived from good faith principles of contract law that covers cases not explicitly regulated by the statute. Finally, the Nordic and Baltic countries often provide only for a fragmentary codification of directors' duties, with the consequences that contractual freedom plays an important role and a number of duties (for example, the duty of loyalty) are implied under general legal principles.

[53] In most countries, case law plays an important role in interpreting and amplifying directors' duties. We classify a country as 'partly statutory law, partly case-law' if several of the most important duties, e.g. the duty of skill and care and the duty of loyalty, are not derived from a statutory enactment, but are exclusively developed by the courts.

[54] A notable exception are the rules on derivative actions (Companies Act 2006, ss. 260-269), which have replaced the famous (and for individual shareholders disadvantageous) principles established by *Foss v Harbottle* (1843) 67 ER 189 and its progeny. In countries influenced by the English common law that have not followed the UK's lead in changing the case law, namely Cyprus and Ireland, the restrictive rule in *Foss v Harbottle* continues to apply, see *Table 3.2.a* below.

[55] Companies Act 2006, s. 170(4).

[56] See the description of directors' duties in *Table 2.1.a* above.

[57] Code de Commerce, L225-251.

[58] See below 3.4.

[59] German Stock Corporation Act, § 93.

[60] German Stock Corporation Act, § 88.

[61] German Stock Corporation Act, § 93(1), sentence 2.

Therefore, the source of the jurisdiction's rules on directors' duties and liability seems to be of secondary importance. Notwithstanding a country's regular approach, the analysis suggests that the law in most legal systems is elastic enough to allow the courts to derive solutions for novel conflicts that are not addressed by the statute. Furthermore, irrespective of the paucity or indeterminacy of the statutory sources of directors' duties, we find that the content of the duties is nuanced and applicable to a variety of conflicts, provided that the courts have had the opportunity to build on the codified rules and develop the legal principles.[62] This observation implies two findings. First, the indeterminate or fragmentary codification of directors' duties *as such* does not necessarily lead to an insufficient level of investor protection. Second, it may, however, suggest a higher level of legal uncertainty, at least until judicially developed rules are well established, which, in turn, may require time and the existence of procedural rules that facilitate access to justice.

2.2 Addressees of directors' duties

2.2.1 Who owes the duties?

Summary of the country reports

Table 2.2.1.a: Who owes the duties?

Country	*Does the concept of the de facto or shadow director exist?*	*If yes, how are de facto or shadow directors defined?*	*Under what conditions are de facto or shadow directors liable?*	*Application to parent companies / controlling shareholders?*
Austria	**Yes** de facto directors are recognised in case law and academic writing	No statutory definition A de facto director is defined as a person who is not formally appointed as director and, thus, not registered in the Companies Register as director but who, in fact, significantly influences the management of the company	De facto directors are not generally subject to the same duties as formally appointed directors; liability may, however attach under certain circumstances. In particular, liability for failure to file for insolvency and liability for grossly negligent depletion of assets in a pre-insolvency context have been accepted by the courts.	**Yes** Most relevant cases involve sole or controlling shareholder who in fact manages the company, with the appointed director only executing the directions received from that shareholder/parent company Liability also attaches where persons intentionally use their influence over the company to induce a director to act to

[62] Case in point is Dutch law, which contains only two rather indeterminate provisions on the (internal) responsibility of directors: ss. 2:8 and 2:9 of the Dutch Civil Code. The sections provide that 'the legal entity and those who . . . are involved in its organisation must act in relation to each other in accordance with the principles of reasonableness and fairness' (s. 2:8 DCC) and that directors 'are responsible towards the legal person for a proper performance of the tasks assigned to them' (s. 2:9 DCC). The Dutch courts have relied on these provisions to regulate issues as diverse as the determination of the required standard of care and competence of directors, noncompliance with the articles of associations, entering into related-party transactions for which the director lacked authority, or starting a competing business. For more details see the Dutch country report and the summary below in *Tables 2.4.2.a* and *2.5.2.a*.

Country	*Does the concept of the de facto or shadow director exist?*	*If yes, how are de facto or shadow directors defined?*	*Under what conditions are de facto or shadow directors liable?*	*Application to parent companies / controlling shareholders?*
				the detriment of the company or the shareholders
Belgium	**Yes** de facto directors are recognised in case law and academic writing and referred to in statutory law	No statutory definition Case law defines a person as a de facto director, where such person performs *"positive and independent acts of management"*. Unclear whether mere influencing of management suffices to be held liable as de facto director. Concept may also cover shadow directors (i.e. directors who do not act as directors vis-à-vis third parties), subject to the requirement of "active" management	Mainly relevant in relation to insolvency and near-insolvency duties. Liability based on tort law principles; liability based on general duties disputed, and no relevant case law	**unclear** Unclear whether parent company may also fall under relevant provisions
Bulgaria	**No** not recognised as such by Bulgarian law; not recognised in court practice	-	-	**no** strong presumption that limited liability shields shareholders in virtually all circumstances; controlling shareholder cannot be held liable as a de facto director
Croatia	**unclear** *(in relation to de facto directors)* not addressed in	**de facto directors** Based on discussion in legal	**de facto directors** *unclear* **shadow directors** General liability for	**yes** Parent company may be held liable as shadow director

Country	*Does the concept of the de facto or shadow director exist?*	*If yes, how are de facto or shadow directors defined?*	*Under what conditions are de facto or shadow directors liable?*	*Application to parent companies / controlling shareholders?*
	legislation and no relevant case law discussed in scholarly writing based on German legal doctrine **yes** *(in relation to shadow directors)*	literature, persons whose appointment was invalid due to a defect in the appointment procedure and persons acting as if they were directors in relation to both the company and in relation to third parties may be considered de facto directors *(but unclear and disputed)* **shadow directors** any person who can effectively influence decisions of the company, subject to conditions for liability	deliberately exercising influence on company organs, causing the performance of an act that results in damage to company or co-shareholders	
Cyprus	**Yes** Both de facto and shadow directors are recognised	statutory definition of shadow directors; any person on whose advice or instructions the directors of a company are accustomed to act concept of de facto directors mainly applied in relation to defective appointment	De facto/shadow directors are liable under conditions applicable to de jure directors, but no clear guidance in Cypriot case law	**Yes** But only in exceptional circumstances. Exercise of control rights (i.e. voting) will not normally suffice
Czech Republic	**Yes** Statutory law	statutory definition: persons who, as a result of contract, shareholding, or	De facto directors are liable under the same conditions applicable to de	**Yes** Influence due to shareholding explicitly mentioned

Country	Does the concept of the de facto or shadow director exist?	If yes, how are de facto or shadow directors defined?	Under what conditions are de facto or shadow directors liable?	Application to parent companies / controlling shareholders?
		otherwise have "substantial influence" over the company's conduct, despite not being appointed as directors	jure directors	
Denmark	**Yes** Recognised by courts	no statutory definition, but person who effectively makes executive decisions may be considered de facto director without having been appointed	Very demanding requirements for holding de facto directors responsible based on case law	**unclear** No clear rule on application to parent company, but discussion about liability of de facto directors seems to centre around natural persons
Estonia	**Yes** Recognised by courts, primarily for purposes of criminal law	no statutory definition, but according to case law a person who manages the company without being formally appointed as de jure director	**De facto directors:** So far, this has only been discussed in relation to criminal liability. It is unclear whether general duties also apply to de facto/shadow directors	**yes** liability may arise due to statutory rule about misuse of influence
Finland	**Yes** Has been discussed in relation to criminal liability in particular	Exercising functions and fulfilling tasks of director without being formally appointed	**de facto directors:** probably liable like de jure directors where appointment was defective **shadow directors:** only in exceptional cases	**yes** but only in very limited circumstances as shadow directors
France	**Yes** Recognised in case law and scholarly writing ("dirigeants de fait")	no statutory definition, but according to case law and legal literature Person who freely and independently carries out	liability based on general tort principles (solvent companies) statutory liability, equivalent to de jure director liability,	**yes** but only in very limited circumstances – harm to company must have been intended; note: application of *Rozenblum*

Country	Does the concept of the de facto or shadow director exist?	If yes, how are de facto or shadow directors defined?	Under what conditions are de facto or shadow directors liable?	Application to parent companies / controlling shareholders?
		management activities, whether alone or together with other people, on a regular and continuous basis, without being a de jure director	in insolvent companies[63]	doctrine allows parent to (intentionally) take certain actions to the detriment of subsidiary in group context[64]
Germany	**Yes** Recognised in case law and scholarly writing	**de facto directors:** no statutory definition, but accepted where person acts as if he or she was a de jure director without valid appointment, including in cases of defective appointment **shadow directors:** person who instructs and directs de jure directors, if instructions and directions are complied with	liability accepted for failure to file for insolvency and liability for grossly negligent depletion of assets in a pre-insolvency context; for de facto directors, a more extensive application of directors' duties and liability is being discussed, but subject to dispute; limited case law outside insolvency context	**Yes** Liability may arise for damaging influence and under German group law Liability of persons who intentionally use their influence over the company to induce a director to act to the detriment of the company or the shareholders, s. 117
Greece	**Yes** Recognised in case law and scholarly writing ("dirigeants de fait")	no statutory definition; but according to case law and legal literature the concept covers persons who "exercise the real direction and management of the company's business affairs"; this may include	liability as for de jure directors special liability in insolvency context, where exercise of influence led to insolvency criminal liability also applies	**yes** mainly relevant in insolvency context, where parent company's influence causes or aggravates insolvency

[63] See PH Conac, L Enriques, and M Gelter, 'Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy' (2007) 4 *European Company and Financial Law Review* 491, 509.

[64] The *Rozenblum* doctrine is derived from the criminal law judgment of the French Supreme Court of 4 February 1985 ('Arrêt Rozenblum'). It provides that financial assistance by one group company to another will not be qualified as a misuse of company assets (*abus de biens sociaux*) if (1) a firmly established group structure exists; (2) the financial assistance was dictated by a common economic or financial interest of the group; and (3) it involves an element of consideration and does not disturb the balance of commitments of the group companies.

Country	Does the concept of the de facto or shadow director exist?	If yes, how are de facto or shadow directors defined?	Under what conditions are de facto or shadow directors liable?	Application to parent companies / controlling shareholders?
		controlling shareholder, or major creditors or suppliers who exercise "significant influence" over management of the company		
Hungary	**Yes** Special statutory rules regarding undue influence on company	Statutory liability applies to controlling shareholder	Unlimited liability where shareholder caused the pursuit of a business policy "permanently detrimental to the company"	**yes** mainly relevant in insolvency context, but under group law provisions special rights for creditors may also apply in solvent companies
Ireland	**Yes** Both de facto and shadow directors are recognised in case law; shadow directors explicitly addressed in statutory law	**de facto directors:** concept mainly applied in relation to defective appointment **shadow directors:** according to statutory definition a person "in accordance with whose directions or instructions the directors of a company are accustomed to act."[65]	De facto directors are generally liable under conditions applicable to de jure directors (if natural person) Shadow directors probably have less extensive duties, but civil liability for fraudulent and reckless trading applies to shadow directors	**Yes** In exceptional circumstances as shadow director; exercise of control rights (i.e. voting) will not normally suffice
Italy	**Yes** concept accepted (*amministratore di fatto*) by analogy to criminal law provisions – Art. 2639 Civil Code – and civil law rules pursuant to	no clear definition	Liability accepted by courts Clear liability rule in case members intentionally decided or authorised actions that proved to be harmful for the	**Yes** At least in circumstances where parent company intentionally decided or authorised actions that proved to be harmful for the

[65] An exception applies for persons offering professional advice.

Country	*Does the concept of the de facto or shadow director exist?*	*If yes, how are de facto or shadow directors defined?*	*Under what conditions are de facto or shadow directors liable?*	*Application to parent companies / controlling shareholders?*
	Articles 2369 and 2030 Civil Code		company (*atti dannosi per la societa'*). In this case, shareholders are jointly and severally liable with the *de jure* directors according to Article 2476 (7) Civil Code	company
Latvia	**No** not recognised in court practice	-		**No (unclear)**
Lithuania	**Yes** but only in relation to "undue intrusion" by shareholders into management affairs	-	Recognised in case of "undue intrusion" by shareholder; liability also applies for breach of certain insolvency related duties	**yes** in case of "undue intrusion", controlling shareholder may be treated as member of management body for liability purposes
Luxembourg	**Yes** Recognised in case law and scholarly writing	Fact-based analysis by the courts: positive activity, carried out independently and freely, that results in *directing* the company, and that goes beyond advising the company	liability as for de jure directors	**Yes** but only in limited circumstances, based on tort law.
Malta	**Yes** Recognised in case law	Person carrying out substantially the same functions in relation to the direction of the company as those carried out by a director	liability as for de jure directors	**Yes** In exceptional circumstances; exercise of control rights (i.e. voting) will not suffice
Netherlands	**Yes** statutory rules in relation to	someone who (partly)	liability equivalent to de jure directors	**Yes** in insolvency of company, under

Country	*Does the concept of the de facto or shadow director exist?*	*If yes, how are de facto or shadow directors defined?*	*Under what conditions are de facto or shadow directors liable?*	*Application to parent companies / controlling shareholders?*
	insolvency law; case law suggests wider application	determines the policy of the company as if s/he was a director	special statutory liability in case of insolvency; also tax liability in certain circumstances;	exceptional circumstances
Poland	**unclear** not addressed in legislation and no relevant case law discussed in scholarly writing in relation to corporate groups and based on tort law	possibly parent company under exceptional circumstances	*Unclear*	**unclear** possible under tort law, but situation is unclear
Portugal	**Yes** statutory rules in relation to insolvency law; case law suggests wider application	any person who, without sufficient title, performs in an autonomous way, either directly or indirectly, functions usually performed by de jure directors	Mainly relevant in insolvency context; Criminal liability also applies to de facto directors	**Unclear** Application to legal persons unclear
Romania	**Yes** Recognised in case law	persons who overwhelmingly influenced the company's activities	Mainly relevant in insolvency context	**Yes (unclear)** Possible liability under tort law
Slovakia	**No** Concept not generally recognised in Slovak law	In limited cases, appointed directors may be treated like directors before the appointment has formally become valid	Tort law-based liability may exist	**No** Only general tort law liability
Slovenia	**No** Not recognised in Slovenian law	-	Whereas the concept of de facto directors is not recognised, liability	**No** Except for knowingly inducing company to act in a way that

Country	Does the concept of the de facto or shadow director exist?	If yes, how are de facto or shadow directors defined?	Under what conditions are de facto or shadow directors liable?	Application to parent companies / controlling shareholders?
			attaches for knowingly inducing a company to act in a way that damages company or its shareholders	damages company/its shareholders
Spain	**Yes** Part of statutory law	Not defined in statute, but persons who continuously and independently act on behalf of the company with the knowledge of the shareholders; actions must amount to "real administration"; unclear whether powers must be exercised in relation to third parties. Shadow directors are generally defined as persons who do not exercise the powers of de jure directors, but whose instructions are complied with by the directors	de facto and shadow directors are generally exposed to the same liability as de jure directors	**Yes** Liability as de facto directors when managing the companies affairs on a regular and continuous basis
Sweden	**Yes** Recognised in case law and legal literature	person not formally appointed, but carrying out tasks and making decisions as if he or she was a director	Liability as for de jure director	**Yes** If parent carries out tasks and makes decisions as if it was a (corporate) director; liability may also arise on basis of tort law
United Kingdom	**Yes**	**de facto directors:** A de facto director is a person who assumes the	De facto directors are subject to the same duties as de	**Yes** In exceptional circumstances as shadow or de facto director;

Country	*Does the concept of the de facto or shadow director exist?*	*If yes, how are de facto or shadow directors defined?*	*Under what conditions are de facto or shadow directors liable?*	*Application to parent companies / controlling shareholders?*
		status of, and performs the functions of, a director, is held out to be a director, and undertakes functions in relation to the company which could only be properly discharged by a director. **shadow directors:** according to statutory definition a person ‘‘in accordance with whose directions or instructions the directors of a company are accustomed to act.”	jure directors; Unclear whether all duties also apply with full force to shadow directors	exercise of control rights (i.e. voting) will not suffice

Discussion

In all jurisdictions covered by this report, the main addressees of directors’ duties are, of course, the validly appointed members of the relevant company bodies. A person appointed in accordance with the applicable company law rules and the relevant provisions set out in the company’s articles of association is referred to as de jure director, and the application of the rules set out below to de jure directors form the core scope of this report.

As is evident from the table above, however, the vast majority of Member States recognise that the duties that national company law defines for de jure directors should, under certain circumstances, also apply to other persons with a comparable relationship to the company and its stakeholders. In the table above, we distinguish between two main sets of circumstances in which company law often extends the scope of application of some or all rules primarily applicable to de jure directors.

The first category concerns, in general terms, persons who act *as if they were de jure directors*, despite not having been validly appointed as such. This category can be further divided into two sub-groups. First, the act of appointing a director may have been “defective”, e.g. because one or more formal requirements for a valid appointment have not been complied with. This is probably the group of cases with the longest history.[66] It is also the group of cases in relation to which the suitability of an extension of the scope of application of directors’ duties is least controversial. Typically, neither the

[66] In the UK, for instance, courts have been dealing with this problem since the 19th century; see D Kershaw, *Company Law in Context* (2nd ed., Oxford: Oxford University Press 2012) 320.

"director" nor the appointing body will be aware of the defects of the appointment. Even the jurisdictions that do not formally recognise the application of directors' duties to de facto directors according to the table above typically resolve the matter by providing that any defects that may have attached to the process of appointment "are healed" upon registration of a person as director with the relevant register.[67]

The second sub-group concerns persons in relation to whom no attempt has been made to formally appoint them as directors. Nevertheless, they *behave* as if they had been validly appointed – i.e. they perform the same function and fulfil the same tasks as de jure directors would usually do. As can be seen above, most Member States also extend at least *some* of the duties to this type of director. In some jurisdictions the application of directors' duties may require that such persons act *as if they were (de jure) directors* not only internally, but also vis-à-vis third parties and/or require such persons to be held out as directors by the company. The exact content of the duties applicable to this type of director differs significantly across Europe, and in a number of jurisdictions no clear definition exists of the requirements that have to be met before someone is treated as a director.

The most problematic category concerns persons who do not act as if they were de jure directors, nor purport to be directors. Rather, they exercise a certain degree of influence over the company's affairs that affords them a level of factual control comparable to the power that is typically vested in the board(s). As a matter of fact, in most groups of companies, the (group-wide) corporate strategy is not set at the level of each legal entity, but rather centrally at the parent company level. This then raises the question whether the parent company itself, or its directors, may be held liable in the same manner as the de jure directors of the legal entities they control.

None of the Member States answers this question with an unqualified "yes", not least because doing so would call into question the very concept of limited liability. However, a number of Member States do provide for liability of legal or natural persons wielding significant influence over the company. These Member States differ significantly in the degree of control and influence that may lead to the imposition of director-like duties on the parent company or its management. The spectrum reaches from jurisdictions where a controlling shareholder or parent company will *virtually never* be held liable for exercising control over a company,[68] to jurisdictions where – at least in the company's insolvency – a significant risk of liability may exist for a parent company actively exercising control.[69] In a number of jurisdictions, general tort law concepts are used to achieve similar results. Where this is the case, the liability will often also apply to foreign-incorporated companies.[70]

2.2.2 To whom are the duties owed?

Summary of the country reports

Table 2.2.2.a: Constituencies to whom directors' duties are owed

Country	***Duties owed to the company / source of directors' powers***	***Shareholders***	***Creditors***	***Other stakeholders***
Austria	- Company - Powers derived from statute, not	1) Company law: no 2) General civil	1) Company law: no 2) General civil	-

[67] See Art 3 of the codified version of the First Company Law Directive (Directive 2009/101/EC of the European Parliament and of the Council of 16 September 2009 on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second Paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent, OJ 2009 L 258/11).
[68] This seems to be the position of Bulgaria, for instance.
[69] See, e.g. the Czech law position, where the parent company may owe a duty of care in relation to the exercise of its control. Even where liability is provided for, the exact conditions differ significantly from jurisdiction to jurisdiction.
[70] See also Section 5. below concerning this problem.

	delegated from the shareholders; articles of association cannot change the basic allocation of powers between shareholders, supervisory board and management board; no instruction rights of shareholders, but where directors choose to put a question to the general meeting, they are bound to comply with decision of the shareholders	law: directors are liable personally if they acted intentionally and pursued significant economic self-interests or an exceptional trust relationship was created with the plaintiff shareholder 3) Tort law: a) s. 1295(2) ABGB: general liability for intentionally caused damages, provided that defendant acted unconscionably ; b) s. 1300 ABGB: knowingly giving wrong advice c) s. 874 ABGB: deceit d) a violation of rules directed at protecting third parties can also lead to direct liability, e.g. violation of s. 255(1) AktG (criminal liability of directors who intentionally make incorrect statements in public reports)	law: pre-contractual duty to provide the creditors with relevant information (requirements as with liability to shareholders (2)) 3) Insolvency law protective rules with respect to the creditors a) delayed application for the opening of insolvency proceedings, s. 69(2) Insolvency Act: b) grossly negligent encroachment on creditors' interests, s. 159 Criminal Act	
Belgium	- Company - Groups: the group interest can be taken into account under the conditions of *Rozenblum*[71] - Liability based on Art. 527 CC (general law of contract)	Tort/Art. 528 CC Note: The relevance of this claim is limited to scenarios where the company has suffered a loss distinct from the loss suffered by all shareholders proportionally as a result of the decrease of the	1) Tort/Art. 528 CC 2) Art. 530 CC (bankruptcy)	Tort/Art. 528 CC

[71] See above n 64.

		company's assets. Example of liability: the shareholder bought his/her shares at a price that was too high, having based his/her decision on incorrect accounts		
Bulgaria	Company	No	No	No
Croatia	Company	No special duties to the shareholders; but indirectly, by acting in the best interest of the company, the directors may have duties to the shareholders. If they suffer damage independently from the damage caused to the PLC, shareholders have a claim against the directors (or other person who deliberately influenced members of board or executive officers to perform an action which caused damage).	Duties not owed to the creditors, except indirectly, by acting in the best interest of the company, which includes the requirement that the company has sufficient assets to honour the obligations towards the creditors.	No duties to other stakeholders
Cyprus	Company	In particular situations according to English case law (see below)	In the vicinity of insolvency (according to English case law)	No
Czech Republic	- Company - The executive and supervisory organs are subordinated to the GM, which can give instructions to the other organs (derived from s. 194)	- No - Shareholders may have a direct claim under tort law (see s. 415 Civil Code: everyone is obliged to act so as not to cause damage to health, property, nature and the	No	No

		environment), but the claim is generally directed against the company, not the individual director		
Denmark	- Company - Powers delegated from the shareholders, who have instruction rights	Members of the management who, in the performance of their duties, intentionally or negligently cause damage to shareholders or third parties are liable to pay damages, s. 361(1)	Yes, see left	Yes, see left
Estonia	- Company - Powers derived from statute, not delegated from the shareholders	In general no duty owed to the shareholders, but directors can be held liable to the shareholders (and creditors) where the damage was caused wrongfully as the result of a merger, Commercial Code, § 403(6)	In general no duty owed to the creditors, unless the director breaches a duty established for the protection of the creditors (duty to organize accounting, file for bankruptcy, mergers etc.); this liability is based on tort law	-
Finland	- Company - The directors have general powers to manage the company; in contrast, the GM shall only decide over specifically defined matters	Liability can exist towards the shareholders for breaches of provisions of the Companies Act, Ch. 22, s. 1(2)	Liability can exist towards third parties for breaches of provisions of the Companies Act, Ch. 22, s. 1(2)	Liability can exist towards third parties for breaches of provisions of the Companies Act, Ch. 22, s. 1(2)
France	- Company - Groups: the group interest can be taken into account under the conditions of *Rozenblum* - Source of directors' powers: with a decision from 1943, French company law shifted from a contractual to an	Yes; duty of loyalty: e.g., if the director transacts directly with the shareholder and buys the shares without disclosing that a potential buyer exists who is prepared to purchase them for a higher price	-	Directors owe duties directly to third parties, and are liable to these parties, if they commit a fault that is separable from their functions (*faute séparable des fonctions*) (stems from administrative law). Definition

	institutional approach, i.e. directors receive their powers from statute			separable fault: if the director 1) intentionally 2) commits a particularly serious fault that is incompatible with the normal exercise of the director's functions (e.g., the director failed to insure the employee's executive car)
Germany	- Company - Powers derived from statute, not delegated from the shareholders	1) Company law: no 2) Possibly general civil law or tort law, but requirements are restrictive	1) Company law: no 2) Possibly general civil law or tort law, but requirements are restrictive	-
Greece	Company	-	Shift in the vicinity of insolvency to the creditors	-
Hungary	- Company - Powers derived from statute, not delegated from the shareholders	In limited cases duties under general private law may be owed directly to the shareholders, e.g. if the directors, upon the request of the shareholders, provide information about the affairs of the company or make direct approaches to, and deal with, the shareholders and hold themselves out as agents for them in connection with the acquisition or disposal of shares	Shift in the vicinity of insolvency to the creditors	-
Ireland	- Company - Powers delegated from the shareholders	Duties may be owed to a shareholder directly where what is at issue is not the collective interests of the corporate entity	Limited duty of directors to consider the interests of creditors when their interests intrude on the company being	No common law duty to consider the interests of employees, but s. 52 of the Companies Act 1990 requires directors to

		but the interests of the shareholder qua individual	wound up, on occasion where a company is insolvent and even where insolvency is simply looming on the horizon	consider the interests of the company's employees as well as the interests of members (not significant in practice given the lack of a direct enforcement mechanism)
Italy	Company	Only if the director's action exclusively affected the rights of the shareholder, Art. 2395 Civil Code	Art. 2394 Civil Code: liability directly to creditors if the company's assets have not been preserved (particularly relevant when the company is insolvent) (majority of case law: tort-based liability, with the consequence that the claimant has to prove negligence)	-
Latvia	- Company - Powers derived from statute, not delegated from the shareholders	Only according to principles of tort law	Only according to principles of tort law	Only according to principles of tort law
Lithuania	Civil Code, Art. 2.87(1): - Company - Members of other bodies of the company	Art. 19(8) Law on Companies: 'The management bodies of the company must act on behalf of and in the interest of the company and its shareholders.'	The Supreme Court has stated that civil liability of the directors can arise both to the company, when directors act against the interests of the company, and to third parties when they violate statutory restrictions that are aimed at protecting such third parties (3K-7-266/2006).[72]	-
Luxembourg	- Company	General tort law or	General tort law or	General tort law or

[72] It should be noted that this case involved bankruptcy fraud and directors had already been proven guilty in criminal proceedings. Therefore, liability to third parties is presumably restricted to exceptional cases (bankruptcy fraud). In such cases, creditors can claim damages directly from directors.

	- Groups: the literature wants to apply the *Rozenblum* doctrine	Art. 59(2): directors "shall be liable jointly and severally both towards the company and third parties for damages resulting from the violation of the Companies Act or the articles of association".	Art. 59(2) (see left)	Art. 59(2) (see left); for management faults, the literature wants to apply the French doctrine of *faute separable*, i.e. directors are only liable to third parties if the fault is separable from their functions
Malta	- Company - Groups: the director is primarily required to act in the interests of his/her company, not in the interests of the group or the holding company; but in practice the affairs of the subsidiary are often conducted in the overall interests of the group, even if this is potentially to the detriment of the subsidiary	Duties are generally not owed directly to the shareholders, although there may be exceptions under limited circumstances	It is controversial whether, and under which circumstances, duties are owed directly to creditors under general principles of tort law short of fraud.	Duties are generally not owed directly to other stakeholders, although there may be exceptions under limited circumstances
Netherlands	- Company - Groups: the director owes the duties to his/her company, not the group or the holding company - Powers derived from statute, not delegated from the shareholders	1) s. 2:8(1) (duty to act reasonably and fairly) is owed to other corporate organs (internal responsibility) 2) s. 2:9 can only lead to internal liability (to the company) 3) s. 2:139 (liability for misleading accounts) is owed to the shareholders 4) Directors may be liable to shareholders based on tort law	1) s. 2:139 (liability for misleading accounts) is owed to third parties 2) Directors may be liable to third parties based on tort law	1) s. 2:139 (liability for misleading accounts) is owed to third parties 2) Directors may be liable to third parties based on tort law
Poland	- Company - Powers derived	Only according to principles of tort law (Art. 415 Civil	Only according to principles of tort law (Art. 415 Civil	Only according to principles of tort law (Art. 415 Civil

	from statute (Art. 368(1)); no instruction right by the shareholders or the supervisory board (Art. 375); presumption of management board competences to conduct the company's business	Code)	Code)	Code)
Portugal	- Company (Art. 72) - Groups: directors of the parent company have the duty to act in the interest of the group (if subordination agreement or 100% subsidiary; this follows from Arts. 504(1), 64 and 503(2)) - Powers derived from statute, Arts. 405, 406; no instruction right of shareholders	Directors may be liable to shareholders pursuant to Art. 79	Directors may be liable to creditors pursuant to Art. 78 for the loss suffered by them due to the insufficiency of the company's assets as a consequence of the intentional or negligent breach of rules designed to protect those assets by the directors (for example, the rules on maintenance of capital, acquisition of own shares, or mandatory declaration of the insolvency)	Directors may be liable to third parties pursuant to Art. 79
Romania	- Company - It is acknowledged by the literature that some competences belong exclusively to the directors and could not have been delegated from the shareholders → the board is an independent organ of the company	Only according to principles of tort law	Only according to principles of tort law	Only according to principles of tort law
Slovakia	Company	No	No	No
Slovenia	- Company - The board of directors is an	Under some conditions (see below 3.1.)	Under some conditions (see below 3.1.)	-

	independent organ; powers are not delegated from the shareholders, and the shareholders do not have an instruction right, Art. 265(1)			
Spain	Company	-	-	-
Sweden	- Company - Shareholders have an instruction right	Directors are liable directly to the shareholders if they cause damage to them as a consequence of a violation the Companies Act, the applicable annual reports legislation, or the articles of association, Ch. 29, § 1	Directors are liable directly to third parties if they cause damage to them as a consequence of a violation the Companies Act, the applicable annual reports legislation, or the articles of association, Ch. 29, § 1	Directors are liable directly to third parties if they cause damage to them as a consequence of a violation the Companies Act, the applicable annual reports legislation, or the articles of association, Ch. 29, § 1
United Kingdom	Company, not the shareholders, s. 170(1)	Duties owed to the shareholders if a special factual relationship exists between the directors and the shareholders, e.g. directors make direct approaches to, and deal with, the shareholders, make material representations to them etc.	Duties not owed to the creditors, but where the company is in the vicinity of insolvency the directors when considering the company's interest must have regard to the interests of the creditors	-

Discussion

Directors' duties are owed primarily to the company, i.e. to the legal entity and not to the shareholders owning that entity. This basic principle is universally accepted and undisputed. We also include information, where available, on the nature and origin of corporate power.[73] The Member States may conceptualise the company, and the role of the directors and shareholders, in two ways. The shareholders may be seen as the source of corporate power and the director as agents who receive the authority to make decisions on behalf of the company by way of delegation from the shareholders. Alternatively, the directors may be qualified as *sui generis* actors or fiduciaries who act for the benefit of the shareholders and, depending on how the interests of the company are defined,[74] the benefit of other stakeholders, but whose powers are derived directly from a statutory act of authorisation. This difference does not affect the principle that directors' duties are owed to the company and (save exceptional cases) not directly to the shareholders. Nevertheless, it is of great practical importance because it determines the extent to which shareholders have direct control over the company's

[73] First column in *Table 2.2.2.a*.
[74] See below 2.3.

operations (as opposed to indirect control through the process of board appointments), for example by being able to give the managers directions, and the extent to which private ordering is permissible in shaping the governance structure of the company. The latter aspect has implications for directors' duties. In a jurisdiction allowing broad contractual freedom the incorporators may contract out of specific behavioural constraints on the part of the directors, for example the prohibition to enter into related-party transactions, and they may limit the directors' liability.

A prime example of the first strategy is English law, where the shareholders can intervene in the management of the company[75] and enjoy relatively unfettered freedom of contract to structure the company's governance system in the articles.[76] The Scandinavian jurisdictions are close to the common law tradition, allowing for a high degree of contractual freedom and often granting the shareholders instruction rights. Most jurisdictions in the French and German legal tradition, on the other hand, characterise the board of directors (in two-tier systems the management board and the supervisory board) as independent corporate organs that are to some extent insulated from the shareholders.[77] This insulation commonly goes hand in hand with limited possibilities for the incorporators to alter the company's governance structure in the articles.[78]

In exceptional circumstances duties may be owed directly to shareholders, creditors, or other stakeholders. The basis of such a claim may be found in company law, notably in the common law countries UK, Cyprus, and Ireland. Here the rule is that directors owe their duties directly to the shareholders if a 'special factual relationship'[79] exists between the director and the shareholders. Such a relationship may arise according to the English courts where directors make direct approaches to the shareholders in order to induce them to enter into a specific transaction, they hold themselves out 'as agents for the shareholders in connection with the acquisition or disposal of shares',[80] or they make disclosures and provide information on which the shareholders rely.[81] Cypriot and Irish law operate in principle along similar lines, although case law is rare in Cyprus.[82] Irish courts have added that duties may be owed to shareholders in their individual capacity where the interests of the shareholders *qua shareholder* are concerned, as opposed to their collective interests represented by the company.[83] In any case, this jurisprudence is restricted to the relationship between the director and the shareholders. Duties owed to creditors or to other constituencies, such as the employees, are not accepted in any of the common law jurisdictions, although the focus of the company's interests may shift from the shareholders to the creditors in the vicinity of insolvency.[84]

Theoretically, a direct legal relationship between directors, shareholders, and other constituencies may arise from an application of general principles of civil law, particularly tort law. The general tort law clauses that can be found in many French legal tradition jurisdictions may be said to be particularly suitable for establishing such direct legal relationships, given that they provide for liability

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[75] The default rule in the Model Articles for Public and Private Companies, introduced by the Companies (Model Articles) Regulations 2008 (2008 No. 3229), provides for an instruction right of the shareholders, to be exercised by special resolution, see Art. 4(1) Model Articles for Private Companies Limited by Shares; Art. Art. 4(1) Model Articles for Public Companies. This rule can, of course, be altered in the specific articles of the company.
[76] However, limitation of the directors' liability is now restricted in Companies Act 2006, ss. 232-235.
[77] For a more detailed discussion of these issues see above 1.5.
[78] See, for example, the German principle of limited contractual freedom (*Grundsatz der Satzungsstrenge*) that characterises the law of the public stock corporation. The principle is laid down in s. 23(5) Stock Corporation Act: The articles may only deviate from the provisions of the statute if this is expressly permitted in the Stock Corporation Act. For a detailed discussion and comparative analysis see M. Lutter and H. Wiedemann (eds.), *Gestaltungsfreiheit im Gesellschaftsrecht: Deutschland, Europa und USA* (de Gruyter, 1998); and for a short exposition in English see P. Mäntysaari, *Comparative corporate governance: shareholders as a rule-maker* (Springer, 2005), 246-247.
[79] *Peskin v Anderson* [2001] 1 BCLC 372, para. 33.
[80] Ibid. para. 34.
[81] Ibid.
[82] Fir Ireland see the decision of the Irish Supreme Court in *Crindle Investments v Wymes* 1998] 4 I.R. 567, [1998] 2 I.L.R.M. 275.
[83] *Securities Trust Ltd v Associated Properties Ltd*, High Court, unreported, McWilliam J., November 19, 1980.
[84] This shift does not mean that duties are owed to individual creditors. Rather, the directors are required to act in the interest of the creditors as a whole, instead of the interests of the shareholders. For UK law see Companies Act 2006, s. 172(3) and *Re Pantone 485 Ltd* [2002] 1 BCLC 267; for Irish law *Jones v Gunn* [1997] 3 I.R. 1, [1997] 2 I.L.R.M. 245. For a more detailed discussion see below 4.2.

for any damage caused by intentional or negligent conduct.[85] However, French law has developed the doctrine of *faute séparable des fonctions*, which provides that third parties may only bring a claim directly against the director where the director has committed a wrong separable from his or her functions. The courts define a separable wrong as the intentional commission of a particularly serious fault that is incompatible with the normal exercise of the director's functions.[86] In addition, similar to the jurisprudence of the common law jurisdictions, the French courts have held that directors owe a duty of loyalty to shareholders where they transact directly with them, for example by purchasing their shares.[87] We find references to general tort law provisions in other countries as well, for example in the Czech Republic, Poland, or Romania, but there the principles have not been amplified and tailored to the specific circumstances of directors' duties, and they do not seem to play an important role in practice.[88]

The tort law of countries following the German legal tradition is usually characterised by narrower provisions. For example, they apply if the tortfeasor has inflicted intentional damage in violation of public policy[89] or if so-called protective provisions have been violated, i.e. provisions that are designed to protect specific constituencies.[90] Often, these protective provisions constitute criminal offences, such as incorrect statements in public reports or misuse of wages. Thus, they cannot be relied on as complements of the company law duties capturing general directorial misconduct, but they afford additional protection to shareholders and some other constituencies in particularly severe cases of wrongdoing.

Finally, a number of legal systems distinguish in their company laws between internal liability of the director (to the company) and external liability to shareholders or third parties, for example Belgium, Denmark, Finland, Italy, Luxembourg, the Netherlands, Portugal, and Sweden. External liability usually requires conduct that goes beyond mere mismanagement or conflicts of interest (i.e. beyond a breach of the general duties of care and loyalty).[91] It is triggered by a breach of specific legal requirements of the companies legislation or the articles of association,[92] conduct that affects exclusively the rights of the shareholders,[93] or the drawing up of misleading accounts.[94]

In summary, all legal systems allow for exceptions to the general rule that the duties of directors are owed to the company and not to shareholders, creditors, or other parties directly. But the Member States differ both in the determination of the situations when such direct legal relationships arise and the legal mechanisms that they employ to supplement the core directors' duties. In some legal systems, corporate law devices are simply extended to encompass shareholders or third parties; others rely on tort law or quasi contractual principles. These issues are not only of conceptual interest, but of great practical relevance for purposes of enforcement. Where it can be argued that duties are owed directly to the shareholders, they do not have to rely on the company to bring an action or take recourse to a derivative action, if such a mechanism exists, but can bring a lawsuit in their own name. This is particularly important where the corporate organ that is authorised to enforce the company's claims against the director (usually the board of directors or the supervisory board) may be conflicted

[85] See, e.g., Arts. 1382, 1383 French Civil Code; Arts. 1382, 1383 Belgian Civil Code.
[86] Cass. Com. 20.05.2003 n°851: RJDA 8-9/03 n°842, p.717; Cass. Com. 10.02.2009 n°07-20.445: RJDA 5/09 n°445.
[87] Cass. Com. 27.02.1996, JCP E 1996, II, 838: Directors were found in breach of duty where they purchased shares and resold them a few days later at a substantially higher price.
[88] This is different in the Netherlands, where directors have been found liable under general tort law in a number of cases, often for acts in the vicinity of insolvency that frustrated creditors' claims (Section 6:162 sub 1 Civil Code), see HR 6 oktober 1989, NJ 1990, 286, m.nt. J.M.M. Maeijer (Beklamel); HR 3 april 1992, NJ 1992, 411 (Van Waning/Van der Vliet); HR 18 februari 2000, NJ 2000, 295; JOR 2000/56 (New Holland Belgium/Oosterhof); HR 12 juni 1998, NJ 1998, 727; JOR 1998/107 (Coral/Stalt).
[89] Austria: s. 1295(2) Civil Code; Germany: s. 826 Civil Code.
[90] Austria: s. 1311 Civil Code; Germany: s. 823(2) Civil Code.
[91] The rules in Denmark and Portugal are broader, providing that directors shall be liable to pay damages whenever they cause intentionally or negligently damage to the company, shareholders, or third parties (s. 361(1) Danish Companies Act), or when damage to third parties results 'directly from the exercise of their duties' (Art. 79(1) Portuguese Code of Commercial Companies).
[92] Belgium: Art. 528 Commercial Code; Finland: Ch. 22, s. 1(2) Companies Act; Luxembourg: Art. 59(2) Companies Act; Sweden: Ch. 29, s. 1 Companies Act.
[93] Italy: Art. 2395 Civil Code.
[94] Netherlands: s. 2:139 Dutch Civil Code.

in a practical sense and the derivative action mechanism is not easily accessible.[95] Even where a cause of action of the individual shareholder exists, it should be noted, however, that such an action is only possible if the shareholder has suffered a loss different from the loss suffered by all shareholders proportionally as a result of the decrease in the value of the company's assets (so-called reflective loss principle).[96] The reason is that otherwise both the shareholder and the company could claim damages from the director, leading to double recovery. As far as can be judged, this problem is recognised by all jurisdictions that allow personal shareholder claims and is solved in a similar way.

2.3 The interests of the company

Summary of the country reports

Table 2.3.a: Content of the interests of the company

Country	*Mentioned where?*	*General definition*	*Employees*	*Creditors*
Austria	s. 70(1) AktG: 'Wohl des Unternehmens'	Shareholders, employees, public interest = stakeholder oriented	Included	Not mentioned as stakeholders, but the literature assumes that the creditors' interests must also be taken into account
Belgium	Developed in case law and by the literature	Shareholders; group interests can be taken into account under the conditions of *Rozenblum*	Uncertain whether included; a Royal Decree of 2007 has laid down a stakeholder interpretation of the company's interests as the applicable standard in the particular context of takeovers. Literature: stakeholder view is inappropriate unless in crisis situations	- Uncertain whether included, see 'employees' - Different opinions on whether included in the vicinity of insolvency
Bulgaria	s. 237(2) Commercial Act: the directors have to exercise their duties 'for the benefit of the company and all shareholders'	Supreme Court: the interests of the company as a separate legal entity are formed by the general meeting, i.e. the majority of shareholders. s. 237(2)	Not included	Not included

[95] The derivative action will be discussed in detail below at 3.2.
[96] See for example *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204.

		qualifies this principle by requiring the interests of *all* shareholders to be taken into consideration. → shareholder primacy		
Croatia	Art 252 Companies Act 'dobrobit društva' (well-being of the company)	Most important criterion is the profitability of the future business; not the same as the interests of the majority or all shareholders	Indirectly included, not explicitly mentioned	Indirectly included, not mentioned explicitly
Cyprus	-	Primarily shareholder interests, but it has been accepted that the interests of the company may also include the interests of the creditors	See definition	See definition
Czech Republic	Mentioned for example in s. 199	No statutory definition; shareholder-centred view: companies are managed by the directors for the benefit of the shareholders (interpretation of s. 194)	Not included	Not included
Denmark	ss. 108, 127	- No statutory definition; the exact meaning of the term 'interests of the company' is not clear - Some academics: the directors have to act in the interests of the members as a whole	Not included	Generally not included, but the interests of the company change when the company is on the verge on insolvency
Estonia	Not codified	Stakeholder theory	Included	Included

Finland	Companies Act, Chapter 1, s. 8 (but no definition given in the law)	Shareholder-centred: the company's interests are equal to those of the shareholders (see also Chapter 1, s. 5: the purpose of a limited company is to generate profits for the shareholders)	Not mentioned in the law	Not mentioned in the law
France	Art. 1848 Civil Code: 'l'intérêt de la société'	Differently interpreted depending on the context : 1) *Conception contractuelle*: the company's interests are equivalent to the shareholders' interests 2) *Conception institutionnelle*: the company is regarded as having its own interests, which go beyond the shareholders' interests; can be found in different provisions	Included in the *conception institutionnelle*: the company is considered as a separate economic agent, pursuing its own objectives, which represent the common interests of shareholders, employees, creditors, suppliers and customers (Vienot report)	Included in the *conception institutionnelle*
Germany	s. 93(1) AktG: 'Wohl der Gesellschaft'	Stakeholder theory: acting in the interests of the company requires that the interests of all affected constituencies are taken into consideration, including those of society at large	Included	Included
Greece	Art. 2 of Law 3016/2002; Art. 22a of Law 2190/1920	- No statutory definition - Directors have to act in the best interest of the company, which does not merely equate to the	Not included	Shift to creditors in case of financial distress

		interests of the shareholders (see Art. 22a(3a)-(3b)) - Some articles refer to the interests of other stakeholders (creditors, employees, banks, etc.); however, there is no general shift towards a stakeholder model; non-shareholder interests are mainly protected by other laws (labour regulation etc.) → shareholder-centred view		
Hungary	Not specified in Hungarian company law; no case law	No definition or prevailing theory. Uncertainties regarding the meaning of the term, apart from the understanding that directors shall be prevented from using their position to advance their own interests.	Only on the basis of their employment relationship, covered by labour law regulation	Not included
Ireland	-	Shareholder primacy, the interests of the company are equated with the collective interests of the shareholders, but in some contexts the interests of other stakeholders can become relevant (see Companies Act 1990, s. 52(1)).	To some extent included, see Companies Act 1990, s. 52(1): directors owe a duty to 'consider the interests of the company's employees in general, as well as the interests of its members.'	Included in specific situations e.g. vicinity of insolvency (see 2.3.)

		In the group context, it has been held that the best interests of the company may be served by ensuring the survival of other group companies, and authority exists that has regarded it as a general proposition that a director is entitled to consider the interests of the group as a whole		
Italy	References to the interest of the company in Art. 2358 (company's own shares), Art. 2373 (conflict of interests), and Art. 2441 (option right). However, no general definition of the term in the Civil Code.	Shareholder primacy: no room for a pluralistic or enlightened shareholder value approach	Not included	Not included
Latvia	Not codified	Shareholder primacy	unclear/disputed	unclear/disputed
Lithuania	Article 19(8) Law on Companies: 'the management bodies of the company must act on behalf of and in the interest of the company and its shareholders'	- Lithuanian Supreme Court: the interests of the company and the interests of the shareholder may be different - Corporate governance code and literature: the general duty of loyalty requires the director to act for the benefit of the company, its shareholders, creditors,	Included, see definition left	Included, see definition left

		employees, and the public welfare		
Luxembourg	Art. 1859(2) Code Civil: 'l'intérêt de la société'	Not defined in the statute; it is a fluctuant and case-law defined concept that does not correlate with the interests of the shareholders. What the corporate interest is depends on the nature of the corporate activities; for some types of company the shareholder value theory might be adequate, whereas for other types the stakeholder theory applies	May be included, depending on the type of corporate activity, see left	May be included, depending on the type of corporate activity, see left
Malta	Art. 136A(1) Companies Act: duty to act in good faith in the best interests of the company	Relevant are both the short-term interests of the present members and the long-term interests of future members → shareholder primacy	Not included	Not included
Netherlands	Interest of the company not defined in statutory law,[97] but understood as "inclusive" system	Stakeholder theory, but no statutory definition	Included	Included
Poland	Mentioned several times throughout the Code of Commercial Companies, e.g. Art. 249	No statutory definition; the meaning is not settled. The literature argues that the interests	To some extent included, but shareholder focus (see left)	To some extent included, but shareholder focus (see left)

[97] But see Article 2:129 of the Dutch Civil Code: management in "the interests of the Corporation and of the enterprises connected with it" (emphasis added).

		of the company are derived from the economic interests of the groups involved in it (shareholders and other stakeholders), but that shareholder interests should have the strongest influence on the interpretation of the concept of the company's interests		
Portugal	For example in Art. 64(1)(b) Code of Commercial Companies	Art. 64(1)(b): The interests of the company are equated with 'the long term interests of the partners and taking into account the interests of other relevant parties such as employees, clients and creditors in ensuring the sustainability of the company'	Included, but it is argued by the literature and held by some courts that priority should be given to the interests of the shareholders	Included, but it is argued by the literature and held by some courts that priority should be given to the interests of the shareholders
Romania	-	- Not defined in the Companies Act or the New Civil Code - High Court of Cassation: the company's interests are represented by the common intention of the shareholders to associate with a view to obtaining a profit - Literature: the company's interest comprises the	The majority of the literature argues that directors do not have to take the interests of stakeholders into account → pure shareholder value approach	The majority of the literature argues that directors do not have to take the interests of stakeholders into account → pure shareholder value approach

		common, collective, and legitimate interest of the shareholders to have a share in the profits (influenced by the neoliberal French doctrine of the 'intérêt social')		
Slovakia	For example in s. 194(5) Commercial Code	- No definition in the statute or in case law - Literature: Shareholder primacy	Not included	Not included
Slovenia	For example in Art. 508 (the general meeting must be convened if it is necessary for the interests of the company)	The company's interests are understood as including the shareholders, management, employees, other market participants (e.g. suppliers, banks), the state, and the public at large. The shareholders' interests shall take priority, but limited by the interests of other stakeholders.	Included, but subordinated to the shareholders' interests	Creditors' interests are generally subordinated to the shareholders' interests; but as a company nears insolvency, the creditors' interests prevail and directors have to act primarily to protect them
Spain	Art. 226 Ley de Sociedades de Capital: 'interés social'	The concept is not well developed in Spanish law. Frequently, the interests of the company are equated with those of the majority shareholders. Supreme Court: to be interpreted in line with shareholder primacy	Not included	Not included
Sweden	Various sections of the Companies	No general definition, but	-	-

	Act	understood as going beyond a pure shareholder-centric approach		
United Kingdom	s. 172 CA 2006: duty 'to promote the success of the company'	Enlightened shareholder value approach	Included, s. 172(1)(b), but directors must primarily consider the interests of the shareholders	Included if vicinity of insolvency, s. 172(3)

Discussion

Companies, as legal persons, only "exist" in the realm of the law. As such, any question about the "interests of the company" is, in essence, necessarily a question about the content of the law. The table above summarises the legal position of the Member States in relation to this question.

Why is this important in the context of directors' duties? First, as will be explored in more detail below,[98] the behavioural expectations of the law in relation to directors' actions are often defined by reference to the interests of the company. Where directors owe a duty of loyalty to the company, this duty can only be interpreted if and to the extent that we have a clear understanding of the legally relevant interests that the director should guard.

Second, and related to this point, the interests of the company also play a role in shaping the role of managers in the corporation. Where the interests of the company are defined in a way that includes multiple constituencies, the managerial role necessarily involves the balancing of these interests. As explained above, the extent to which such balancing is required of or permitted to corporate managers also influences the degree of managerial discretion that a legal system grants to directors.[99]

2.4 Duty of care

The duty of care addresses one of the main aspects of the agency problem between the shareholders and the company. It aims at ensuring that directors devote sufficient time, care, and diligence to managing the company, act only on an informed basis, possess the necessary skills and experience to make sound business decisions, and consider the likely outcome of their decisions carefully. In this sense, it is a concept familiar to all legal systems. However, the legal systems differ with regard to the precise behavioural expectations that the duty of care imposes on directors, for example the definition of 'due care', the responsiveness of the duty to different types of director (e.g., executive vs. non-executive director, or member of board committees, such as the audit committee, vs. other directors) or the distribution of responsibilities among the board members, and the burden of proof for showing due care (or lack thereof).

Apart from the aim of constraining the directors' discretion, the duty of care has another side. It is often argued that directors may become risk averse if the liability risk faced by them is too high. Since directors operate under conditions of uncertainty and the *ex post* judicial review of business decision may give rise to hindsight bias, they may forgo investment opportunities with a positive net present value in favour of less risky alternatives.[100] This problem is appreciated in most jurisdictions. One solution is the famous business judgment rule, which emerged in the US as early as 1829,[101] and

[98] See in particular Sections 2.4 and 2.5.
[99] See e.g. M Gelter, 'Taming or Protecting the Modern Corporation - Shareholder-Stakeholder Debates in a Comparative Light' (2011) 7 *NYU Journal of Law & Business* 641.
[100] See, e.g., S.M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 *Vand. L. Rev.* 83, 114-116.
[101] See below n 130.

which has recently spread, in one form or another, to several jurisdictions in Europe. However, the response of the Member States is not uniform. Even those jurisdictions that have adopted the business judgment rule differ with regard to the scope of the rule, the threshold requirements that have to be satisfied for directors to be protected, and the possibilities to rebut the protections of the rule.

In the following subsections, we discuss the dogmatic foundation of the duty of care (*2.4.1.*), the behavioural expectations established by the duty (*2.4.2.*),[102] and the existence and content of the business judgment rule or equivalent mechanisms (*2.4.3.*).

2.4.1 Dogmatic foundation

Summary of the country reports

Table 2.4.1.a: Dogmatic foundation of the duty of care

Country	***Statutory corporate law***	***Contractual / fiduciary principles***	***Tort law***	***Other***
Austria	Yes, s. 84(1)	-	Yes, for liability towards third parties, provided the director breaches a provision which is designed to protect that third party	-
Belgium	Internal liability, Art. 527 CC: liability for faults committed in the exercise of the directors' management (referring to contract law, i.e. rules of agency apply by analogy where appropriate)	-	External liability according to tort law (Art. 1382 Civil Code): for breaches of the general duty of care and breaches of statutory obligations. However, personal liability of directors to third parties requires an *individual fault*, e.g. breach of a statutory obligation that is addressed to the director.	-
Bulgaria	Yes, s. 237(2) Commercial Act	-	-	-
Croatia	Yes, s. 252(1) Companies Act	-	-	-

[102] This comprises the issues raised above: (1) How is the standard of care defined? (2) Does the standard of care differ depending on the role and position of the director and the type of company? (3) Is the standard of care modified if directors delegate duties? In particular, are directors required to monitor and supervise the discharge of the delegated functions? (4) Who bears the burden of proof for showing due care (or lack thereof)?

Cyprus	No	-	Yes, tort of negligence (adopted from English law)	-
Czech Republic	Yes, s. 194(5) Commercial Code	-	-	-
Denmark	Yes, s. 361(1) Companies Act	-	-	-
Estonia	Yes, § 35 Civil Code for all members of the directing body of a legal person; in addition § 315(1) Commercial Code for the members of management boards of companies	-	-	-
Finland	Yes, Companies Act, Ch. 1, s. 8	-	-	-
France	Yes, Art. 225-251 (for the unitary board SA), but no statutory definition of the standard of care	-	Art. 1382 Code Civil for liability of de facto directors	-
Germany	Yes, s. 93(1)	-	-	-
Greece	Yes, Arts. 22, 22a of Law 2190/20	Art. 22a(1) derives from a general fiduciary principle that requires directors to act prudently	-	-
Hungary	No	Principles of general civil law apply (law of service contract/breach of contract)	General tort law principles apply	-
Ireland	No	Yes, the duty of care is regarded as both an equitable and a common law duty	-	-
Italy	Yes, Art. 2392(1) Civil Code	-	-	-
Latvia	Yes, Commercial Law 2000, s 169(1)	-	-	-
Lithuania	Yes, Civil Code, Art. 2.87(1)	-	-	-
Luxembourg	Art. 59(1)	One legal basis	General tort law	-

	Companies Act does not directly impose a duty on the directors, but it constitutes the legal basis to bring an action against a director	for the duty of care as such (as opposed to the legal basis for liability, see left) is the agency relationship between the director and the company, Arts. 1984 et seq. Civil Code. But see right: the courts also apply tort law principles	(Arts. 1382, 1383 Civil Code) are interpreted by case law as containing an underlying duty of prudence and diligence that is imposed on any individual in any circumstance of his life, making them liable to all those to whom they cause damage. The courts holds that Art. 59(1) is merely an application of Arts. 1382 and 1383 Civil Code	
Malta	Yes, Art. 136A(3)(a) Companies Act	-	-	-
Netherlands	Derived from s. 2:9 Civil Code	-	-	-
Poland	Yes, Art. 483 Code of Commercial Companies	-	-	-
Portugal	Yes, Art. 64(1)(a) Code of Commercial Companies	-	-	-
Romania	Yes, Art. 144(1)	Initially fiduciary principles arising from the law on agency, but since 2006 codified in the Companies Act	-	-
Slovakia	Yes, s. 194(5)	-	-	-
Slovenia	Yes, Art. 263(1) ZGD-1	-	-	-
Spain	Yes, s. 225 LSC	-	-	-
Sweden	The duty of care is not expressly provided for in the Companies Act; however, it is implicitly contained in Ch. 8, § 23, 34 and	-	-	-

	41.			
United Kingdom	Yes, s. 174	-	Originally the duty of care stemmed from the tort of negligence	-

Discussion

All legal systems analysed by this study have behavioural constraints in place that address the problem of mismanagement or lack of due care by the directors and that can, accordingly, be summarised under the heading 'duty of care', even though the legal system may not always be familiar with this term. An example is the Dutch Civil Code, which merely stipulates that directors are responsible for 'a proper performance of the tasks assigned to [them]'.[103] It is commonly accepted that, following this rule, directors have to act diligently and carefully in managing the company and that they are, in principle, liable if they do not meet the required standard of care.

However, the dogmatic foundation of the duty of care varies greatly across Member States. In some jurisdictions, the duty is not codified, but derives from case law (e.g., Cyprus and Ireland), in the majority of legal systems it is laid down in the company legislation. Where it is not codified, the exact dogmatic foundation and the relationship with general principles of tort law remain sometimes ambiguous. Where it is codified, some legal systems provide for one general standard of care (for example, Germany, the Netherlands, UK) and some for different, more specific duties (for example, Spain, which combines the general duty of directors to perform their duties with due diligence and the specific additional duty to be informed).

A substantive difference does not follow from these variations in regulatory techniques. Rather, the effectiveness of the duty of care as a mechanism to align the interests of the directors and shareholders and, at the same time, grant the directors a sufficiently broad margin of discretion in order to promote innovation and efficient (but not excessive) risk-taking depends on the precise definition of the standard of care and the restraint that the courts show in reviewing business decisions. We have no reason to conclude that these elements can be specified in a more appropriate way by one regulatory technique, rather than another. The discussion below will show that countries that share a common legal origin and adopt similar regulatory strategies may still differ in the formulation of the required behavioural standard and the approach of their courts to reviewing business decisions, whereas jurisdictions from different traditions may well arrive at similar results.

2.4.2 Behavioural expectations

Summary of the country reports

Table 2.4.2.a: Content of the duty of care

Country	*General standard of care:* *1) definition* *2) objective / subjective etc.*	*Differences in the standard of care depending on the director's position and type of company*	*Delegation*	*Burden of proof for showing due care/lack of due care*
Austria	1) Care of a diligent and conscientious business leader 2) Objective: does	Yes, the standard depends on size, business, financial situation etc. of the company and	Failure to monitor or negligent delegation leads to liability	Director, s. 84(2)

103 Dutch Civil Code, Art. 2:9.

	not depend on the director's abilities → normal negligence standard	the responsibility of the director within the co. (case law)		
Belgium	1) Art. 527 CC: directors must manage the company prudently and diligently → normal negligence 2) Objective, but scope for individual characteristics of situation through 'margin of appreciation'; ignorance/ inaptitude/ absenteeism are not accepted as defences	- In general, a director's competences or membership of a committee are not formally elements of the judicial determination of liability, although it cannot be ruled out that courts may take the membership of audit or remuneration committees into account when determining what 'similar given circumstances' are - Professional managers are judged more strictly in practice	No general legal requirement to supervise other directors, but failure to monitor may be qualified negligence in case of systematic absenteeism overstepping the margin of discretion	Claimant; except Art. 528 CC (liability for breaches of the CC and the articles, i.e. breaches of an obligation of result): presumption of fault, which can only be rebutted if the director shows that he/she (i) did not participate in the contested decision (e.g. by remaining absent from the meeting, provided that his/her absence was excusable, or by having voted against the decision); (ii) is not blameworthy; and (iii) challenged the decision at the earliest general assembly meeting (or, in case of members of the executive committee, the earliest meeting of the board of directors).
Bulgaria	1) The due diligence of a good merchant who acts in the interest of the company and all shareholders; higher than the ordinary negligence standard because it is owed by professionals	Point of reference is the professional group to which the director belongs, but the standard of care of all board members is principally equal (s. 237(1) Commercial Act and Court of Appeals Burgas)	When the power to act on behalf of the company is delegated to one of the board members (executive director), the delegating directors continue to be subject to behavioural expectations similar to those of	Claimant

	2) Objective		non-executive directors	
Croatia	1) The care of a prudent businessman = the care which would be taken by an independent entrepreneur, aware of his duties, who manages not his own, but other people's assets 2) Objective, but directors have to use special abilities or knowledge that they have	Yes, what is prudent for a non-executive director is not necessarily prudent for an executive director	Delegation does not exclude liability	Director, except when the creditors enforce the claim
Cyprus	The Companies Law does not specify the required level of skill and care; it has been held that if a director acts in good faith he or she cannot be held responsible to pay damages, unless guilty of grossly culpable negligence in a business sense. The Cypriot courts have not developed their own interpretation of the duty of skill and care but refer to the common law approach in Re City Equitable Fire Assurance Co. [1925] Ch 407	Generally the same standard is applied to executive and non-executive directors	No case law	Claimant
Czech Republic	1) No definition of the standard of care in the statute. Literature: the care that a professional equipped with the necessary knowledge and skills takes with	No rules in the Commercial Code, no case law	No rules in the Commercial Code, no case law	Director, s. 194(5) Commercial Code

	regard to his own property (diligentia quam in suis). Courts: Directors do not have to possess all possible technical knowledge, but the fundamental knowledge enabling them to identify and prevent impending damage 2) Objective			
Denmark	1) Simple negligence standard 2) Generally objective; see Calypso case: figurehead director (semi-skilled worker who did not actively participate in the running of the company and signed documents whenever he was asked to do so), but professional knowledge or qualifications increase the required standard	Generally the same standard, also with regard to employee elected and non-executive board members or directors who do not receive remuneration. But higher standard of care if the relevant breach is in a field in which the director holds a professional qualification	Directors must ensure that the agent is competent and are required to monitor the agent	Claimant
Estonia	1) The care that a reasonable person in the same position under the same circumstances would employ (standard of an average, reasonable business leader)[104] 2) Objective	The required level of care depends on the area of activity and operating range of the company; the wider the operating range and the more complicated the area of activity, the stricter are the requirements. Furthermore, the standard of care depends on the background,	No case law	Director

[104] It is noteworthy that directors in Estonia have been found in breach of the duty of care for taking unnecessary business risks (Supreme Court case no 3-1-1-89-11 [2011]: taking risks that exceed the company's everyday business activities and that are contrary to the supervisory board's guidelines are unjustified).

		qualification and obligations of the director.		
Finland	1) Behaviour that would be required from a careful individual in the specific situation 2) Objective	The division of tasks between directors may be relevant when assessing the extent of the directors' liability: one director may bear a greater responsibility than another	Directors may delegate, but the liability remains with the directors, who have the duty to monitor and ensure that the delegated tasks are properly discharged; similarly, the directors must 'monitor' each other; case law exists where directors have been found liable for not arranging for a proper bookkeeping system[105]	Generally the claimant, but Ch. 22, s. 1(3) provides for a reversal in particular circumstances: 'If the loss has been caused by a violation of this Act other than a violation merely of the principles referred to in chapter 1 [general principles of equality or loyalty or general mismanagement], or if the loss has been caused by a breach of the provisions of the articles of association, it shall be deemed to have been caused negligently, in so far as the person liable does not prove that he or she has acted with due care)
France	1) Standard of a reasonably careful and diligent director 2) Objective, but can be raised if the defendant has specific knowledge and experience	Yes; for example, the care required from the director of a listed company is higher than that of the director of a small family-owned business	Directors have been found liable for lack of monitoring	Generally, claimant, but rebuttable presumption if the director participated in a faulty decision of the board
Germany	1) s. 93(1): The care of a diligent and conscientious manager	Yes, the directors have to meet higher standards if they act within	Delegation is permissible, but the management board is required	Director, s. 93(2)

[105] Case KKO 2001:85. The chairman of the board claimed that he had agreed with another director to take charge of the bookkeeping. The Supreme Court did not free the chairman from liability. The control over accounts appropriately organised is specifically mentioned in the law. On the other hand, KKO 1997:110 seems to entitle directors to trust that matters they have delegated between themselves are properly taken care of unless they have reason to believe that this is not the case (the case concerned a bank's irresponsible lending). This case saw the defendant's position as chairman, preparation and presentation of a matter to the board, and self-interest as incriminating factors. Expertise, on the other hand, was not seen as equally decisive.

	2) Objective	their field of responsibility. In addition, the scope and content of the duties depends on the type and size of business, the general financial and market conditions etc.	to provide for an internal monitoring system, s. 91(2). Directors are liable if they do not select the agents with due care, do not instruct or supervise them properly	
Greece	1) Art. 22a: directors must display the care of a "prudent businessman"	Yes; the diligence of the prudent businessman shall be judged by taking into account the capacity of each member and the duties that have been assigned to him (Art. 22a(2)). In addition, the standard of care varies depending on, the company's size, its objective, and whether it is listed or not.	Failure to monitor is considered as a breach of the duty of care	Director, Art. 22a(2)
Hungary	1) The care and diligence as generally expected from persons in the director's position and giving priority to the interests of the company 2) Objective	Generally, the standard does not differ across sectors or between listed and non-listed companies. The courts can, however, adjust the required standard of conduct according to the specific facts of the case.	Directors are supposed to act personally	Director
Ireland	1) A universally accepted definition of the standard of care does not exist in Irish law; the courts employ a flexible, common-sense approach that is fact-specific. 2) Initially: subjective;	Yes, factors considered by the courts include the size of the company, the type of director and his or her experience and qualifications, the type of duties undertaken and the remuneration of the director	- *Barings* was approved by Irish courts: directors are entitled to delegate functions and trust the competence and integrity of their staff to a reasonable extent, but the exercise of the power of delegation does	Claimant

	recently the courts have moved towards a stricter application that promotes objective minimum expectations. However, the courts still take individual circumstances or the director's knowledge and experience into account when defining the standard of care.		not absolve a director from the duty to supervise the discharge of the delegated functions - It was also held that a director who relied on his co-directors 'with an optimism that was certainly not justified, but which perhaps was understandable' acted honestly and responsibly - Courts emphasise that non-executive directors perform an oversight role. It is sometimes contended that non-executive directors can only be expected to perform this role in relation to information given to them or which they ought to have requested.	
Italy	1) The director must exercise his duties with the knowledge, skill and experience that may reasonably be expected by an average director carrying out a similar role and by the specific care and competence that the director has 2) Objective, but subjective elements increase the standard of care	Yes: the standard depends on the specific role (*natura dell'incarico*) carried out by the director	Delegation is permissible; the director must supervise agents and ensure that the management and accounting structure of the company is adequate. Delegated managers have a duty to report to the board of directors and board of statutory auditors at least every 6 month on the management of the company (Art. 2381(5) Civil Code)). The directors are required to make	Director

			informed decisions and may request clarifications on the management of the company (Art. 2381(5) Civil Code)	
Latvia	1) Statutory definition: in fulfilment of their duties, directors must act as prudent and careful managers 2) The literature argues that this should be interpreted as an objective standard: what can be expected from a prudent and careful manager in a business or in a particular type of business (stricter than the standard of care under general civil law)	Probably yes: what it means to be a prudent and careful manager is evaluated on a case-by-case basis	No case law	Director
Lithuania	1) Civil Code, Art. 2.87: duty to act with reasonable care Literature: duty to act in the same way as a reasonable person with the necessary skills and experience who performs similar duties 2) Objective with subjective elements: the standard of care is that of a prudent, diligent and careful person, but in assessing the actions of the director the courts take into account the age,	The standard depends on the functions performed by the defendant director	Delegation of tasks does not lead to the exclusion of liability	- Art. 6.248(3) Civil Code: 'A person shall be deemed to have committed fault where taking into account the essence of the obligation and other circumstances he failed to behave with the care and caution necessary in the corresponding conditions.' - According to the Supreme Court the *claimant* must prove wrongful acts (breach of director's duty), damages, and causality. If these three elements

	education, experience, etc. of the director (however, this does not mean that subjective elements lower the standard of care; from the case law of the Supreme Court it can be inferred that the objective standard shall serve as an irreducible minimum)			are shown, fault is presumed. Then it is left for the director to prove that there was no fault (3K-7-444/2009). There is a close link between the breach of director's duties and fault, but they are considered as two separate elements.
Luxembourg	1) No statutory definition; case law and literature: what can reasonably be expected of a director of average and reasonable prudence and competence acting under the same circumstances, called 'le critère du bon père de famille' 2) Objective for paid directors; subjective for unpaid directors, i.e. the courts take into account the abilities of the particular director	- In determining the standard of care, the courts distinguish between a director who is paid for his services and a director who does not receive compensation (see left) - In general, the definition of the standard of care is flexible enough to allow the courts to distinguish according to the facts of the individual case	Delegation to an *Administrateur-délégué* or *Directeur délégué à la gestion journalière* permissible (Companies Act, Art. 60) and common in practice	Claimant (different for *responsabilité légale* under Art. 59(2) for breaches of the Companies Act or the articles of association: once a breach is established, the director is presumed to have committed a fault)
Malta	1) Art. 136A(3)(a): the degree of care, diligence and skill which would be exercised by a reasonably diligent person having both – a) the knowledge, skill and experience that may reasonably be expected of a	The standard applies to all directors, irrespective of whether they act as executive or non-executive directors	- The model articles allow the directors to delegate competences - Art. 136A(2)(b): the directors are responsible for the general supervision of the company's affairs - Some case law holds that directors are	Claimant

	person carrying out the same functions as are carried out by that director in relation to the company; and b) the knowledge, skill and experience that the director has 2) Objective, but subjective elements increase the standard of care		entitled to focus their attention on the essential aspects of the company's business and rely on the work of employees; however, it has been argued that delegation does not completely absolve the directors from supervising the delegates	
Netherlands	1) Case law: a director is required to meet the standard of care which can be expected of a director who is competent for his task and performs his/her duties with diligence 2) Objective	Courts consider all circumstances of the case, including: the nature of the activities of the company, the risks which generally result from this type of activity, the division of tasks within the board of directors and the knowledge that the director had or should have had at the time of the disputed action	While the management of the company is the task of the board of directors as a whole, delegation is permissible. However, where tasks are delegated, the board is required to monitor the performance of these tasks.	- Internal liability (s. 2:9): Claimant, but the burden of proof is on the director to show that he cannot be held responsible for an unlawful act adopted by all directors (s. 2:9 second sentence) - External liability (general tort and liability in bankruptcy): Generally the claimant, but the burden of proof is on the directors if they have total control over the company, did not keep proper books or did not file the annual accounts with the chamber of commerce - s. 2:139 (misleading accounts): fault of the directors is presumed
Poland	1) Directors shall exercise a degree of diligence proper for the professional nature of their	Benchmark is the knowledge and experience *relevant to the size and profile* of the company; it is expected that a	A clear assignment of tasks between directors can help to limit the exposure of individual	Director

	actions 2) Objective; a person who accepts an appointment as director while lacking the relevant knowledge and experience for the position may be considered as being in breach of the standard care	director of an investment fund or bank has higher degree of experience or knowledge than a director of an ordinary company	directors. E.g., if one director supervises financial operations and the damage occurred in this field, the responsibility of this manager is heightened. However, division or delegation of tasks does not lead to the complete exclusion of liability	
Portugal	1) Art. 64(1)(a): directors must display the willingness, technical competence and understanding of the company's business that is appropriate to their role, and execute their duties with the diligence of a careful and organised manager 2) Objective Supreme Court: the standard is not that of the 'bonus pater familias, but a manager with certain capacities … From the objective nature of the standard of care results the indifference to the personal circumstances of the director, namely his incapacity or	- The standard of care depends on the type, object and size of the company, the economic sector where the company is active, the nature and importance of the decision taken (day-to-day management decision or extraordinary decision), the time available to obtain information, and the type of behaviour usually adopted under such circumstances. - In addition, it varies according to the functions performed by directors in the different corporate governance models available under Portuguese law (Latin, German, or Anglo-Saxon model)[106]	Duties can be allocated among the directors (Art. 407(1)) or the current management of the company delegated to one or more directors or an executive committee (Art. 407(3)). In that case, the other directors are responsible for the general vigilance of the performance of the delegatees and for any losses incurred through acts or omissions on their part, when, having knowledge of such acts or omissions, they fail to seek the intervention of the board to adopt the necessary measures (Art. 407(8)) → oversight liability, but lower standard	Director, Art. 72(1)

[106] (1) In the classic or Latin model, although it is possible to assign certain functions to specific members, all the directors on the board are competent to make business decisions. Thus, the same standard of care applies and the directors are jointly and severally liable for a breach of duty. Internally, they enjoy a right to recourse according to the proportion of their fault (Code of

	incompetence.'	- Directors with supervisory functions are generally subject to the same standard of care as executive directors, Art. 81(1). They are jointly liable with the managers if the damage would not have occurred had they properly executed their supervision duties, Art. 81(2)	than that applicable to executive directors (duty to monitor, examine critically the information received by the other directors or agents, and make enquiries if necessary)	
Romania	1) The standard required from a 'good administrator' → the level of diligence, prudence, and competences that would be required from a good administrator found in the particular business situation of the director 2) Objective; no reference to the knowledge, skill or experience of the director	The standard of care depends on the 'particular situation' of the director	- Delegation of duties to a management committee is common in the one-tier system; in the two-tier system, duties can also be allocated among the members of the executive board or delegated - In this case: duty to gather information (Art. 140) and monitor the managers (Art. 142(2)) - Courts: the duty of inquiry entails the obligation of the directors to be proactive and solicit documents and information from executives - The duty to	The initial burden of proof is on the director to show that he/she acted with prudence and diligence. If the director adduces evidence to the contrary, the burden may be reversed (Court of Appeal of Bucharest, Commercial Division, no. 167 13.04.2011). See now also Art. 1548 New Civil Code, in force since 2011, which provides for a presumption of fault if the debtor does not fulfil a contractual obligation (however, it is problematic whether the article

Commercial Companies, Art. 73). The internal division of powers by delegation Code of Commercial Companies, Art. 407(1) and (2)) may have an impact on the internal relationships between the directors and their right to recourse.
(2) In the one-tier or Anglo-Saxon model, the members of the executive board of directors ("Conselho de Administração Executivo") are bound by the ordinary standard of care. Non-executive directors who are members of the audit committee perform functions similar to those of the audit board in the classic model. As they perform the auditing functions, they are subject to the duty of care and must employ high standards of professional diligence in the interest of the company (Art. 64(2)). Special, analytic and specific monitoring is demanded.
(3) In the two-tier or German model, the members of the executive board of directors ("Conselho de Administração Executivo") are subject to the ordinary standard of care. The standard applicable to the members of the "general and supervisory board" ("Conselho Geral e de Supervisão") corresponds to that of the audit committee's members in the Anglo-Saxon model. However, in relation to matters which, under the law or the articles of association, belong to the executive board, but require the prior consent of the general and supervisory board (Art. 442), the ordinary standard of care is applicable.
.

			monitor does not require the day-to-day supervision of management, but it is understood as the more general task of being familiar with the internal operations of the company	also applies to the non-fulfilment of means, such as the duty of care, or only obligations of results; no case law applying the new article to directors' duties)
Slovakia	1) The director must act with due professional care, obtain and use all relevant information 2) Objective	No case law on the question of whether factors such as the size and nature of the business and the function and role of the director determine what 'professional care' means in the relevant context	No explicit rules on monitoring and no case law; it is argued that where directors delegate functions, the act of delegation will have to conform to the duty of care standards and directors have to monitor the discharge of the delegated tasks	- Supreme Court: the claimant must prove all elements of the claim, but the issue is not settled and the prevailing opinion in the literature disagrees with the court - Literature: the burden of proof is on the director
Slovenia	1) Directors must act with the diligence of a conscientious and fair manager, Art. 263(1) Supreme Court: this should be construed as the highest diligence of a good expert, and not the diligence that is in any case required from reasonable persons in commercial transactions 2) Objective	The required standard of care is determined by considering the rules, customs and expertise established within the particular profession. It differs according to the size of the company, its activities and particular situation, as well as the allocation of responsibilities among the directors.	The ZFPPIPP specifies risk management and monitoring obligations: The directors are required to ensure that the company provides for adequate risk management procedures, which shall include the determination, measurement or assessment, management and monitoring of risks, including reporting on the risks to which the company is or could be exposed in its operations (Art. 30).	Director, Art. 263(2)
Spain	1) Care of an orderly businessman; expressly regulated: duty to be informed 2) Objective	The standard of care depends on the type of business activity, whether or not the company is listed, the position of the director held on	Outside directors are not liable for the executive management, but they are required to select the agents carefully, instruct and	Claimant (but s. 237 may be of assistance if liability is based on a decision by the whole board, see below 2.6)

		the board (executive or non-executive)	supervise them	
Sweden	1) Behaviour that would be required from a careful individual in the specific situation 2) Generally objective, but subjective elements may increase the standard of care	Generally the same standard, also with regard to employee and non-executive board members or directors who do not receive remuneration. However, directors' responsibility may vary depending on their expertise, working tasks, amount of remuneration etc. An expert in a certain area may carry greater responsibility than the other directors with regard to damage or loss which has been caused to the company within the field of expertise. This view may, however, be disputed on the grounds that the board is a collegial body, which means that an individual member of the board shall not bear the primary responsibility for decisions made within a certain area	- The board of directors is exclusively or predominantly composed of non-executive directors; management duties are delegated to executives. Even though the board may delegate, it remains ultimately responsible. - Ch. 8, § 4(3): The board of directors shall ensure that the company's organisation is structured in such a manner that accounting, management of funds, and the company's finances are monitored in a satisfactory manner	Claimant
United Kingdom	1) s. 174 CA 2006: the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the	Yes, see s. 174: 'carrying out the functions carried out by the director in relation to the company'. But note *Barings*: 'The standard of care is not different in relation to	*Barings* decision: 1) Continuing duty to acquire and maintain sufficient knowledge and understanding of the company's business 2) The agents can be trusted to a	Claimant

	director in relation to the company, and the general knowledge, skill and expertise that the director has 2) Objective, but subjective elements increase the standard of care	different types of director. Rather, when applying the standard, what is expected of a part-time director is less than what is expected of a full-time director.'	reasonable extent, but duty to supervise the discharge of the delegated functions 3) The extent of the duty to supervise depends on the director's role in the management of the company	

Discussion

The effectiveness of the duty of care as a deterrent to the deficient discharge of management functions depends essentially on two aspects: the determination of the required standard of care and the allocation of the burden of proof for showing that the standard was not met or (if the burden is reversed) that the director acted with due care. We will discuss both aspects in turn, summarising our findings in *Map 2.4.2.a* (Standard of care) and *Map 2.4.2.b* (burden of proof).

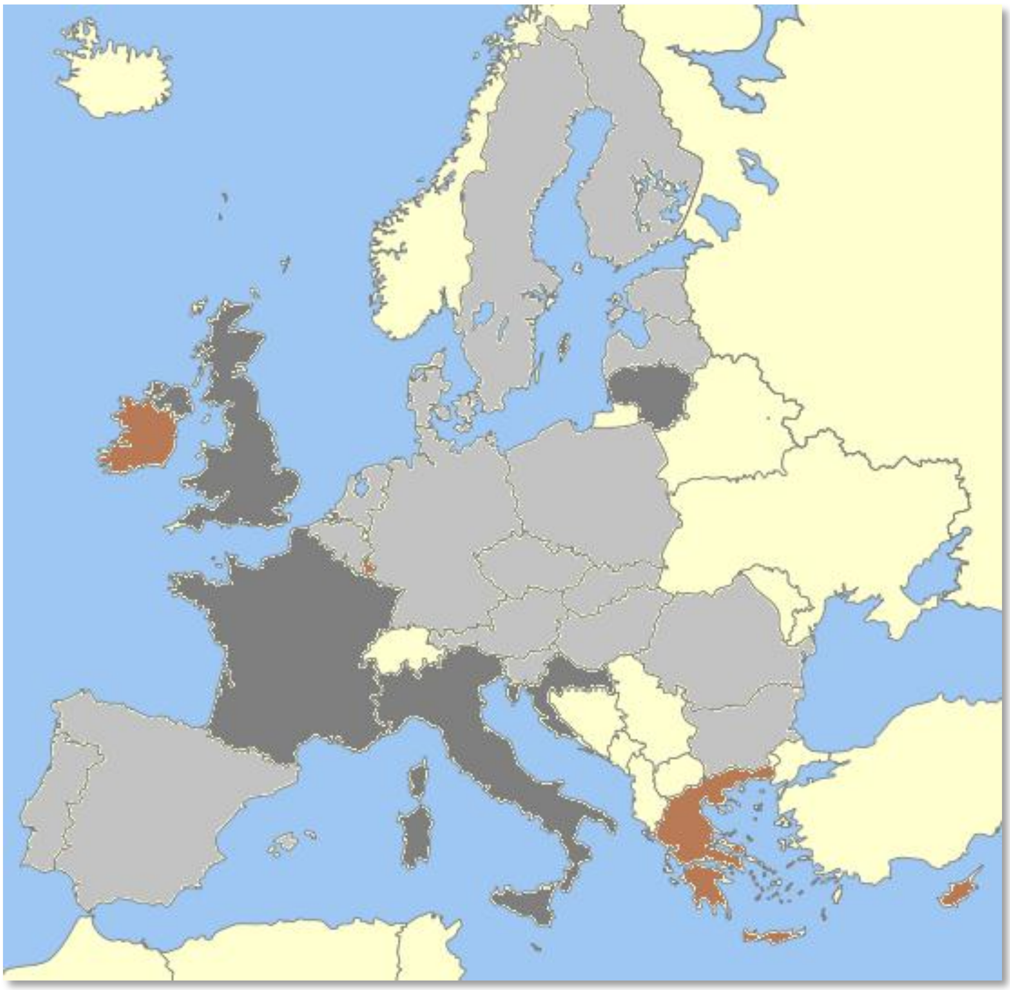
Standard of care

We distinguish between three approaches to defining the required standard of care, which we label, in the order of strictness (i.e. starting with the most demanding standard) *objective/subjective standard*, *objective standard*, and *reduced standard*.

> (1) The objective/subjective standard establishes an objective *lower* benchmark that has to be satisfied by all directors, notwithstanding their individual skill, expertise, or experience. The benchmark is defined with reference to the care exercised by a prudent businessman with the knowledge and expertise that can reasonably be expected of a person in a comparable situation. However, the required standard is heightened if the director in question possesses particular knowledge or experience. In this case, the law expects the director to deploy his or her abilities to the advantage of the company.
>
> (2) The objective standard refers to the prudent businessman, similar to the objective/subjective standard, but does not explicitly provide for increased expectations in light of the individual skills of the defendant director.
>
> (3) Finally, the reduced standard usually also starts from an objective formulation of the care and diligence that directors are expected to employ. In contrast to the other two approaches it allows exceptions that lead to a relaxation of the objective benchmark, for example if the director lacks the knowledge or experience of an average businessman or does not occupy a full-time position on the board.

The Member States are classified according to the three formulations in *Map 2.4.2.a*.

Map 2.4.2.a: Standard of care



Legend	Country
Objective/subjective standard with reference to the prudent businessman (or a comparable formulation), where subjective elements increase the required standard of care	HR, FR, IT, LT, MT, UK
Objective, with reference to the prudent businessman (or a comparable formulation)	AT, BE, BG, CZ, DE, DK, EE, FI, HU, LV, NL, PL, PT, RO, SK, SI, ES, SE
Reduced standard: relaxation of the objective benchmark, for example because subjective lack of experience leads to a reduction of the required standard of care	CY, EL, IE, LU

The clear majority of jurisdictions provides either for the objective/subjective or the objective standard. The four outliers are Cyprus, Greece, Ireland, and Luxembourg. We will deal with them in turn.

- *Cyprus*: The Cyprus Companies Law does not specify the required level of skill and care. It has been held that if a director acts in good faith he or she cannot be held responsible to pay damages, unless guilty of grossly culpable negligence in a business sense. The Cypriot courts have not developed their own interpretation of the duty of skill and care but refer to the common law approach in the English Court of Appeal judgment *Re City Equitable Fire Assurance Co*.[107] This decision was commonly interpreted as establishing a fairly relaxed standard where subjective elements, i.e. the lack of experience of the defendant director, result in a *lower* standard of care. This is no longer the law in the United Kingdom,[108] but it would apply in Cyprus, where the English pre-independence jurisprudence is a common point of reference.
- *Greece*: Greek law provides that in determining the diligence expected of the board members (standard of the 'prudent businessman'), the 'capacity of each member' shall be taken into account.[109] The relevant rules were amended in 2007. The old law distinguished between the CEO, who was subject to liability for any type of negligence, and other directors, who faced a lower risk of liability. This distinction has now been abolished, but the formulation in the amended law still demands a differentiation between board members in light of subjective elements (their capacity) and the allocation of tasks on the board.
- *Ireland*: The ambivalent position of Ireland is a heritage of the influence of English law. The traditional position in the UK was that directors should only be held accountable to the standard of care and diligence that can be expected of them individually. While there was some disagreement in the academic literature whether the standard was entirely subjective or some objective element was retained, it was generally argued that lack of knowledge, inexperience and other subjective deficiencies reduced the standard of care.[110] Since the 1990s, the courts moved to a dual objective/subjective standard that is now codified in the Companies Act 2006.[111] The implications of this change for Irish law are uncertain. Irish case law has not developed a generally applicable definition of the standard of care. Rather, the courts employ a flexible, fact-specific approach that takes account of the individual director's knowledge and experience. On the other hand, inspired by the shift in English law and as a reaction to the increased public focus on corporate governance, the Irish courts have moved towards a stricter test that promotes objective minimum expectations. Thus, it can be said that the case law is in a state of flux and Irish law may rapidly converge on the European median.
- *Luxembourg*: Pursuant to Luxembourg law, the standard of care is objective for paid directors but subjective for unpaid directors, i.e. the courts take into account the subjective abilities of the latter. This may not necessarily mean that the standard is lower, but often part-time, outside directors will effectively be held accountable to a more lenient standard.

It is important not to overstate the difference between group 1 (objective/subjective standard) and group 2 (objective standard). The objective standard often refers to the general definition of negligence in the jurisdiction (with appropriate modifications in order to take account of the professional environment in which the director operates). The general negligence standard is framed objectively, but the information available to us indicates that legal systems will take account of the abilities and knowledge of the defendant. If a harmful outcome could have been avoided if the defendant had made reasonable use of his or her abilities, the law will hold this against the defendant. Thus, while the *formulation* of the required standard of care may differ between groups 1 and 2, with a greater emphasis on the individual abilities of the director in the legal systems allocated to group 1, the *content* of the behavioural expectations imposed on directors is very similar. As discussed above, even the 'outliers' may move in the direction of such an understanding of due care. Accordingly, as far

[107] [1925] Ch 407.
[108] In the UK, the law changed with the judgments in *Norman v Theodore Goddard* [1991] BCLC 1027 and *Re D'Jan* [1994] 1 BCLC 561. The rules established in these decisions are now codified in the Companies Act 2006, s. 174.
[109] Art. 22a(2) Law on Companies, as amended by Law 3604/2007.
[110] This was famously called the 'amiable-lunatic standard', stemming from *Hutton v West Cork Railway Co* (1883) 23 Ch D 654.
[111] Companies Act 2006, s. 174.

as the required standard of care is concerned, we can observe significant convergence in the EU Member States.

In spite of the relative convergence as regards the law on the books, the perception of how the standard of care applies in practice differs widely in the Member States. This can be illustrated by means of the first question of Hypothetical III. The answers are based on the following facts:

> A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.
>
> As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euros. The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The correspondents were asked to assess the likely liability of the CEO for breach of the duty of care in light of these facts. The answers show that settled case law that would allow an assessment of the hypothetical scenario with any degree of certainty is the exception. In the vast majority of Member States, judgments to the point either do not exist at all, or the law is in the process of evolving. It is also interesting to note that even where legal principles exist that are described by the literature, or codified by the statute, in similar terms (such as the concept of an implied or express business judgment rule[112]), the perception of whether the CEO is likely to be in breach of duty varies between Member States.

Table 2.4.2.b: Excessive risk-taking

Country	*Liability for excessive risk exposure*	*Code*[113]
Austria	Liability is unlikely: Judges generally defer to business decisions which have been taken with due preparation of the facts as long as there is no conflict of interest, unless the decision is 'absolutely untenable' (following the principles of the German *ARAG/Garmenbeck* decision[114]). Here this is presumably not the case; judges	N

[112] For a detailed discussion of the business judgment rule see below 2.4.3.

[113] Refers to a perception of high likelihood of liability (L), low likelihood of liability (N), or unclear legal situation (U).

[114] BGHZ 135, 244. The decision established an unwritten business judgment rule in German law. The court held that a management board member who acted solely in the interest of the company and who carefully determined the basis of his decision-making was only liable where the boundaries of the discretion had been 'clearly transgressed' and where 'the willingness to engage in entrepreneurial risk-taking had been carried too far in an irresponsible manner'. These principles are now codified with some modifications in s. 93(1) Stock Corporation Act (see the discussion of the business judgment rule below at 2.4.3).

	would probably analyse the behaviour of comparable banking institutions and base their decision on whether the misconceptions as to the CDOs were shared by other market participants.	
Belgium	Relevant criterion is whether any other reasonable director, placed in similar circumstances, would have entered into the involved transaction; if so, the business judgement falls within a protected margin of discretion. Here, considering the ample presence of warning signs, it may be argued that the CEO is liable.	L
Bulgaria	Unclear	U
Croatia	The CEO is protected by the business judgment rule, unless the warning signs were clear enough to rebut the threshold requirements of the rule.	N
Cyprus	Uncertain, no case law on the issue; Cypriot courts may follow the English common law associated with the Companies Act 1948, which applied a relatively lenient standard.[115]	U
Czech Republic	Breach of duty is possible, but litigation would be unlikely in practice unless the director's conduct could be qualified as criminal activity.	U
Denmark	Liability is likely: Danish courts apply a version of the business judgement rule in that they are reluctant to intervene in business decisions unless they were clearly reckless. Here, the investments appear to have been reckless given the existing warning signs.	L
Finland	Liability not likely for transactions in 2005, 2006, and early 2007 as this type of investment was common market practice and generated high profits. For the end of 2007 and 2008 liability is possible as warning signs became clearer.	L
France	In French law, the business judgment rule does not apply, but French courts are hesitant to second-guess business decisions. This situation is similar to that of some French banks. No suit has been filed and it is doubtful that a judge would find a management mistake. It cannot be said generally when warning signs become so obvious that initially permissible risk-taking constitutes a violation of the duty of care. This is decided by the courts on a case by case basis. Usually it is held that the situation must have been so desperate that there would have been	N

[115] See above text to n 107.

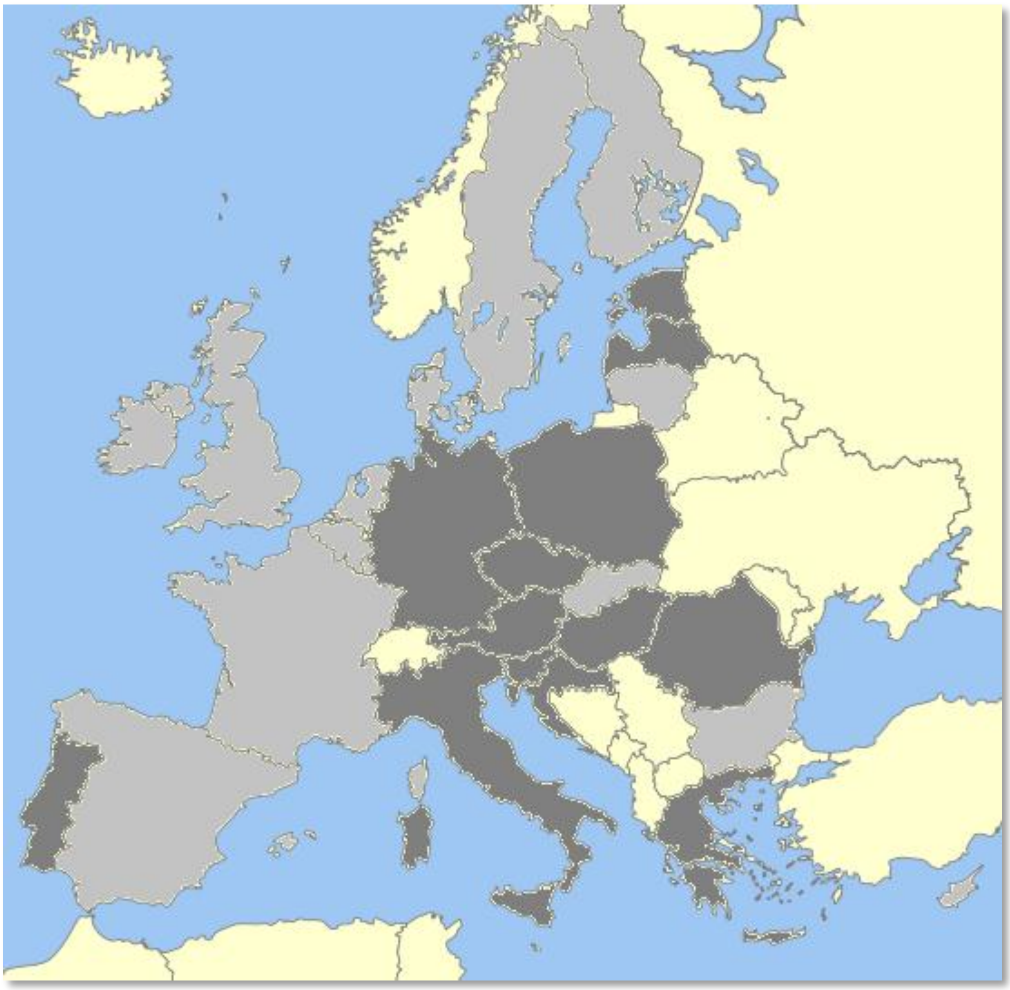
	no hope for survival of the company.	
Germany	Liability is likely at least for the losses attributable to the years 2007 and 2008. Courts have held that speculative investments constitute a breach of the duty of care and are not protected by the business judgment rule where (1) the probability of failure is clearly higher than the probability of success; (2) the risk is disproportionate to the potential profit; or (3) the investment endangers the company's existence.	L
Greece	Liability is likely; the business judgment rule will presumably not apply because of the CEO's persistence in making risky investments in spite of all warning signs and the bankruptcy of comparable firms	L
Hungary	Liability is likely: The CEO may be considered as breaching the duty of care by continuing the investments in CDOs when the market became extremely risky by the end of 2007.	L
Ireland	Irish courts are hesitant to interfere in business decisions. Initially they applied a purely subjective standard, with the consequence that business decisions did not give rise to liability unless they were in breach of the articles of association or could be classed as dishonest or grossly incompetent. Recently courts have become more prepared to evaluate directorial conduct and draw a distinction between calculated risks and rash and reckless risks. However, in the present case it is difficult to assess whether the warning signs would be sufficient to give rise to liability.	N
Italy	Liability is likely: At least towards the end of the period, warning signs became so clear that it can be argued that the CEO acted grossly negligently by engaging in excessively risky transactions. This is the case even if it is accepted that the standard of review for business decisions in Italy follows a pattern similar to the 'business judgement rule'	L
The Netherlands	It is likely that the CEO is considered to have acted 'severely culpable' and that he is, accordingly, liable since he ignored clear warning signs. In practice, however, it is difficult to judge when red flags are so obvious that the threshold of 'severe culpability' is crossed.	L
Poland	Unclear, no case law. According to some commentators, even highly risky investments are not considered to be unlawful.	U

Portugal	In principle the CEO would be liable. Directors are protected by the business judgment rule only insofar as risky business decisions are in line with the general standard of entrepreneurial rationality. Here, it will be difficult to show the rationality of highly risky investments with collaterals that were consistently regarded as weak or overvalued by the economic and financial community long after 2005.	L
Romania	Liability is likely: The business judgment rule does not apply where the director does not act on an informed basis or the information available to the director indicates that the business decision will expose the company to losses. It can be argued here that this is the case.	L
Slovenia	Unclear whether, and under what conditions, a business judgment rule may be applied by the courts.	U
Spain	An implied business judgment rule applies to the effect that the CEO is not liable, provided that he was well informed, the decision was not illegal, and there was no conflict of interest. These conditions seem to be satisfied in the present case, provided that there were at least some other opinions at the time arguing that the investments in CDOs were sound.	N
UK	Liability is unlikely: 1) As far as the *content* of business decisions is concerned, courts ask whether the decision could rationally or plausibly have made sense in the shareholders' interests at the time the decision was made. That is possible in this case even if some warning signs existed. 2) Decision-making process: objective/subjective standard applies. Here, the facts do not suggest that inadequate care was taken in deciding to make the sub-prime investments.	N

Burden of proof

Map 2.4.2.b classifies the Member States according to who bears the burden of proving that the director acted with due care (or failed to do so). Thus, the map focuses on *one aspect* of a claim for damages based on a breach of the duty of care: the care taken by the director in making the business decision. This constitutes, arguably, the central element of the duty. While the burden of proof for other elements, for example the requirement that the company has suffered a loss, is often on the plaintiff, the level of care employed by the director is a function of processes that relate to board proceedings and the director's state of mind. Accordingly, they cannot easily be reviewed by the claimant, especially if the claim is enforced by the shareholders. The allocation of the burden of proof consequently assumes particular importance.

Map 2.4.2.b: Burden of proof for a breach of the duty of care



Legend	Country
Director	AT, HR, CZ, EE, DE, EL, HU, IT, LV, PL, PT, RO, SI
Claimant	BE, BG, CY, DK, FI, FR, IE, LT, LU, MT, NL, SK, ES, SE, UK

It should be noted that the allocation of the burden of proof is generally more nuanced than a binary choice. The above map depicts the general rule, but many countries allow for exceptions or qualify this rule in particular circumstances. We address the most important qualifications in the following paragraphs.

Distinction between obligations of means and obligations of result. Some Member States, in particular France, Belgium and Luxembourg, follow the general procedural rule imposing the burden of proof on the claimant for so-called obligations of means (*obligations de moyens*), but provide for a reversal of the burden of proof in cases of obligations of result (*obligations de résultat*). The former refer to the obligation to employ best efforts in performing a specified task, without assuming responsibility for achieving a certain result, whereas the latter include the result as part of the obligations assumed by the debtor, with the consequence that the debtor is in breach of a contractual or statutory duty if the result is not achieved. The directors' duty to manage the company and act in the company's best interest is commonly interpreted as an obligation of means.[116] Accordingly, in order to establish liability for mismanagement, the claimant bears the burden of proving that the director has acted negligently. Examples of management mistakes are excessively risky or imprudent investments, neglect of the director's supervisory functions, or the conclusion of contracts that the company will most likely not be able to honour. On the other hand, breaches of the company legislation or the articles of association are considered to be obligations of result. For example, it has been argued that the failure of the director to participate in board meetings and be actively involved in the management of the company constitutes a violation of an obligation of result.[117] In this case, the burden of proof shifts to the director who has to show that his absence was excusable and that he challenged the wrongful board resolution at the earliest possibility.

Slovakia. In Slovakia, the legal situation does not seem to be settled. Two rulings of the Supreme Court of Slovakia have held that liability claims for damages, including those brought against company directors, follow the general rule of civil procedure requiring the claimant to prove all elements of the cause of action. The prevailing opinion in the literature disagrees and argues that the liability regime of directors is more specific and stricter than the general regime. Accordingly, it is suggested that directors have to prove that they acted with due care, i.e. that they obtained all relevant information and made a carefully considered decision.

Variations in the standard of care and delegation

The Member States show relatively little variation with respect to the remaining questions regarding the scope and content of the duty of care. As mentioned above, we analyse whether the applicable standard of care differs depending on the role and position of the director and the type of company, and how the standard changes when the directors delegate duties.

As far as the first point is concerned, the statutory definition of the standard of care usually does not distinguish between directors depending on the role they perform and the position they occupy in the company. Generally, the law simply speaks of 'directors' or 'the board of directors' and applies the *same standard* to all board members. However, where the law contains a definition of what constitutes due care, this definition generally leaves room for differentiation in the *application* of the standard. For example, if the law provides that directors should employ the care and skill that a reasonable person would use under the same circumstances,[118] it is clear that this standard varies with the position of the director. Even where the law contains only a general reference to the prudent businessman (or a similar formulation), it seems natural to require more of directors who work full-time and hold an important position in the company, such as chief executive or chairman of the audit committee, since the understanding of what constitutes 'prudent' or 'diligent' behaviour depends on the context. This is recognised in virtually all jurisdictions. In practice, the courts tend to expect more from executive, full-time directors than from non-executive directors. This variation in the applicable standard of care lies probably in the nature of the different roles of the board members and is, therefore, an issue that has become relevant in most Member States, notwithstanding the precise formulation of the duty in the law.

While the general approach to taking account of differences in the directors' professional experience, knowledge of, and familiarity with, the company is fairly similar, we observe nuanced differences in the Member States. The laws of some Member States provide explicitly, or the courts have determined,

[116] However, once it has been established that a board decision constitutes a breach of duty, some legal systems provide for the rebuttable presumption that all directors, whether present or not when the decision was adopted, acted with the required degree of fault. The burden is then on the director to show that he or she opposed the decision and acted generally without fault. See French Supreme Court (*Cour de Cassation*), Cass. Com. 30.03.2010 n°08-17.841, FP-P+B+R+I, n° 08-17.841, *Fonds de garantie des dépôts (FGD) c/ Sté Caribéenne de conseil et d'audit*: P. Le Cannu: RJDA 7/10 n°760. Revue des sociétés 2010, p. 304.

[117] For Belgium: M. Vandenbogaerde, *Aansprakelijkheid van vennootschapsbestuurders* (Intersentia 2009), 63.

[118] See, e.g., the Estonian country report.

that the standard of care expected of directors depends on the position held and level of reward received by the director. A clear enunciation of this view can be found in the famous *Barings* decision of the UK High Court,[119] which was also followed (with modifications depending on the context) by Irish courts.[120] In Luxembourg, the courts define the standard of care differently for a director who is paid and one who does not receive compensation.[121] Similarly, Belgian law applies the general agency law principle that unpaid agents are judged more leniently than paid agents to directors.[122] In Greece, the law requires that the care of a 'prudent businessman' shall be determined in light of the duties assigned to the director.[123] This effectively establishes different standards for executive and non-executive directors. Most countries focus on factors such as the role of the director and the allocation of functional responsibilities between board members.[124] Thus, while the analysis conducted by the courts follows similar parameters, the assessment is highly fact-specific and the observed nuanced differences, combined with the more significant differences in the general formulation of the standard of care discussed above, may or may not lead to different outcomes in individual cases.

A question that is largely unresolved in most jurisdictions is the process by which courts may rationally evaluate and balance the different factors that play a role in the determination and interpretation of the applicable standard of care. A topical example is the responsibility of a non-executive director who holds a key position in the company, for example chairman of the board or of the audit committee. The relevant considerations that commonly inform the court's assessment are not necessarily congruent. For example, non-executive directors are generally judged more leniently than executive directors (if not in law, then at least in practice). On the other hand, a director who has particular qualifications and acts within his or her area of expertise, as will often be the case with the chair of the audit committee, is held to a higher standard.[125] Some non-European courts have found non-executive directors in comparable positions to be liable,[126] but in the EU little guidance exists on the issue. In the wake of the financial crisis courts seem to adopt a less deferential approach, both to managerial decision-making and the monitoring activities expected by non-executive directors, but legal uncertainty is relatively high.

As far as monitoring duties of the directors and the consequences of a delegation of functions for the standard of care are concerned, we observe again a fairly coherent general approach throughout the EU. Virtually all jurisdictions hold, either in the statutory law, in case law, or in the literature, that the delegation of tasks does not lead to an exculpation of the delegating director(s). The Member States differ, however, in the specificity and comprehensiveness with which they regulate the problem. Some legal systems have specified clearly how delegation affects the standard of care, whereas others simply state that the failure to monitor the discharge of the delegated tasks may be qualified as negligence. We may, therefore, distinguish between high-intensity and low-intensity regulation of this issue. High-intensity jurisdictions distinguish between two or three elements of the duty of care in the

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[119] *Re Barings plc (No. 5)* [1999] 1 BCLC 433, confirmed [2000] 1 BCLC 523, CA.
[120] *Re Vehicle Imports Ltd*, unreported, High Court, Murphy J, November 23, 2000. For more details see the Irish country report, 4.4.
[121] See already the discussion above 'Standard of care'.
[122] Art. 1992 Belgian Civil Code.
[123] Art. 22a(2) Law on Companies.
[124] Austria: the type of company and specific responsibilities of the director within the company are considered (RIS-Justiz RS0116167); Denmark: directors are judged more strictly if they act in a field in which they hold a professional qualification (J.S. Christensen, *Kapitalselskaer* (1st ed., 3rd sup., Thomson Reuters Professional 2009)); Germany: the allocation of functional responsibilities among board members influences the behavioural expectations of directors (T. Raiser & R. Veil, Recht der Kapitalgesellschaften (5th ed., C.H. Beck 2010)); heightened expectations if the director acts within the area of his or her expertise (BGH, Judgement of 2 September 2011 - II ZR 234/09, Wertpapier-Mitteilungen (WM) 2011, 2092); Italy: reference in 2392(1) Civil Code to the 'knowledge, skill and experience that may reasonably be expected of an average director carrying out *a similar role*' (emphasis by us); Netherlands: the division of tasks within the board of directors is important (Staleman/Van de Ven, HR 10-01-1997, NJ 1997, 360); Portugal: the standard of care varies according to the functions performed by the directors in the different corporate governance models; Spain: the degree of diligence varies depending on the position of the defendant director on the board. For more details see *Table 2.4.2.a* above.
[125] See the references above n 124.
[126] *Australian Securities & Investments Commission (ASIC) v Rich* 174 FLR 128 (2003) (holding that the qualifications, experience and expertise of the defendant director, as well as his occupation of the positions of chairman of the board and chairman of the finance and audit committee give rise to particular responsibilities); *Australian Securities & Investments Commission (ASIC) v Healey* [2011] FCA 717 (finding executive as well as non-executive directors of an investment company to be in breach of duty because they did not identify inaccuracies in the accounts).

context of delegation. First, the standard of care is applied to the act of delegation, i.e. the director is required to select the person to whom functions are delegated carefully, instruct this person adequately, and provide for training where necessary. Second, the director has to monitor the performance of the delegated tasks. This does not involve day-to-day supervision, but regular monitoring and additional inquiries where reasons for concern or suspicion exist. Where problems are identified, directors are required to take the necessary steps and intervene in the performance of the delegated tasks. Third, it is not sufficient to be reactive, i.e. to act only when a problem arises. Rather, directors are under a continuing duty to familiarise themselves with all relevant aspects of the company's operations, ensure that they are apprised of new developments, and that systems are in place that facilitate the transmission of information within the business. Some legal systems provide more generally that directors are responsible for the establishment of effective risk management and control systems, which include sound accounting structures and, depending on the size of the business and the industry, additional operational and compliance controls. This latter aspect of the duty of care has become particularly relevant in financial institutions, where the financial crisis exposed significant risk management failures in some institutions.

Examples for high-intensity jurisdictions are the UK, Germany, or Slovenia. However, it should be noted that there is no clear divide between high-intensity and low-intensity jurisdictions. Rather, as the third column of *Table 2.4.2.a* shows, the countries differ in degrees. In addition, where a legal system has not developed the specific behavioural expectations outlined in the preceding paragraph, this may simply be a function of the lack of case law. These duties are usually not laid down in the statute, or only laid down in general and fragmentary terms.[127] The emergence of coherent and comprehensive rules, therefore, requires that the courts have the opportunity to build on and amplify the existing regulatory framework.[128]

The answers received to Hypothetical III (duty of care) illustrate the degree of legal uncertainty that currently exists in the EU with regard to delegation and monitoring. We assume in the hypothetical that the CEO of a large banking institution repeatedly used ostensibly arms-length transactions with investment firms that were controlled by his nominees to transfer assets at an undervalue to a company owned by himself. We ask whether (1) the members of the audit committee and (2) the other non-executive directors are liable for oversight failure. *Table 2.4.2.c* shows the general tendency of legal systems to expect more of directors with specific knowledge and expertise, such as members of the audit committee, than of other non-executive directors. However, the table also implies differences in emphasis with regard to the amplification of the duty of directors to supervise internal operations. Some jurisdictions emphasise the heightened responsibilities of the members of the audit committee in financial matters, others the general responsibility of the whole board for the establishment of sound internal control systems. Yet other jurisdictions allow directors to rely on the information provided by colleagues and lower-level managers in most cases, unless specific facts give rise to suspicion. It is difficult to assess in how far these differences in emphasis would lead to different outcomes in litigation. A conclusive assessment of the non-executive directors' liability would require a much more detailed set of facts, but the table may indicate the general approach of the legal systems to these issues.

[127] See for Germany s. 91 Stock Corporation Act; for Slovenia Arts. 31, 32 ZFPPIPP. In the UK, relatively detailed provisions on risk management and internal control are contained in the corporate governance code, see UK Corporate Governance Code 2012, C.2.

[128] A good example for the derivation of specific monitoring and oversight duties from general duty of care standards is the *Barings* case, cited above n 119.

Table 2.4.2.c: Duty to supervise

Country	***Audit committee***	***Non-executive directors who are not committee members***
Austria	Members of the audit committee have to control the books and, in doing so, meet the regular standard of negligence for supervisory board members	Other members of the supervisory board are also in principle subject to a negligence standard, but they are generally justified in relying on the accuracy of the accounts
Belgium	A director's competences or membership of a committee are not formally elements of the judicial determination of liability, although it cannot be ruled out that courts will take the membership of the audit committee into account when determining the standard of care	The threshold for liability is relatively high, as directors are not required to monitor their colleagues
Bulgaria	The members of the audit committee must have unlimited access to the financial information of the bank and ensure that the bank's assets are safeguarded against misuse. Hence, they are likely to have breached their duties by not identifying the true nature of the ostensibly arms-length transactions.	The members of the board have equal rights and obligations, regardless of the internal distribution of functions among them, but no explicit obligation to supervise each other. If the transactions are carried out without the knowledge and participation of the rest of the directors, they will not be liable.
Croatia	Subject to the same rules as all board members, but if the audit committee members have special knowledge or abilities they must use such knowledge and abilities	All board members are generally subject to the same rules; they are required to be acquainted with company transactions and must take all reasonable measures to be informed of the actions of the management
Cyprus	Uncertain, no case law on supervisory duties; some indication that Cypriot courts may follow the old English common law under *City Equitable Fire Assurance*,[129]	Uncertain, see right

[129] See *In Re City Equitable Fire Assurance Co.* [1925] Ch 407. According to this decision, non-executive directors are entitled to rely upon the judgment, information and advice of the executives. They are under no obligation to examine the company's

	which is a light-touch approach	
Czech Republic	The audit committee must assess the effectiveness of internal auditing and risk management. If they negligently failed to establish and assess such systems, they are liable.	Other directors may be liable if they should have recognised that the transactions are damaging to the company
Denmark	Liable if information was available to the audit committee members that indicated that there was a problem	Even if the audit committee members are liable, liability may not extend to the other members of the board, unless the alarming information was also available to them. A director cannot excuse himself by arguing that he relied on the audit committee to discover any wrongdoing.
Finland	The members of the audit committee are liable if the real nature of the transactions taken by the CEO was evident from the information received by the audit committee or there were other reasons to doubt the true nature of those transactions	Same standard as for audit committee members: they are liable if they had reason to doubt the true nature of the transactions on the basis of the information available to them. They may have had less possibility than the audit committee members to notice the suspicious transactions and it is possible that only the latter are liable.
France	Members of the audit committee are not subject to specific liability rules or a separate standard of care in light of their position and/or expertise. However, if the board of directors is held liable for having approved the transaction, members of the audit committee will face a secondary action by other members of the board in order to share a larger portion of the damages by arguing that they are more	Directors are generally not required to monitor their colleagues. If a director provides incorrect information to them or deceives them, they will probably not be held liable for not having identified the incorrect statements, unless they were obvious.

books and records. The decision is no longer fully applicable in the UK, where the rules have become more stringent in the wake of the *Barings* decision (above n 119). See also the discussion above, text to n 108.

	liable.	
Germany	Board members who have specific knowledge or skill in a particular area such as accounting are required to meet a higher standard of care when acting in their area of expertise. Depending on the quality of the control structures in place, the frequency with which the related transactions occurred, and the value of the transactions the directors should have recognised the irregularities and investigated further.	Other members of the supervisory board are also under an obligation to monitor the activities of the management. Therefore, they may also be found liable in the present case, but what is expected of them may in practice be less than what is expected of the members of the audit committee if they lack expert knowledge in accounting and such knowledge was necessary to identify the irregularities.
Greece	The diligence of the prudent businessman is determined in light of the capacity of the directors and the duties assigned to them. Therefore, presumably more is expected of members of the audit committee, but difficult to assess due to the scarcity of case law.	Failure to monitor is considered to be a breach of the duty of care, but the hypothetical is difficult to assess due to the lack of guidance from case law
Hungary	The directors may have breached their duty to supervise, but there is no case law or legislation indicating how this case would be decided	The directors may have breached their duty to supervise, but there is no case law or legislation indicating how this case would be decided
Ireland	Case law in the area of disqualification in relation to banks in Ireland indicates that directors are under a duty to inform themselves appropriately in relation to the company's affairs. The members of the audit committee would be expected to use their expertise in accounting to identify the irregularities.	A duty to monitor is expected in relation to other directors but it is difficult to identify the circumstances where the other directors will be in dereliction of their duty in failing to spot a complex transaction as being connected with one of the directors. If they have relevant financial expertise, they would be expected to exercise it. And if they do not have it, they would be expected to take steps to educate themselves.
Italy	Liability is likely since	Unclear

	members of the company's internal audit committee are supposed to be able to identify the true nature of the ostensibly arms-length transactions in carrying out their duties in accordance with the knowledge, skill and experience that may reasonably be expected of an average director carrying out a similar role. They must also use the specific care and competence that the individual member may have.	
The Netherlands	The members of the audit committee may be held liable for not being cautious enough while monitoring the CEO's actions. In case law the specific knowledge and expertise a member of the supervisory board is deemed to have could be a factor determining the outcome in court proceedings. This may apply to the members of the audit committee.	The other board members may also be held liable as all board members should take sufficient care when fulfilling their specific supervisory tasks; they bear a collective responsibility for the performance of the company. However, possibly a lower standard applies than the one outlined to the left (because possibly no specific knowledge in accounting/finance)
Poland	Duty to monitor exists, but whether the members of the audit committee have violated their duties in the present case is difficult to judge due to the lack of guidance in the case law	The members of the supervisory board have the duty to monitor the management, but whether the directors have violated their duties in the present case is difficult to judge due to the lack of guidance in the case law
Portugal	Liability is likely; the members are subject to a particularly high standard of professional care	Liability is likely if the directors failed to identify the wrongdoing of the CEO due to the lack of appropriate monitoring
Romania	Presumably the members of the audit committee would be subject to a higher standard of care, but unclear how this case would be decided	Directors are not required to supervise their colleagues.

Slovenia	Members of the audit committee would effectively be held to a higher standard of care because they would be expected to take advantage of their auditing expertise	Directors are not explicitly required to monitor their colleagues on the board. However, the supervisory board is required to monitor the management board; members of the supervisory board may be in breach of their duty if they could have identified wrongdoing by the CEO, but did not do so.
Spain	It does not seem to be the case that members of the audit committee are subject to a higher standard of care than other directors; they also do not have to have specific expertise	Outside directors are not liable for the actions of the executive management unless in cases of fault *in eligendo*, *in vigilando* or *in instruendo*. On the other hand, they are liable to the company if they negligently perform the tasks that are assigned to them as non-executive directors. Monitoring is one of them.
UK	No liability if the directors took care that internal controls were in place to provide for the reporting of the transactions. If on the other hand the directors were aware of the red flags but did not take any steps to address the issues they may be found liable.	The extent of the duty to supervise depends on the director's role in the management of the company. It was held that the duty of directors to question accounts prepared by the company's finance director was limited to matters which would have been apparent to a man of the director's business experience and knowledge. However, all directors have responsibility for the existence of internal control structures (see left).

2.4.3 Business judgement rule

Summary of the country reports

Table 2.4.3.a: Business judgment rule and similar mechanisms to address risk aversion

Country	*Adoption of an institution comparable to the US business judgment rule (BJR) in statute or case law*	*Threshold requirements for the protections of the BJR to apply*	*Burden of proof for the threshold requirements*	*Possibilities for liability when the protections apply*
Austria	No explicit BJR, but long-standing acceptance by the courts that directors have a margin of discretion when taking business decisions. Some commentators argue that the margin of discretion afforded to directors under Austrian law is more effective in shielding directors from liability than some codified BJRs, such as the German BJR.	-	-	-
Belgium	Courts accord directors a 'margin of discretion'; they will not interfere with business decisions if the director's act falls within that margin	No threshold requirements, but breach must involve an obligation of means. In case an obligation of result is breached, the director bears the burden of proof.	-	-
Bulgaria	Literature: the duty of care is procedural in character; it does not apply to the content of the decision taken, e.g. whether it is in the interests of the company	Literature: the directors must make an objective assessment and act on an informed basis	Burden of proof for all elements of liability is on the claimant	-
Croatia	Yes, in s. 252(1)	1) Entrepreneurial decision (not	Director	-

		applicable to supervisory board) 2) Director must reasonably believe that he acts in the best interest of the company 3) Not excessively risky (to be judged objectively) 4) Based on appropriate information 5) No conflict of interest 6) Good faith		
Cyprus	No BJR	-	-	-
Czech Republic	No	-	-	-
Denmark	Yes, developed by the courts: the courts are reluctant to intervene in business decisions if the threshold requirements are satisfied	1) Business decision 2) Directors have informed themselves of all material information reasonably available to them 3) No disloyal behaviour	Claimant	Claimant must show that the directors exercised their discretion recklessly
Estonia	Liability for any type of negligence, no clear expression of the BJR. However, the courts distinguish between the decision-making process and the outcome of the director's act and have held that directors are not liable solely for the reason that their business decisions were detrimental to the company	-	-	-
Finland	Not expressed in the Companies	If the directors have based their	Claimant, unless burden of proof	-

	Act, but the preparatory works to the Act refer to the BJR and acknowledge that risk-taking is characteristic for business and that decisions are typically made under conditions of uncertainty.	decision on information that is sufficient and appropriate, considering the circumstances, they will not be held liable.	reversed (see above Table 2.4.2.a for more details)	
France	No BJR, but French courts are not likely to second-guess business decisions as long as the company does not become insolvent	-	-	-
Germany	Yes, s. 93(1), sentence 2	1) Management decision 2) The director reasonably believes to act for the good of the company (subjective, but the director is not protected if he misjudged the risks of a business decision in an irresponsible way) 3) No conflict of interest 4) Based on appropriate information	Director	No
Greece	Yes, Art. 22a	1) Business decision 2) Reasonable 3) In the company's best interests 4) Good faith 5) Based on sufficient information 6) No conflict of interest	Director	Rationality review exists, but belongs to the threshold criteria that have to be shown by the director (the decision must have been reasonable)
Hungary	No explicit BJR, but courts do not	-	-	-

	hold directors liable if their decisions fall within the boundaries of normal business risk			
Ireland	No BJR	-	-	-
Italy	The approach developed by the courts resembles the Delaware BJR, but it has never been expressly endorsed by the courts	The director must not have acted grossly negligently in the *process* of making the business decisions. If gross negligence: the court will review the fairness of the transaction (*vaglio della legittimità della decisione*)	Contractual liability standards apply: once it has been established that the company has suffered a loss due to the director's actions, the director has to demonstrate the lack of gross negligence	Rationality review (*decisione irrazionale o arbitraria*)
Latvia	No BJR	-	-	-
Lithuania	Developed by case law	The director is not liable if his/her decision complies with legal requirements, does not exceed normal economic risk, and is not obviously loss-making to the company	-	-
Luxembourg	No statutory BJR, but courts accord directors a certain margin of discretion, i.e. management errors do not give rise to liability as long as the directors stay within their margin of discretion (marge d'appréciation). In addition, directors are only subject to an 'obligation de moyens', i.e. a duty to use their best endeavours without having to achieve a	1) Courts consider the circumstances that existed at the time when the directors' decision was made and the information which was known or should have been known to the director when deciding whether the director acted within his/her margin of discretion 2) The BJR does not apply to the *responsabilité légale* under Art. 59(2) for breaches	-	-

	concrete result.	of the Companies Act or the articles of association		
Malta	No BJR, but the courts do not hold directors liable for *culpa levissima*, i.e. slight negligence which could have even been committed by an attentive person	-	-	-
Netherlands	No BJR, but it is widely recognized in the literature as well as in case law that judges should apply a margin of discretion when assessing directors' liability	-	-	-
Poland	No BJR - Supreme Court: the reference to an economic risk cannot exculpate the manager when damage caused to the company was the result of careless management - However, in some judgments Polish courts accepted a degree of managerial discretion and allowed directors to take risks inherent in economic activities	-	-	-
Portugal	- Yes, Art. 72(2) - It is controversial whether the BJR applies only to the directors who perform management functions or also to members of the audit committee;	The director must have acted: 1) in an informed manner 2) free of any personal interests 3) not irrationally: the director has to show that he took	Director	Rationality review exists, but belongs to the threshold criteria that have to be shown by the director

	some commentators argue that the BJR applies to the latter if the decision involves a discretionary margin - The majority of the legal literature argues that the BJR does not apply in actions brought by creditors, by shareholders in their own capacity and by third parties, because the law requires the breach of specific rules which protect those people (there is no discretion; the question is simply one of compliance or non-compliance)	a reasonable and adequate decision compared with the possible set of decisions that could have been taken. Directors must not to dissipate the company's assets or take disproportionate risks. → objective standard		
Romania	Yes, Art. 144(1)	1) Existence of a business decision taken within the powers (intra vires) 2) The director was disinterested and acted in good faith (the director was reasonably entitled to believe that he/she acted in the best interest of the company) 3) The director was adequately informed prior to taking the decision	Director (see also the general remarks regarding the burden of proof above in *Table 2.4.2.a*)	No
Slovakia	No express BJR; acccording to s. 194(7) Commercial Code, a director is not liable for actions taken in (i)	-	-	-

	good faith and (ii) with professional diligence, meaning that the objective standard also applies in reviewing business decisions			
Slovenia	No statutory regulation, but some judges have expressed the willingness to apply the US BJR in judicial practice; however, case law does not yet exist	-	-	-
Spain	Not explicitly regulated, but the literature interprets some judgments as accepting the BJR	Some court decisions: the BJR prevent the review of business decisions, provided that: 1) the director acts in the best interests of the company 2) the decision is not irrational 3) no technical mistakes	Normal rules apply	Rationality review
Sweden	No BJR is expressed in the Companies Act, but it is mentioned in the literature. In addition, according to case law certain mistakes of the board in making business decisions will be tolerated, provided that these mistakes remain within the range of the discretion accorded to the director.	If the directors have based their decision on information that is sufficient and appropriate, considering the circumstances, they will not be held liable.	Claimant	-
United Kingdom	No, at least not explicit, although courts are	-	-	-

	prepared to grant directors a margin of discretion			

Discussion

The business judgment rule is an invention of the US courts that dates back at least to the first decades of the 19th century.[130] In its modern version, which has mainly been shaped by the Delaware courts, it is interpreted as 'a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'[131] If this presumption is not rebutted by the claimant, i.e. if the claimant does not show that the directors did not act on an informed basis, in bad faith, or in breach of the duty of loyalty, the courts will respect the directors' business judgment, 'unless it cannot be "attributed to any rational business purpose."'[132] If the presumption is rebutted by the claimant, the burden of proof shifts to the directors to demonstrate that the transaction was 'entirely fair' to the corporation.[133] Thus, the Delaware version of the business judgment rule consists of three elements: First, a number of threshold requirements that have to be satisfied for the protections of the rule to be triggered (acting on an informed basis, in good faith, without conflict of interest); second, a procedural element that allocates the burden of proof and provides for a shift in the burden when the presumptions are rebutted; and third, a standard of review that is either very light (irrationality test) or, if the presumptions are rebutted, consists in a complete fairness review. These three elements make the Delawware business judgment rule very effective in protecting directors against liability if the context does not give rise to a conflict of interest.[134] It is important to note that this effectiveness is a function of a *combination* of the three elements: the relatively high threshold requirements (for example, in order to refute the presumption that the director acted on an informed basis, the claimant has to show gross negligence[135]), the allocation of the burden of proof (initially on the claimant), and the limited review if the presumptions cannot be not rebutted (irrationality[136]).

Accordingly, we test the jurisdictions of the Member States along all three dimensions. We first ask whether an express, codified business judgment rule exists or the courts accord directors an implied margin of discretion, within which business decisions are not subjected to full review. If an express or implied business judgment rule can be found, we then examine the threshold requirements, the burden of proof for these requirements, and the remaining standard of review if the protections apply.

Map 2.4.3.a shows (1) the Member States that have adopted a codified business judgment rule that resembles the US version at least to some extent, without necessarily being identical in the three dimensions of the rule; (2) the Member States that have no express business judgment rule, but where case law indicates that the courts are willing to grant the directors a margin of discretion and exercise restraint in reviewing business decisions or, if no case law to the point exists, where the

[130] *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (La. 1829). While the precise contours of the rule have changed over time, its main tenets are already clearly discernible in the early case law: 'But when the [director] has the qualifications necessary for the discharge of the *ordinary duties* of the trust imposed, we are of opinion that on the occurrence of difficulties, in the exercise of it, which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the agent responsible, if the error was one into which a prudent man might have fallen. . . . The test of responsibility therefore should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by shewing that the error of the agent is of so gross a kind, that a man of common sense, and ordinary attention, would not have fallen into it.' Id. at 4.

[131] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

[132] *Re Walt Disney Co. Derivative Litigation*, 907 A.2d 693 (Del. Ch. 2005) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.1971); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del.1985)).

[133] See, for example, *Walt Disney*, 907 A.2d 747.

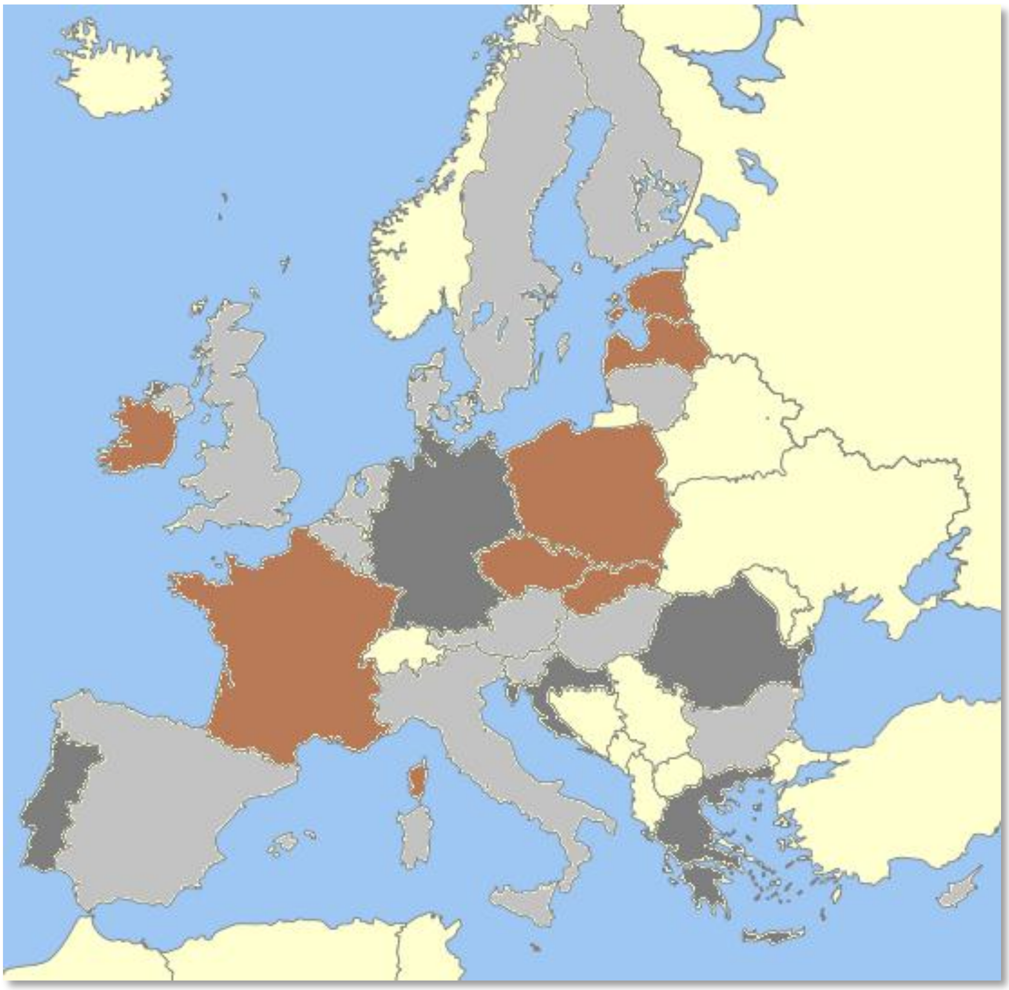
[134] See, e.g., *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del.Ch. 2009), dealing with the fallout from the global financial crisis. The case served as a template for our Hypothetical III. Under Delaware law, the defendant directors and officers of Citigroup were not found liable for the losses that the company had suffered from exposure to the subprime lending market.

[135] *Re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 52 (Del. 2006).

[136] The Delaware courts have defined a business transaction as irrational if it 'is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration', see *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993). In other words, liability under this standard is 'confined to unconscionable cases where directors irrationally squander or give away corporate assets', *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000).

literature argues that the law should be interpreted in this way; and (3) the Member States that have no express or implied business judgment rule.

Map 2.4.3.a: Business judgment rule and managerial discretion



Legend	Country
Codified BJR with similarities to the Delaware approach	HR, DE, EL, PT, RO
No express BJR, but the courts and/or the literature acknowledge that the directors enjoy a margin of discretion and that their decisions will not be reviewed if they act within this margin	AT, BE, BG, CY, DK, FI, HU, IT, LT, LU, ES, SE, SI, UK
No express or implied BJR	CZ, EE, FR, IE, LV, MT, PL, SK

General comments: The business judgment rule as a codified legal institution has spread over the last six or seven years to a number of European jurisdictions. The first country to introduce the rule was

Germany,[137] followed by Portugal,[138] Romania,[139] Croatia,[140] and Greece.[141] The majority of legal systems in the EU, however, do not contain an explicit formulation of the business judgment rule. In that case, the margin of discretion accorded to the directors depends on the interpretation of the duty of care's behavioural expectations by the respective courts. Often, clear definitions and bright-line rules are missing, with the consequence that the limits of the implied protection of business judgments are shifting and not easy to identify. Naturally, therefore, the border between what we classify as group 2 (no express business judgment rule, but the courts and/or the literature acknowledge that the directors enjoy a margin of discretion and that their decisions will not be reviewed if they act within this margin) and group 3 (no business judgment rule) is blurred. Three countries on the borderline are Cyprus, Poland, and the United Kingdom. Courts in these countries have not endorsed the business judgment rule and also do not expressly accord the directors a margin of discretion. It is suggested that the United Kingdom and Cyprus, which follows the UK case law in most respects, fall on one side of the demarcation (implied business judgment rule), because the UK courts take a hands-off approach if the directors have taken an informed decision and the transaction was not tainted by bad faith or a conflict of interest. Poland is on the other side (no business judgment rule), as the Polish Supreme Court has held that the reference to an economic risk cannot exculpate the manager when damage caused to the company was the result of careless management. However, in some judgments Polish courts accept a degree of managerial discretion and allow directors to take risks inherent in economic activities.

In the end, the difference between groups 2 and 3 is one of emphasis. In most jurisdictions, there is evidence that the courts appreciate that a review of decisions taken under conditions of uncertainty has to acknowledge that the decision-maker has to rely *ex ante* on expectations and probabilities, and that a full *ex post* review may suffer from hindsight bias.[142] Nevertheless, some differences can be observed. The Netherlands may be said to be an example of a jurisdiction at one end of the spectrum, where, in particular in inquiry proceedings,[143] the investigator and the courts conduct a thorough review of the company's affairs in order to assess whether mismanagement has occurred,[144] without taking recourse to any form of business judgement rule. At the other end of the spectrum are the countries that have codified the business judgment rule and thus explicitly provide for an area of managerial decision-making that will not be reviewed by the courts. However, this does not mean that directors face the lowest risk of liability for breaches of the duty of care in these countries. Given that the level of protection afforded by the business judgment rule is a function of several factors, the advantage of recognising a protected margin of discretion by statute may be offset by rules that shift the burden of proof to the directors. This is in fact the case in most of the countries that have codified the business judgment rule.

Procedural nature of the duty of care: Some countries interpret the duty of care as procedural in nature, i.e. the courts will not review the content of the decision if it has been taken on the basis of adequate information and in the absence of any conflict of interest. This approach can be found, for example, in Bulgaria and the United Kingdom. While these jurisdictions do not use the terminology of the business judgment rule, and we classify them, accordingly, differently, their interpretation of the

[137] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), Law of 22 September 2005, Federal Law Gazette I, p. 2802. The statutory amendment, in turn, is based on a decision of the Federal Court of Justice (Bundesgerichtshof) of 1997, BGHZ 135, 244 (ARAG/Garmenbeck), which adopted principles resembling the business judgment rule.
[138] Decree-Law no. 76-A/2006 of 29 March.
[139] Company Law Reform of 2006.
[140] Amendments of 2007, Official Gazette 107/2007.
[141] L. 3604/2007.
[142] For a justification of the US business judgment rule in light of the problem of hindsight bias, see Bainbridge, n 100 above, 114-116.
[143] Investigations into the policy and affairs of a legal person conducted by an investigator appointed by the Enterprise Chamber (*ondernemingskamer*) of the Amsterdam Court of Appeal upon the application of, among others, shareholders holding at least 10% of the issued share capital, see Dutch Civil Code, ss. 2:344-2:359. For more details regarding the Dutch inquiry proceedings see below 3.2.
[144] Dutch Civil Code, s. 2:355.

duty of care is very close to the Delaware understanding of the business judgment rule.[145] This illustrates that the existence or lack of a formal business judgment rule is of secondary importance, compared to the procedural or substantive function of the duty of care and the precise definition of the duty's elements.

2.5 Duty of loyalty

The duty of loyalty, broadly understood, addresses conflicts of interest between the director and the company. Particularly in common law, it has a long tradition as a distinct and comprehensive duty that encompasses a variety of situations where the interests of the director are, or may potentially be, in conflict with the interests of the company.[146] It may not be surprising that the duty of loyalty was fairly early well developed in common law, given that the business corporation as a legal institution evolved in a series of innovations and reforms from partnership and trust law[147] and that the position of the director was, accordingly, seen as that of a trustee or fiduciary who had to display the utmost integrity in dealing with the property of the beneficiaries.[148] In other legal traditions, the fiduciary position of directors is less accentuated and the duty to avoid conflicts of interest and not to profit from the position on the board of companies is less pronounced. Nevertheless, the social conflicts that the common law duty of loyalty is intended to address are, of course, identical and are recognised in most jurisdictions as in need of regulatory intervention.

The most important conflicts addressed by the duty of loyalty are: (1) related-party transactions (self-dealing), i.e. transactions between the company and the director, either directly or indirectly because the director is involved in another business association that transacts with the company (as major shareholder, partner, etc.) or because a person related to the director (for example a close relative) deals with the company; (2) corporate opportunities, i.e. the exploitation of information that 'belongs' (in some sense of the word, which will need to be defined more precisely) to the company, for example information regarding a business venture that is of commercial interest to the company. Most other aspects associated with the expectation that the director act loyal towards the company can be related to these two main applications of the duty of loyalty, even though they may be regulated separately in some jurisdictions. Examples are the duty not to compete with the company, not to accept benefits from third parties that are granted because of the directorship, or not to abuse the powers vested in the directors for ulterior purposes. We will focus in our analysis on the two main expressions of the duty of loyalty, related-party transactions and corporate opportunities, making references to other formulations of the behavioural expectations of directors in the legal systems of the Member States where appropriate.

While the duty of care is pervasive in the Member States and the formulation of the directors' behavioural expectations does not differ widely between jurisdictions, the regulatory techniques employed to address conflicts of interest are markedly different. What we call here duty of loyalty, following the common law terminology, is a compilation of functionally comparable legal instruments that are, however, not necessarily duty-based in the strict sense. They range from broad fiduciary standards to approaches that utilise rules determining internal authority, external representation, or classify related-party transactions into prohibited agreements, agreements requiring disclosure and approval, and ordinary transactions valid without further requirements. While no one approach is, by definition, superior to another, it seems that the effectiveness of the respective rules depends on the flexibility that they allow and that some approaches lend themselves more to an application sensitive to the particularities of the individual case than others. We will address these issues below in the relevant context.

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[145] See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000), speaking of '*process* due care' when referring to due care in the decision-making context.
[146] For an early enunciation in common law see the English House of Lords decision in *Bray v. Ford* [1896] A.C. 44.
[147] See, e.g., R.R. Formoy, *The Historical Foundations of Modern Company Law* (Sweet & Maxwell, 1923); B.C. Hunt, *The development of the business corporation in England, 1800-1867* (Harvard University Press, 1936).
[148] See *Bray v. Ford*, n 146 above, 51.

2.5.1 Dogmatic foundation

Summary of the country reports

Table 2.5.1.a: Dogmatic foundation of conflicts of interest regulation

Country	*Statutory corporate law*	*Fiduciary principles*	*Tort*	*Other*
Austria	Yes, three express provisions: 1) Duty to act in the best interests of the company, s. 70 AktG 2) Duty of non-competition, s. 79; 3) Duty of confidentiality, s. 84(1) last sentence	Yes	-	-
Belgium	Art. 1134, 3 Civil Code; specific applications in case of conflicts of interest: art. 523/524/524*ter* CC	General duty to act in good faith (in the company law context interpreted as the duty to act in the company's interest), but not well developed	-	-
Bulgaria	1) Disclosure of conflicts of interest: s. 237(3) Commercial Act 2) Non-competition: s. 237(4) 3) Confidentiality: s. 237(5)	Director's mandate, s. 280 Obligations and Contracts Act: general duty of loyalty	-	-
Croatia	-	Yes	-	-
Cyprus	Duty to disclose self-dealing laid down in s. 191 CA	Other aspects of the duty of loyalty (except disclosure of self-dealing) stem from common law	No	-
Czech Republic	1) Non-competition, s. 196 Commercial Code 2) Conflict of interests, s. 196a 3) s. 194(5) (duty to act with due	-	-	-

	managerial care) is interpreted as being the main duty of directors, which includes the requirement to act loyally towards the company; ss. 196, 196a are specifications of this general duty			
Denmark	Two express provisions: 1) Regulation of related party transactions, s. 131 2) Duty of confidentiality, s. 132	-	-	-
Estonia	Yes 1) General duty of loyalty: Civil Code, § 35 2) Prohibition of competition: Commercial Code, § 312(1) 3) Confidentiality: Commercial Code, § 313(1) 4) Prohibited loans: Commercial Code, § 281	-	-	-
Finland	Companies Act, Ch. 1, s. 8 is interpreted as including the duty of loyalty	-	-	-
France	No	Legal basis for duty of loyalty unclear; some authors argue that it is based on the role that directors assume, others that it is based on the principle of good faith	-	-
Germany	The duty of loyalty finds its expression in s, 88 (duty of non-	Yes	-	-

	competition), but it derives from general fiduciary principles			
Greece	- The duty of loyalty can be derived from Art. 22a(3): directors have a duty to manage corporate assets in the best interests of the company; this encompasses the requirement to avoid any action that could conflict with the corporate interests or obstruct the corporate objectives - In addition, specific aspects of the duty of loyalty are expressly regulated, e.g. non-competition (Art. 23) or related party transactions (Art. 23a)	-	-	Application of the general principle of good faith and the prohibition of abusive behaviour laid down in Art. 288 Civil Code
Hungary	The general duty of loyalty is not regulated in the Companies Act, only certain cases of conflicts of interest	Principles of general civil law apply (law of service contract/breach of contract)	-	-
Ireland	Generally no, but some rules in Part 3 of the Companies Act 1990	Yes, comprising three elements: 1) duty to act in the best interest of the company 2) duty to act for proper purposes 3) duty to avoid conflicts of interests and secret profits	-	-
Italy	1) General duty to act in good faith when fulfilling contractual obligations, Arts. 1175, 1375 Civil	-	-	-

	Code 2) Self-dealing, Art. 2391 Civil Code 3) Corporate opportunities, Art. 2391(5) Civil Code			
Latvia	Some aspects of the duty of loyalty regulated in the Commercial Law, e.g. the duty to disclose conflicts of interest (s. 309(3))	Yes, derived from the law of agency (Civil Code, s. 2304) and the fiduciary nature of the director's role as an agent	-	-
Lithuania	Yes, Civil Code, Art. 2.87: 1) duty to act in good faith 2) duty of loyalty 3) duty to avoid conflicts of interest 4) duty to avoid commingling the property of the company and private property 5) duty to declare interest in proposed transactions	-	-	-
Luxembourg	Some aspects of the duty of loyalty regulated in the Companies Act, e.g. the duty to disclose conflicts of interest (Art. 57)	General duty of loyalty derives from the position of the director, the agency relationship between the director and the company, Art. 59 Companies Act, and Art. 1134 Civil Code (duty of parties to a contract to execute their obligations under the contract in good faith)	-	-
Malta	Yes, Companies Act, Art. 136A: 1) Duty to act	General fiduciary obligations laid down in the Civil	-	-

	honestly and in good faith in the best interests of the company, Art. 136A(1) 2) Duty not to make profits from the position of director, Art. 136A(3)(b) 3) Duty to ensure that their personal interests do not conflict with the interests of the company, Art. 136A(3)(c) 4) Duty not to use any property, information or opportunity of the company for their own benefit, Art. 136A(3)(d)	Code also apply, but they largely overlap with Art. 136A Companies Act		
Netherlands	s. 2:146: in case the company has a conflict of interest with one or more directors, the company is represented by its supervisory directors. The conflicted director who nevertheless represents the company is liable pursuant to s. 2:9 to the company	-	A director who is prohibited from acting because of a conflict of interest (see left) may be liable to third parties on the basis of tort law (s. 6:162)	-
Poland	No, but some statutory provisions are considered as expressions of the duty of loyalty (e.g., Arts. 15, 370 Code of Commercial Companies). Liability for breach of the duty of loyalty is based on the general liability provisions of Art. 483 CCC or	The duty of loyalty derives from the fiduciary relationship between the company and the director and provisions in the Code of Commercial Companies prohibiting specific types of action, e.g. the duty not to compete with the company	-	-

	Art. 415 Civil Code (tort law)			
Portugal	Yes, Art. 64(1)(b) Code of Commercial Companies	-	-	-
Romania	Yes, Art. 144 Companies Act	Initially fiduciary principles arising from the law on agency, but since 2006 codified in the Companies Act	-	-
Slovakia	Derived from s. 194(5) Commercial Code	-	-	-
Slovenia	Companies Act: - General duty to avoid conflicts of interest and regulation of related party transactions, Art. 38a - Duty of non-competition, Art. 41 - Confidentiality, Art. 263(1)	-	-	-
Spain	Yes, regulated in the LSC are: 1) General duty of loyalty, s. 226 2) Prohibition to use the company name, s. 227 3) Prohibition to take advantage of business opportunities, s. 228 4) Conflict of interest, s. 229 5) Duty of non-competition, s. 230	-	-	-
Sweden	The duty of loyalty is set forth in the general clause of Ch. 8 § 34 in the Companies Act, providing that the board and the	Not all of the duties of the directors can be determined on the basis of the Companies Act. The mandate of a	-	-

	managing director may not undertake measures which might provide an undue advantage to a shareholder or other person to the disadvantage of the company or another shareholder.	board member is accompanied by the general duty of loyalty towards the company.		
United Kingdom	Now statutory corporate law, in particular: 1) Duty to avoid conflicts of interest, s. 175 2) Duty to declare interest in proposed transaction, s. 177	-	-	-

Discussion

The duty of loyalty is less coherently regulated in the Member States than the duty of care.[149] Most Member States contain at least some express rules on transactions of the director with the company, corporate opportunities, and/or competitive behaviour by the director. However, the express rules on conflict of interest situations are only in a few, if any, cases exhaustive.[150] This does not necessarily indicate gaps in the legal system, because all jurisdictions are familiar with fiduciary principles derived from general civil law, for example the law on agency. These fiduciary concepts inform much of corporate law and can be relied on where the rules on directors' duties do not address a particular conflict. Indeed, this is what we observe in several jurisdictions, notably Cyprus and Ireland, but also civil law jurisdictions such as France, Germany, Hungary, Latvia, and Poland. Legal systems with a two-tier board structure often also use the allocation of authority between the different organs as a mechanism to alleviate conflicts of interest, which explains the absence of some rules regulation conflicted interest situations in such jurisdictions that are found in one-tier board systems.

Two interesting cases are the Netherlands and Finland, both jurisdictions with a fragmentary regulation of the duty of loyalty. In these two Member States, the courts have built on the general formulation of the directors' position as set out in the companies act and utilised duties not specifically designed to address related party transactions and corporate opportunities. The relevant Dutch rules require directors to act 'in accordance with what is required by standards of reasonableness and fairness'[151] and provide that they shall be liable 'for a proper performance of the tasks assigned' to them.[152] The Finnish rule requires managers to 'act with due care and promote the interests of the company.'[153] Thus, the courts have displayed some ingenuity in finding solutions where the law did not provide an explicit answer.

[149] See above *Table 2.4.1.a*.
[150] The most comprehensive regulation can be found in modern codifications of company law, such as the Spanish Corporate Enterprises Act of 2010 or the UK Companies Act 2006.
[151] Dutch Civil Code, s. 2:8(1).
[152] Dutch Civil Code, s. 2:9(1). For an application of these provisions to the conflict of interest context see below n **Error! Bookmark not defined.**.
[153] Companies Act, Ch. 1, s. 8.

While the dogmatic foundations, therefore, do not seem to be decisive for a comprehensive regulation of conflicts of interest, it may be the case that narrowly tailored rules are more effective in preventing violations and ensuring legal certainty. We will discuss below how the different approaches compare with each other and where deficiencies may exist.

2.5.2 Behavioural expectations

Summary of the country reports

Table 2.5.2.a: Behavioural expectations in a conflict of interest case

Country	*Requirements for self-dealing*	*Requirements for corporate opportunities*	*Resigning directors*	*Other behavioural expectations*
Austria	The supervisory board represents the company in dealings with the members of the management board, s. 97 AktG	s. 79: duty not to compete → 1) Members of the management board may not operate another business; 2) be member of another company's supervisory board; 3) be a personally liable partner of another business association; 4) enter into transactions in the company's line of business; --unless authorised by the supervisory board (authorisation in the articles or by shareholder resolution not sufficient)	s. 79 (non-competition): duty generally ends when the director ceases to be a director	Confidentiality, s. 84(1) last sentence: duty not to reveal business secrets; this duty extends beyond the end of the director's term in office
Belgium	Art. 523 CC: 1) Ex ante disclosure to the board and auditor 2) The conflicted director does not need to abstain from voting, unless the company has issued securities to the public (which includes	- No specific corporate opportunities regulation in the Companies Code. The literature has developed a corporate opportunities doctrine based on the general duty to act in good faith (which comprises, for directors, a	- The duty of loyalty ends when the service contract ends. However, non-compete clauses may be construed to apply after resignation. - Resignation can in itself be a basis for liability if it is given in an untimely and	Duty to act in good faith, which also gives rise to the duty not to compete and the duty of confidentiality

	listed companies) 3) Notwithstanding compliance with Art. 523, liability is triggered if the transaction results in an 'abusive' or 'excessive' advantage to the director (e.g., misuse of assets), Art. 529 CC	duty of loyalty) and inspired by Anglo-Saxon tests (business line, etc.), but opinion differs as to the exact scope of the doctrine and there is no established case law. - Enforcement has to rely on the general rules of Art. 527 CC - Possibly application of the conflicts of interest regime or the prohibition of 'abuse of company assets'	harmful way, but no case law exists on this point	
Bulgaria	s. 240b: 1) Directors must inform in writing the board of directors (or the management board in two-tier systems) when they (or related persons) enter into a contract with the company that goes beyond its usual business or materially deviates from market terms 2) The board of directors (or management board) decides about the conclusion of such contracts. The interested director cannot vote or participate in the decision-making process.	1) Duty of non-competition, s. 237(4): - Directors shall not execute business transactions or participate in companies as managers or board members if this would constitute a competitive activity - Competitive activity: the transaction must fall within the actual line of business of the company; it is not sufficient if it falls within its objectives as specified in the articles - Exception: if the articles of association allow the competitive activity expressly, or the body which elects the board member has given	Only the duty of confidentiality applies after resignation	1) Disclosure of conflicts of interest, s. 237(3): A person nominated as director must, prior to his election, notify the general meeting or the supervisory board of his participation in any companies as an unlimited liability partner, of holding over 25 per cent of the equity in any other company, and of his participation in the management of other companies. When these circumstances arise after the election, the director must issue a written notice 2) Confidentiality, s. 237(5)

		its express consent (this is in one-tier systems the GM and in two-tier systems the supervisory board) 2) Very little case law and no developed corporate opportunities doctrine		
Croatia	Supervisory board represents company in dealings with the management board	1) Prohibition of competition, s. 248: without the consent of the supervisory board, a member of the management board cannot, either for his account or for the account of others, perform activities pursued by the PLC, act as a member of the management or supervisory board in another company engaged in business similar to that of the PLC, or use the PLC's premises to conduct any business. Without such consent, the director also cannot be a member of another company or be personally liable for its obligations if that company performs the same activities as the PLC in question. 2) Directors are required not to use confidential information, acquired in the course of their	Unclear	General unwritten duty of loyalty

		duty, for their personal benefit		
Cyprus	- s. 191 CA: directors who are directly or indirectly interested in a contract or proposed contract with the company must declare the nature of their interest at a meeting of the board of directors; s. 191 does not require the interested director from abstaining from voting, but the articles commonly contain such a provision - Failure to comply with s. 191 renders the agreement voidable, but it may be accepted by the company in general meeting	- Directors must not make use of the company's property or any information and opportunities which arise from holding office - Cypriot courts may apply the English precedents	No provision under Cyprus law on the continuation of the duty of a director not to make use of corporate opportunities even after his resignation as director, or for the continuation of any other director's duty after resignation	1) Duty to act in good faith for the benefit of the company and exercise their powers for the purposes for which they were conferred: subjective test 2) Duty not to put themselves in a position where their own interest conflicts with the interests of the company: no violation if the company consents after full and proper disclosure
Czech Republic	1) s. 196a(1), (2) Commercial Code: credit or loan contract with directors; contract securing the debts of directors; free-of-charge transfer of property from the company to directors require: a) approval by GM b) conclusion 'under the conditions usual in trade' 2) s. 196a(3): transfer of assets for consideration exceeding 10% of the company's capital requires: a) that the price is determined by an	s. 196(1) Commercial Code: duty not to compete → directors shall not carry on business activities in a *similar line of business* as the company	No rules dealing with resigning directors	Confidentiality, s. 194(5)

	expert; and b) the GM gives ex ante consent Does not apply to assets acquired in the ordinary course of business			
Denmark	s. 131: no member of the management may participate in a transaction that involves an agreement between the company and that member (→ strict prohibition, the director is disqualified from participation and has to leave the meeting), or between the company and a third party, if the member has a material interest in the transaction and that material interest could conflict with the interests of the company (e.g., the director is a major shareholder in a company that transacts with the director's company; no further case law definition of "material interest" and "conflict with the interests of the company")	No corporate opportunities doctrine under company law; only regulation: the service contract usually includes a non-competition clause → contract law applies. In addition, the ordinary standards of duty of care and loyalty may be used to prevent directors from exploiting corporate opportunities.	Duties no longer apply	Confidentiality, s. 132
Estonia	The supervisory board represents the company in dealings with the members of the management board, Commercial Code, § 317(8)	Commercial Code, § 312: duty of non-competition. Without the consent of the supervisory board, a member of the management	Duties no longer apply (except the duty not to disclose the company's business secrets)	- Confidentiality: Commercial Code, § 313(1) - Prohibited loans: Commercial Code, § 281 (loans of the company to the directors are

		board shall not: 1) be a sole proprietor in the area of activity of the company; 2) be a partner of a partnership which operates in the same area of activity as the company; 3) be a member of the managing body of a company which operates in the same area of activity (except for groups)		prohibited)
Finland	Companies Act, Ch. 6 § 4: a director is prohibited from participating in decisions regarding matters between the company and himself	Ch. 1, s. 8 would apply: the director may be judged as not having promoted the interests of the company and thus be held liable if there was an identifiable harm to the company	- Possibly application of Ch. 1, s. 8, but the duties only apply as long as the director holds office. - Directors are bound by confidentiality as regards information received as a board member also after resignation and can be held liable for violation of business secrets in accordance with the Criminal Code Ch. 30, § 5	General duty to act in the best interest of the company
France	The law distinguishes between: 1) Prohibited agreements (e.g. loans or guarantees by the company to the director): directors cannot enter into the agreement; ratification by GM not possible 2) Regulated	The case law on the corporate opportunities doctrine is not well developed. Directors (but not the managers of the SARL) are allowed to run competing businesses.	Resigning directors who set up a competing business and attracted other employees of their former company to the new business were found liable for breach of the duty of loyalty	General duty to act in the best interests of the company, which comprises the duty not to disclose confidential information and not to compete with the company

	agreements: transactions between the company and the director that are not prohibited, but also not entered into in the ordinary course of business; valid if prior authorisation by the board (the interested director must not vote). If the director takes part in the vote, the transaction is void, regardless of whether the director's vote is essential or the transaction is beneficial to the company. Shareholder authorization does not exempt the director from liability. 3) Transactions entered into in the ordinary course of business and at arm's length: valid without authorisation; not even disclosure is required			
Germany	The supervisory board represents the company in dealings with the members of the management board, s. 112	1) Duty not to compete, s. 88: members of the management board are not permitted to operate a trading business (Handelsgewerbe) or enter into transactions in the company's line of business, unless the supervisory board gives its consent 2) Unwritten corporate	Resigning directors continue to be subject to the prohibition to exploit corporate opportunities (BGH WM 1985, 1443: director resigns and forms a new company to exploit the business opportunity)	-

		opportunities doctrine: encompasses corporate opportunities made available to family members and other cases that do not fall within s. 88		
Greece	Art. 23a: 1) Absolutely prohibited contracts, e.g. loan, credit or guarantee/security agreements between the company and a director (or a related person) 2) Contracts subject to certain limitations: contracts that do not fall under the definition of absolutely prohibited contracts and that are not within the scope of ordinary business transactions need approval by the GM 3) Other contracts can be freely concluded without approval by the GM, provided that they fall within the company's ordinary business transactions (Art. 23a(2))	- Art. 23: directors participating in the management of the company and managers must not take on their own account or on the account of a third party any action that falls within the company's objectives, or be partner in an unlimited company that conducts the same business, without permission of the general meeting - This prohibition covers mainly the executive directors, de factor directors, and major shareholders who can exercise influence over the board's decisions - Literature: non-executive directors are considered to participate in the company's management indirectly; hence they are caught by Art. 23 - No case law on this issue	- The duty stemming from Art. 23 continues for a 'reasonable time' after the director resigns (Art. 23 in conjunction with Arts. 288, 281 of the Civil Code) - This prohibition may be extended contractually	Duty of confidentiality, Art. 22a(3)
Hungary	No specific rules (except for private limited companies	1) Directors are prohibited from: - acquiring shares,	Solved by asking whether a causal link exists	Duty of confidentiality

	where authorisation of the general meeting is required). According to general rules of the Civil Code covering representation and agency, the agent is prohibited from acting if the other party is himself or represented by him as well. The supervisory board is not supposed to represent the company and act on behalf of it, either in general or in this specific situation. The law is unsatisfactory and the New Civil Code does not seem to change that.	other than shares in public limited companies, in any business organization whose main activity is similar to that of the company - accept an executive office in a business association whose main business activity is similar to that of the company Exceptions: if permitted in the articles of association or the supreme body of the company has given its consent 2) Directors are also prohibited from entering into any transactions falling within the scope of the main activities of the company, unless permitted in the articles of association. The authority to grant permission may be delegated to the supervisory board. Otherwise the supervisory board has no role to play in this situation.	between the director's conduct and the loss suffered by the company in spite of the resignation	
Ireland	A director must not have an unauthorised personal interest in transactions with the company 1) fairness of the transaction is irrelevant 2) duty to disclose any interest in a transaction with	- A director must not make a secret profit through the use of opportunities which have arisen in the course of his or her management of the company's affairs. The requirements	- The no-conflict and no-profit rules continue to apply after resignation where post-resignation behaviour is tainted by prior breaches of duty - Whether the English maturing business	1) Duty to act in the best interest of the company (applies also where related a party transaction has been disclosed pursuant to Companies Act 1963, s.194) 2) Duty to act for

	the company, Companies Act 1963, s.194 3) authorisation: a) the articles of association or shareholder agreements may authorise the directors to enter into certain types of contract; OR b) approval: it is controversial whether consent has to be declared by the company in general meeting or the board of directors (most authority supports the latter view; but note that there is persuasive authority suggesting that for the purposes of compliance with s.194 it is irrelevant whether the contract is approved by the board or not so long as the requisite disclosure has been made) 3) consequences of violation: the company can avoid the contract	are not well established, but it has been held that liability can arise irrespective of whether the company could have made a profit → comparable to English cases that generally do not allow capacity facts as an excuse - Authorisation by the board of directors is possible; Irish case law suggests that the conflicted director should not participate in the decision of the board, but the issue has not been the subject of the direct ruling and the model articles would allow the director to vote	opportunities doctrine is applicable has not yet been decided; the decisions in Island Export Finance Ltd v. Umunna [1986] BCLC 460; Balston Ltd v. Headline Filters Ltd [1990] FSR 385; and Framlington Group plc v. Anderson [1995] 1 BCLC 475 would have persuasive value for courts in Ireland	proper purposes
Italy	Art. 2391: 1) Duty to declare the nature and extent of any direct or indirect interest to the directors and the statutory auditors 2) The conflicted director can attend and vote at the board meeting, provided that the board's resolution	Art. 2391(5): 1) Corporate opportunity: questionable whether this has to be within the company's line of business (no case law yet, but unlikely because otherwise 2391(5) would be redundant and already covered by the duty of	Directors cannot take advantage of corporate opportunities after they resign if they resign *because* they want to use the opportunity, as this would be a way of avoiding the mandatory rule	Heightened requirements for related-party transactions if the company is listed or widely held: a committee, with a majority of independent directors, must give its opinion on any related-party transaction

	appropriately justifies the reasons and the opportunity for entering into the transaction 3) If there has not been the required disclosure by the conflicted director and the resolution, which was adopted with the determining vote of the interested director, may harm the company, it may be challenged by the remaining directors and the board of statutory auditors (voidable)	non-competition) 2) The article requires that the director must have obtained the opportunity 'in connection with the appointment' → unclear whether the director must have learned of the opportunity in his role as director 3) No breach of duty if the company is unable to take advantage of the opportunity		
Latvia	1) The supervisory board represents the company in dealings with the members of the management board 2) The member of the management board must disclose any conflict of interest between the company and him-/herself or his/her spouse, a relative or brother/sister-in-law before the board meeting and is not entitled to vote in the meeting (Commercial Law, s. 309(3))[154]	Duty of non-competition, s. 171 Commercial Law: without prior consent of the supervisory board (or the general meeting if no supervisory board is formed) a director may not: - be a partner of a partnership acting in the same field of business as the company; - enter into transactions in the same field of business; - be a member of the management board of any other company in the same field of business	Unclear	-
Lithuania	1) Civil Code, Art. 2.87(5): a director	1) 2.87(3): duty to avoid conflicts of	No special statutory rules for	1) General duty of loyalty: case law

[154] Note: In a decision from 2009 the Riga City Vidzeme Municipality Court did not recognise that a conflict of interest existed in a situation where the management board member concluded an agreement with a company owned by him. The court argued that the Commercial Law does not prohibit the management board member from entering into agreements with a related company.

	must notify other members of the board or shareholders about any circumstances where his/her personal interests conflict, or may conflict, with the interests of the company 2) Civil Code, Art. 2.87(6): directors may enter into a contract with the company, but they must notify the other corporate bodies or shareholders of the contract (if there is a collegial management body then the notification is usually made to such body; if there is only a managing director then shareholders must be notified) 3) No approval requirements. Failure to disclose the conflict results in the invalidity of the contract (3K-3-557/2009). 4) The conflicted director must abstain from the decision-making, Art 35(6) of the Law on Companies: A director is not entitled to vote when the board discusses issues related to his work or his responsibility.	interest → a director must avoid a situation where his personal interests conflict with the interests of the company; this includes the obligation not to use the property or information that he/she obtains *in the capacity of a director* for personal gain (note: no case law on this issue; a systematic interpretation of the Civil Code would lead to the conclusion that the director can pursue a business opportunity that he acquired in a personal capacity as long as his personal interests do not conflict with the interests of the company) *without the consent of the shareholders*. If the opportunity does not fall within the company's line of business, it may be considered not to be against the interests of the company (however, usually the articles state that the company is interested in pursuing any type of economic activity that is not prohibited by law) 2) See Art. 2.87(5) (left)	resigning directors. Usually non-competition clauses are included in the contract that apply after resignation.	ambiguous (requires directors to avoid conflicts of interest or act in accordance with the articles and the decisions of other corporate bodies). Literature: duty to act for the benefit of the company, its shareholders, creditors, employees and the public welfare 2) Duty to act in good faith 3) Duty to avoid commingling the property of the company and private property (all Civil Code, Art. 2.87)
Luxembourg	Companies Act, Art. 57: duty to declare conflict of	Not regulated	Not regulated	Companies Act, Art. 66: duty of

	interest in a transaction submitted for approval to the board, unless the transaction falls within the scope of the company's current operations and is entered into under normal conditions. The director may not take part in the decision-making. In addition, the conflict of interest must be reported to the next general meeting of shareholders.			confidentiality
Malta	Art. 136A(3)(c): duty of directors to ensure that their personal interests do not conflict with the interests of the company. Conflicted interest transactions are only valid under the following conditions: 1) The director must declare the nature of the conflict to the other directors at the first meeting at which he/she knows about the potential conflict, Art. 145(1) 2) Model articles: the director must not vote at the board meeting deciding on the conflicted transaction (but the articles or the GM can provide for a different rule and allow the director to vote)	1) Art. 136A(3)(d): Duty not to use any property, information or opportunity of the company for their own or anyone else's benefit, nor obtain benefit in any other way in connection with the exercise of their powers, except with the consent of the company in general meeting or except as permitted by the company's memorandum or articles of association 2) Art. 143(1): duty not to compete with the company → only applies to activities actually performed by the company, or which could reasonably be foreseen to be undertaken by the	It is argued by the literature that the corporate opportunities doctrine developed by the English courts should apply, but no case law exists	1) Duty to act honestly and in good faith in the best interests of the company, Art. 136A(1): subjective standard, directors must have honestly believed to act in the best interests of the company 2) Duty not to make secret or personal profits from their position without the consent of the company, nor make personal gain from confidential information, Art. 136A(3)(b) 3) Duty to act within powers and not for an improper purpose, Art. 136A(3)(e)

		company in the near future. Authorisation can be given by the company in GM		
Netherlands	- Law as of January 1, 2013: prohibition of directors who have a direct or indirect interest in a transaction to participate in the decision-making process regarding that transaction. If as a result of the prohibition no board resolution can be passed, the supervisory board decides. - If the director does not comply with these requirements: the director is liable for breach of the duty to properly manage the company (s. 2:9), provided that his fault is personal and sufficiently serious - Definition of conflict of interest: if the director as a result of (i) a personal conflict of interest or (ii) an indirect interest in the transaction (e.g. family interest or interest in another company) cannot be expected to protect the interests of the company as should be expected of an unbiased director	- No statutory regulation (but see Corporate Governance Code, II.3.1(d)) - Legal literature: a business opportunity is a corporate opportunity if the company has a reasonable interest in the opportunity (test: connection with the activities of the company) - Courts: have held directors who usurped corporate opportunities liable for starting a competing company (based on ss. 2:8, 2:9) - In addition, possibly violation of a non-competition provision in the employment contract of the director	The duty to properly manage the company (s. 2:9) is no longer applicable; but general principles of tort law continue to apply	-
Poland	Art. 377: In the event of a direct	Art. 380(1): - A member of the	Duties no longer apply (except the	-

	or indirect conflict of interest between the company and a management board member (or the member's spouse and other close relatives) the management board member shall abstain from participating in deciding such matters 2) Art. 379: in a contract between the company and a management board member, the company shall be represented by the supervisory board	management board shall not, without consent of the company, involve himself in a competitive business, nor shall he be director in a competing company or 10% shareholder - Consent is given by the supervisory board	duty of confidentiality)	
Portugal	1) Art. 397(1): the company is prohibited to enter into loan or other credit agreements with directors or to pay in advance remuneration for more than one month 2) Art. 397(2): transactions between the company and a director are void unless: a) prior authorisation by the board (the conflicted director must abstain from voting) b) assent of the supervisory board or audit board c) disclosure in the annual report OR: no authorisation or other requirements if the transaction is	Business opportunities doctrine: not codified, but developed in analogy to Arts. 254, 398(3), 428 by the literature 1) Directors are prohibited from taking advantage of business opportunities without the consent of the GM or the general and supervisory board 2) An opportunity belongs to the company if it falls within its scope of activity, the company has an objectively relevant interest in the opportunity, or has expressed its interest and received a contractual proposal or is in negotiations	1) A director was held liable for breach of duty who set up a competing enterprise with facilities next to the first company while holding office. He did so by using information regarding clients, prices and employees obtained during the performance of his duties. The court held that the director was liable because of the unlawful use of information received when he was a director in favour of the new company incorporated by him 2) No rules or case law on directors who resign to exploit	Duty of non-competition, Art. 398(3): the directors shall not exercise any activity competing with the company, unless the GM gives its authorisation. Competing activity: any activity that falls within the corporate objects of the company, provided that it is actually performed by the company, Arts. 398(5), 254(2)

	part of the company's regular activities and no special benefit is granted to the director	3) The prohibition only applies to opportunities of which the director becomes aware while performing his functions; opportunities offered to the director in a personal capacity are excluded	corporate opportunities, but according to some Portuguese commentators the prohibition of using corporate opportunities is also applicable to directors who have resigned from office in order to exploit a specific existing opportunity	
Romania	1) Art. 144(3): a) If directors (or a member of their family) have a personal interest in a transaction with the company, they must disclose the conflict of interest to the board and to the internal auditors, and refrain from participating in the decision on the transaction b) If the disclosure obligation is not complied with: the interested transaction remains valid, but has to pass the test of fairness in a court of law c) These obligations do not apply to transactions in the ordinary course of business 2) Art. 144(4): prohibition of the provision of any financial advantages, loans, guarantees etc. by the company to the directors 3) Art. 150:	1) Corporate opportunities doctrine Scope: unclear, as no explicit statutory regulation and no case exist 2) Duty not to compete with the company, Art. 153[11] - Competing companies: "companies pursuing the same type of activity" - The provision refers only to executive directors and managers; non-executive members of the board are not bound by a statutory duty, but they may be subject to a contractual obligation not to compete - No case law	No statutory regulation or case law	Duty of confidentiality, Art. 144(1)

	transactions of the director with the company involving assets amounting to more than 10% of net assets require approval by the GM			
Slovakia	s. 196a: directors (and related persons) shall not be granted credit or a loan by the company; have company property transferred to them or provided for their use; or a liability secured by the company, unless the supervisory board gives its prior consent and the transaction is conducted on an arms' length basis	1) No business opportunity doctrine, only the general duty of loyalty applies: directors shall not pursue a business opportunity if this conflicts with the interests of the company 2) Duty of non-competition, s. 196: directors must not: a) enter into transactions that are related to the company's business activity b) mediate the company's business arrangements for other parties c) participate as a shareholder or member with unlimited liability in another company pursuing a similar business activity d) be a manager or director of another company pursuing a similar business activity	- The duty of confidentiality continues to apply after resignation, which may apply where the director exploits company information for the benefit of another party - The decision to resign in order to take advantage of a business opportunity may be a breach of the duty of loyalty, but no case law on this point	1) Duty of confidentiality, s. 194(5) 2) Duty to act in good faith, s. 194(7)
Slovenia	Regulation of related party transactions, Art. 38a: 1) Transactions with another company in which a director (or a family member)	1) Duty of non-competition, Art. 41(1): members of the management board and the supervisory board may not participate as director or	The ban on competition may continue after the end of the director's term of office	Duty of confidentiality, Art. 263(1)

	holds at least 10% of the share capital, is member of a dormant company, or participates in any other way in the profits, require the consent of the supervisory board (or the GM if the company does not have a supervisory board) 2) If the director (or family member) holds less than 10%: the directors must notify the supervisory board within three working days	employee in another company, or pursue as entrepreneur an activity that is or could be in competition with the activity of the company 2) A member of the management board may not pursue an activity with a view to profit in the area of the company's activity without the consent of the supervisory board, Art. 271 3) The general duty of loyalty can be interpreted as prohibiting the exploitation of corporate opportunities, but no case law since the duty was introduced very recently (2012)		
Spain	- s. 229: self-dealing is permitted if the director: 1) informs the board of directors of the conflict 2) abstains from any decisions relating to the self-dealing transaction (Note: the provisions is wide and encompasses not only self-dealing, but any conflict of interest, e.g. affecting internal decision-making processes) - In addition, transactions can be challenged on	s. 228: directors are prohibited from exploiting corporate opportunities if: 1) they have become aware of the opportunity by reason of their position 2) the company has an interest in the opportunity (it falls within the company's line of business) and has not ruled out the investment. The director must communicate the conflicting situation to the company; the company can authorize the	1) Duty of secrecy (s. 232) continues after resignation. Legal literature: it ends when the consequences of disclosure are no longer detrimental to the company or the information can be disclosed 2) Some case law exists that has held resigning directors liable for the exploitation of corporate opportunities (Supreme Court, 2 September 2012, RJ/2012/9007)	Non-competition, s. 230: authorisation of the GM required

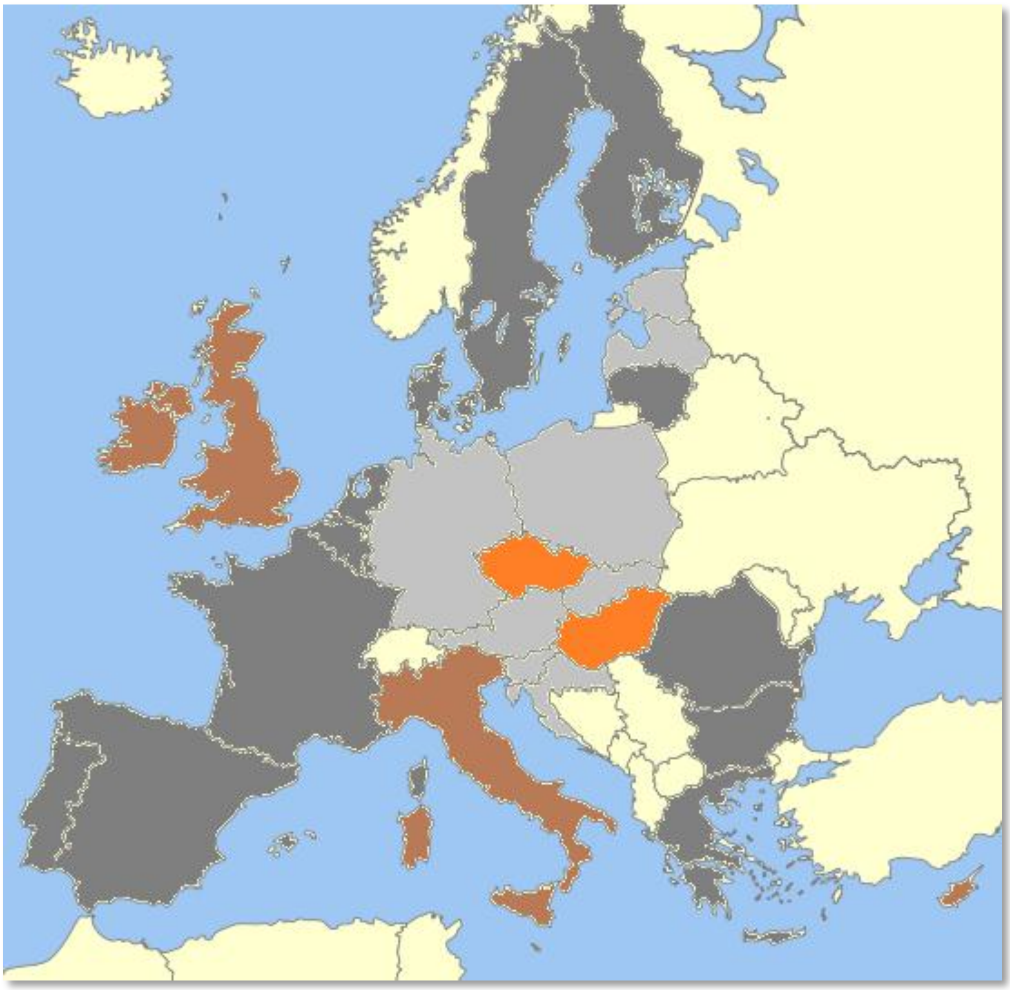
	the ground that they are unfair, i.e. not in the best interest of the company	transaction (the conflicted director must abstain)		
Sweden	1) Ch. 7, § 46: shareholder may not vote in respect of the following matters: a) legal proceedings against them b) their discharge from liability in damages or other obligations towards the company c) legal proceedings or a discharge in respect of another person, where the shareholder possesses a material interest which may conflict with the interests of the company 2) Ch. 8, § 23: directors may not participate in a matter regarding: a) agreements between the board member and the company b) agreements between the company and a third party, where the board member in question has a material interest which may conflict with the interests of the company c) agreements between the company and a legal person which the board member is entitled to represent	No binding regulation, the general duty of loyalty may apply. Directors have a duty to pursue corporate opportunities on behalf of the company.	The duties no longer apply when a director resigns. However, according to some scholars, directors who set up a competing business, take advantage of business secrets of the company and/or of corporate opportunities, can be found liable for breach of the general duty of loyalty.	No statutory rule regarding confidentiality in the Companies Act, but the general duty of loyalty provides that the director may not reveal information that may jeopardise the company's interests.

	d) litigation and other legal proceedings are equated with agreements within the meaning of the preceding paragraphs			
United Kingdom	1) s. 177: the director declares the nature and extent of his interest to the other directors *before* the company enters into the transaction. (note that some transactions require members' approval, ss. 188-225); the interested director does not have to abstain from voting (but see Art. 16 Model Articles for Public Companies: the director is not to be counted as participating in the meeting for quorum or voting purposes) 2) Ex ante authorisation by shareholders, s. 180(4)(a) 3) Ex post ratification by shareholders , s. 239 (the interested director cannot vote)	s. 175(2): 1) Exploitation of any property, information or opportunity 2) The company does not need to be able to make use of the opportunity 3) Line of business test applied by older case law, but see O'Donnell v Shanahan [2009] B.C.C. 822: an opportunity falling outside the scope of business of the company may nevertheless give rise to the prohibitions of the corporate opportunities doctrine	s. 170(2)(a): the duty not to exploit corporate opportunities continues after resignation. Old case law: maturing business opportunities doctrine → directors are liable if they resign in order to take up the opportunity or use special knowledge of a business opportunity or trade secrets (as opposed to general know-how acquired in the course of their employment)	1) Duty to act in accordance with the company's constitution and proper purpose doctrine, s. 171 2) Duty to promote the success of the company, s. 172 3) Duty to exercise independent judgment, s. 173 4) General duty to avoid conflicts of interest, s. 175(1) 5) Duty not to accept benefits from third parties, s. 176

Discussion

Related party transactions

Map 2.5.2.a: Related party transactions



Legend	Country
The country applies a broad rule to conflicted transactions that makes all or the most important such transactions (exempting, for example, transactions in the ordinary course of business) conditional upon disclosure and a decision by a disinterested organ (i.e. the conflicted director cannot participate in the decision that authorises the interested transaction)	BE, BG, DK, FI, FR, EL, LT, LU, NL, PT, RO, ES, SE
The country uses the two-tier board system and allocates decision-making power for	AT, EE, DE, HR, LV, PL, SK, SI

	transactions between the company and the director to the supervisory board	
	The country makes all or the most important conflicted transactions conditional upon disclosure, but the interested director can participate in the decision that authorises the interested transaction	CY, IE, IT, MT, UK
	Fragmentary regulation	CZ, HU

As is to be expected, the regulatory landscape follows largely the distribution of the one-tier and two-tier models in the EU. Two countries that offer formally a choice between the one-tier and two-tier systems are included in the group of countries with a mandatory two-tier board structure: Croatia, where the unitary board system has only recently been introduced (2007) and has no tradition in company law, and Slovenia, where the majority of companies opt for the two-tier system. Hungary would also fall into this category, given that the choice between the one-tier and two-tier model only dates back to 2006 and most companies have a supervisory board, but the law does not use the existence of the supervisory board to reallocate decision-making power.[155]

Two-tier versus one tier board system: The two-tier board system is less flexible than a broadly defined and generally applicable no-conflict rule. In two-tier board systems, the law simply re-allocates decision-making power (to a supervisory organ with regard to transactions between the company and a member of the management organ),[156] but it does not impose a duty on directors to avoid any kind of conflict of interest. This has the consequence that particular questions are left unregulated, for example the problem of who decides on a transaction that is not formally between the company and the director, but in which the director is interested. A good example is a contract between the director's company and another company in which the director is a substantial shareholder. In some countries, for example Germany, the management board would continue to have the power to represent the company in such a transaction.[157]

However, this does not apply to all two-tier board systems. Slovenian law, for examples, specifically provides that the authorisation by the supervisory board is required where the director (or a family member) holds 10% or more of the share capital, is a silent partner, or participates in any other way in the profits of the other undertaking. If the holding amounts to less than 10%, the director must still notify the supervisory board within three working days.

Alternative tests: French law allows an interested transaction (other than those entered into in the ordinary course of business) if it was authorised by the board, with the interested director abstaining from voting, the transaction has no prejudicial consequences for the company, or it is approved by the general meeting.

Intermediate cases: Ambivalent cases are Cyprus, Ireland, Malta, and the United Kingdom. The company law does not prohibit interested directors from participating and voting in the board meeting that decides on the interested transaction, but good practice (and the model articles of association that apply if the company does not adopt alternative articles) require the director to abstain from voting. In addition, in the UK, companies with a premium listing on the London Stock Exchange are subject to additional requirements.[158] The Listing Rules promulgated by the UK Listing Authority (UKLA) require

[155] See the discussion below 'Fragmentary regulation'.
[156] See, for example, German Stock Corporation Act, § 112.
[157] OLG Saarbrücken, AG 2001, 483.
[158] Companies listed on the Main Market of the London Stock Exchange can choose between premium and standard listing. Premium listing involves the most stringent standards of regulation with rules that are partly super-equivalent, i.e. that go beyond the requirements imposed by EU law.

such companies to disclose related party transactions to their shareholders and obtain shareholder approval for the transaction.[159] Related party transactions are defined as transactions between the company and, among others, a director, shadow director, or substantial shareholder of the company.[160] Exceptions apply to small transactions and a number of other enumerated transactions.[161] Importantly, the interested director is not allowed to vote on the resolution approving the related party transaction.[162] In spite of these qualifications, we assign the intermediate cases to group 3 because the rules preventing the interested director from participating in the decision regarding the self-dealing transaction do not stem from binding company law and are limited in their scope.

As regards Belgian law, it should be noted that a distinction is drawn between private companies and companies that have issued shares to the public (including listed companies). The general rule is that the conflicted director does not have to abstain from participating in the decision approving the related party transaction, unless the articles of association provide otherwise. However, the rules are more stringent if the company has issued shares to the public. The Companies Act requires directors of such companies not to participate in the proceedings of the board or vote on the matter.[163]

Fragmentary regulation: In the Czech Republic, the law only regulates a limited number of specifically defined interested transactions, namely credit or loan contracts with the directors, contracts securing the debts of directors, free-of-charge transfers of property from the company to directors, and transfers of assets for consideration exceeding 10% of the company's capital. In Hungary, the law does not contain any specific rules on related party transactions in the public company (in private companies, authorisation of the general meeting is required). Therefore, it is necessary to take recourse to general principles of civil law, notably the law on representation and agency. According to agency law, the agent is prohibited from contracting with him- or herself or from acting if the other party is also represented by the agent. While a supervisory board exists in many companies, the law does not reallocate decision-making power to that board where the company engages in related-party transactions. The supervisory board is not expected to represent the company and act on behalf of it, either in general or in this specific situation. These rules are commonly regarded as being unsatisfactory.

Netherlands: The law in force until December 2012 regulated conflicts of interest as a matter of representation, i.e. the interested director lacked authority to represent the company, with the consequence that a conflicted transaction was not valid in relation to third parties that contracted with the director's company. These rules were widely criticised as leading to legal uncertainty and were reformed by the Management and Supervision Law, which entered into force on January 1, 2013. The new regime no longer relies on corporate representation, but introduces a bright-line prohibition of directors who have a direct or indirect interest in a transaction to participate in the decision-making process regarding that transaction. If as a result of the prohibition no board resolution can be passed, the supervisory board will be entrusted with the decision (or, if a supervisory board does not exist, the general meeting, unless provided for otherwise in the articles of association).

Corporate opportunities

Corporate opportunities can be defined as business opportunities in which the corporation has an interest. The effectiveness of the regulation of corporate opportunities thus depends on two factors. First, is the exploitation of corporate opportunities by the directors for their own account restricted and, if yes, under which conditions (disclosure, disinterested approval, etc.) are the directors free to pursue a business opportunity that belongs to the corporation? Second, how is it determined when a business

[159] Listing Rules, LR 11.1.7R.
[160] LR 11.1.4R. Substantial shareholders are holders of 10% or more of the company's voting rights (LR 11.1.4AR).
[161] Threshold ratios for small and smaller transactions are 0.25% and 5% of the company's value, respectively. Small transactions are exempted from the rules and for smaller transactions modified requirements apply. See LR 11.1.6R, LR 11.1.10R, LR 11 Annex 1 R.
[162] LR 11.1.7R(4).
[163] Companies Code, Art. 523 § 1, 4.

opportunity 'belongs' to the corporation? With respect to both dimensions, the law may adopt a narrow approach (i.e., the regulation is applicable to a narrowly defined set of cases) or a broad approach (applicable to a wide range of directors' activities). It could be said that the narrow approach imposes a smaller risk of liability on directors and facilitates the realisation of business opportunities, which may contribute to an efficient allocation of resources, while the broad approach ensures a more comprehensive protection of shareholders. For example, as far as the first dimension is concerned, the law may only address direct conflicts of interest, i.e. where the director him- or herself exploits a corporate opportunity (narrow approach), but not indirect conflicts created by the activities of a company or other business association in which the director has an interest (broad approach). As far as the second dimension is concerned, the law may define the necessary link between the business opportunity and the company narrowly, requiring the opportunity to fall within the line of business actually pursued by the company (or at least identified as one of the company's objects in the articles of association), or broadly, capturing for example any type of economic activity and disregarding the capacity of the company (financial or otherwise) to make use of the opportunity.

The Member States employ two general strategies to regulate corporate opportunities. One group of countries (in particular, those belonging to the common law) impose a fairly broad duty on directors not to exploit any information or opportunity of the company, as this would constitute a case of a prohibited conflict of interest, and a second, larger group relies on the duty not to compete with the company. No country establishes an absolute prohibition. All jurisdictions allow directors to exploit corporate opportunities after authorisation by the board of directors, supervisory board, or general meeting of shareholders, as applicable.

Furthermore, in most jurisdictions the rules apply both to direct conflict cases (the director him- or herself takes advantage of the opportunity) and indirect conflicts (the director is involved in a business that engages in activities that are potentially or actually of economic interest to the company). The legal systems differ in details, for example with respect to the question of when the interest of the director in a competing business is significant enough to trigger the prohibitions of the no-conflict or non-compete rule or when the activities of a person affiliated with the director implicate the director him- or herself. But all legal systems that regulate these conflicts (which is not the case for all jurisdictions analysed) provide for *some* mechanism that goes beyond the purely formal director-company relationship and includes affiliates that are economically identical or closely related to the director.[164]

The Member States differ systematically with regard to the second dimension: the definition of the necessary link between the business opportunity and the company. Interestingly, the difference correlates with the regulatory strategy employed by the legal system: the duty not to exploit corporate opportunities on the one hand, or the prohibition to compete with the company on the other hand. If the jurisdiction adopts the former strategy, the duty generally encompasses all cases of an actual or potential conflict, i.e. the director is prohibited from exploiting the business opportunity notwithstanding the company's current activities or financial means. The non-compete rule, on the other hand, is generally interpreted narrowly. 'Competing with the company' is understood as pursuing an economic activity within the scope of the company's business, i.e. engaging in actual, not only potential, competition with the company.

However, it is not clear that this correlation lies in the nature of the regulatory strategy adopted. Essentially, this is a simple matter of how the boundaries of the no-conflict and non-compete duties are defined and interpreted. For example, Portugal's company law contains a codified version of the non-compete duty.[165] In addition, it is argued that an unwritten corporate opportunities doctrine exists that applies if the business opportunity falls within the company's scope of activity or the company has expressed an interest in the opportunity and received a contractual proposal or is in negotiations.[166]

[164] For details see *Table 2.5.2.a* and the country reports.
[165] Portuguese Code of Commercial Companies, Art. 398(3).
[166] Jorge Manuel Coutinho de Abreu, *Deveres de cuidado e de lealdade dos admnistradores e interesse social*, in *Reformas do Código das Sociedades* (N.º 3 da Colecção, Almedina 2007), 17, 26-27.

Thus, the definition of “corporate opportunity” is narrower than the one developed by, for example, the English courts. In this manner, the corporate opportunities doctrine and the codified duty not to compete with the company are aligned. On the other hand, under the heading ‘prohibition of competition’, Austria and Germany prohibit directors from operating any other business enterprise, notwithstanding its line of business.[167] Nevertheless, it may be argued that the structure of the corporate opportunities doctrine as found in common law jurisdictions is more conducive to an open-ended, flexible interpretation, given that it is based on a broadly understood requirement to avoid conflicts of interest of any kind, whereas the use of the term ‘competition’ implies a proximity of the prohibited activity and the company’s business. On this view, the differences in the scope of the prohibition would be a natural consequence of the different legal strategies initially adopted.

On the basis of the foregoing considerations, we divide the Member States in *Map 2.5.2.b* below into the following groups.

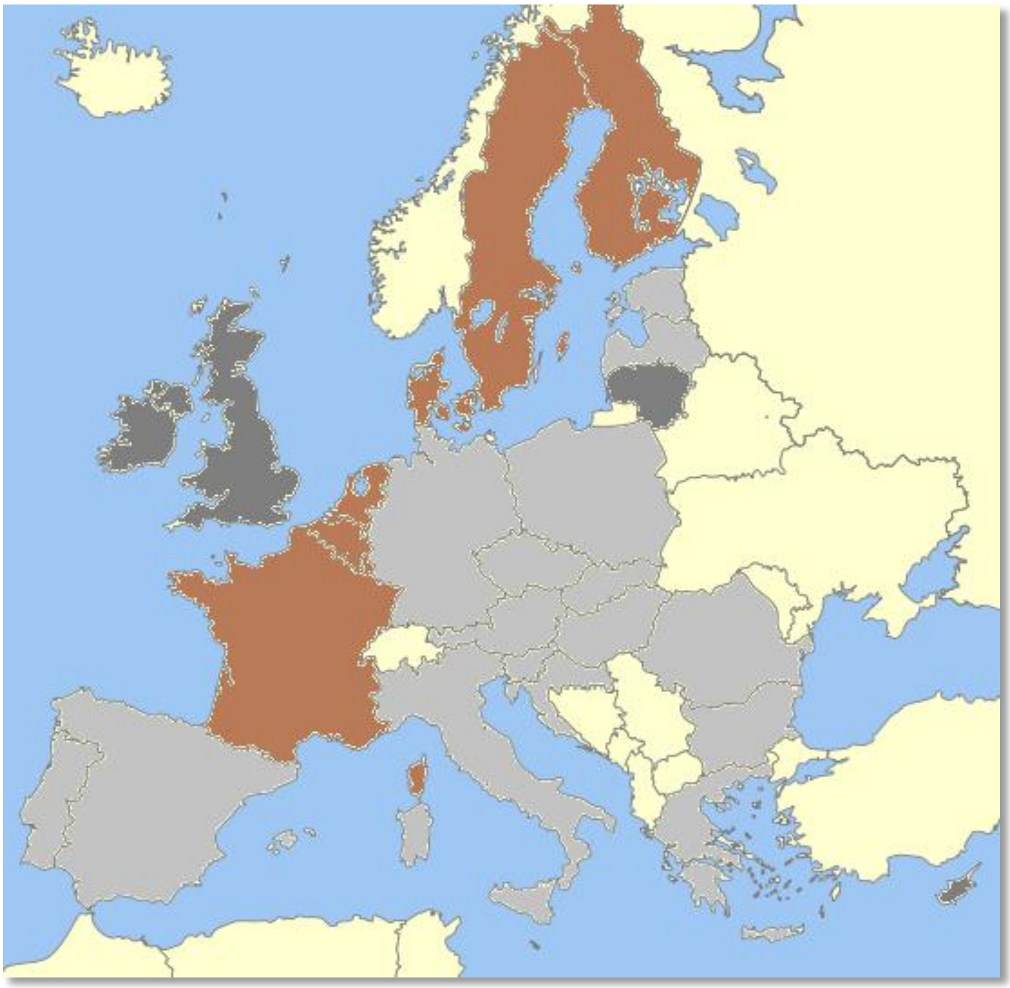
(1) The broad approach is based on what can be called the ‘no-conflict rule’: Directors are required to avoid any type of conflict of interest with the company, which means in this context that they must refrain from exploiting business opportunities. As explained, the legal systems that employ this approach define the term ‘corporate opportunity’ broadly, encompassing any business opportunity that is actually or potentially of economic interest to the company. The prohibition does *not* only apply if the company has expressed an interest in the opportunity or it can be assumed that such an interest exists because of the close link with the company’s current operations. The theoretical possibility of a (future) overlap with the company’s activities is sufficient. In addition, the financial capacity of the company to exploit the opportunity is irrelevant.

(2) The narrow approach relies on the duty not to compete with the company. The director is generally[168] only required to refrain from pursuing economic activity in the company’s line of business.

(3) Finally, the third group comprises jurisdictions that do not contain any binding regulation of corporate opportunities, either by way of a statutory no-conflict or non-compete provision or a well-established case-law based corporate opportunities doctrine.

[167] Austrian Stock Corporation Act, § 79(1); German Stock Corporation Act, § 88(1).
[168] For a more detailed discussion see below.

Map 2.5.2.b: Corporate opportunities



Legend		Country
	Duty not to make use of corporate opportunities (broad definition, i.e. not requiring that the director must act in the company's line of business)	CY, IE, LT, MT, UK
	Duty not to compete (narrow definition, i.e. generally requiring that the director must act in the company's line of business)	AT, BG, CZ, DE, EE, EL, HR, HU, IT, LV, PL, PT, RO, SI, SK, ES
	No binding regulation	BE, DK, FI, FR, LU, NL, SE

General comments: The majority of jurisdictions contain some regulation of corporate opportunities. The common law countries Ireland and the UK, as well as the mixed jurisdictions strongly influenced by English common law (Cyprus and Malta), but also Lithuania have developed a corporate opportunities doctrine stemming from the duty to avoid conflicts of interest. The paradigm of this doctrine, and its most developed version, can be found in the UK. The UK courts have produced a wealth of case law on corporate opportunities that have shaped the details of the doctrine and clarified that: (1) directors do not have to learn of the corporate opportunity in their capacity as director, but it is sufficient that they obtain knowledge of the opportunity in a private capacity, for example during their spare time; (2) it is irrelevant whether the corporate opportunity falls within the company's line of business or not, as long as the possibility is not excluded that the company may now or in the future adjust or refocus operations so that the business opportunity becomes economically interesting to the company; and (3) the fact that the company is currently unable to exploit the opportunity for financial reasons or because of the existence of a legal impediment (e.g., a restricted objects clause in the company's articles) that may be removed through appropriate action (for example, a resolution by the general meeting amending the objects clause) is immaterial.[169]

In the other jurisdictions inspired by the English principles, the reach of the corporate opportunities doctrine is often less clear than in the UK. This is generally not a function of a conscious deviation from the English law, but simply of the paucity of case law that could settle these questions. Often the literature discusses in how far the English principles should apply, but the smaller size of the jurisdiction and possibly non-legal reasons for the less frequent use of the judicial system mean that the courts did not have the possibility to decide on the issue or develop their distinct solutions. In the absence of case law to the contrary, we have classified these jurisdictions in the same way as the UK, but it should be kept in mind that the courts may well decide differently should a case come before them.

Austria, Germany, and Slovenia: Three ambivalent jurisdictions are Austria, Germany, and Slovenia. These jurisdictions, belonging to the same legal family, have influenced each other and provide for similar rules prohibiting competitive activity by the directors. They distinguish between two types of activity: The operation of another business enterprise and the conclusion of transactions.[170] The former is prohibited in a general and comprehensive way, notwithstanding the scope of the other enterprise's business, in order to ensure that the director devotes his or her undivided attention to the company. Therefore, this part of the prohibition is not, in essence, a non-compete rule, but is concerned with a more general conflict of interests. The latter prohibition only applies if the director is active within the company's line of business and follows the traditional non-compete rules that can be found in other jurisdictions. Consequently, the three jurisdictions stand somewhat between group 1 and group 2. We assign them to group 2 (non-compete) since they leave scope for a number of conflicted interest transactions that may be caught by the corporate opportunities doctrine (group 1), for example transactions that are potentially of economic interest to the company, but do not fall within the scope of current, actual operations.[171]

Both corporate opportunities doctrine and duty not to compete: A few jurisdictions now provide both for a corporate opportunities doctrine and a duty not to compete with the company (Italy, Malta, and Spain). The case of Malta illustrates well the difference in scope between the two regulatory instruments. The corporate opportunities doctrine is phrased in an open-ended way, whereas the duty not to compete with the company applies only to activities actually performed by the company or which can reasonably be foreseen to be undertaken in the near future. It was mentioned that this difference is not a necessary consequence of the employment of either the no-conflict or the non-compete rule. In Italy and Spain, the corporate opportunities doctrine was introduced recently into the Civil Code and Corporations Act, respectively. The traditional approach to regulating these issues was by means of the prohibition to compete, which remains in force. It is uncertain how the two provisions relate to each other and what the reach of the corporate opportunities doctrine is in the two countries. Case law is scarce or non-existent. We accordingly assign both countries to group 2.

No binding regulation: Several jurisdictions do not contain any binding rules on corporate opportunities, either in the company legislation or in case law. These are: France, Belgium, Luxembourg, the Netherlands, and the Scandinavian jurisdictions. However, this does not mean that

[169] For a comprehensive discussion see P. Davies and S. Worthington, *Gower and Davies' Principles of Modern Company Law* (Sweet & Maxwell, 9th ed. 2012), paras. 16145 to 16-164.

[170] Austrian Stock Corporation Act, § 79(1); German Stock Corporation Act, § 88(1); Slovenian ZGD-1, Art. 41.

[171] However, it should be noted that especially German law is flexible in that the existence of an unwritten duty of loyalty is accepted, which was used by the courts to address cases not caught by the codified duty (see, for example, BGH WM 1967, 679, where the court held that the director was in breach of fiduciary duties by acquiring property that was not required by the company for its current operations).

the issue is left without any regulation. The service contract concluded with the director may contain a non-compete clause, with the consequence that directors are contractually liable if they engage in competitive behaviour. This is common practice in most jurisdictions. In addition, the legal mechanisms of the jurisdictions in this group are, in general, flexible enough to address the usurpation of a corporate opportunity by the director. In French law, the existence of a general duty of loyalty is commonly acknowledged, although the legal basis of the duty is somewhat unclear. In addition, it was argued by some French commentators that the exploitation of corporate opportunities may constitute the criminal offence of *l'abus des biens sociaux*.[172] In Belgium, liability for disloyal behaviour is based on the general provision establishing responsibility of directors for management mistakes and failures to exercise their mandate properly.[173] As discussed, under Luxembourg law, the duty of loyalty can also be derived from general provisions, but it was pointed out that the courts tend to be reluctant to intervene in cases of competitive behaviour or the exploitation of corporate opportunities by directors, given the general liberal approach embedded in Luxembourg company law. In the Netherlands, general principles of, for example, the duty of care or tort law, have been utilised in some cases to arrive at suitable solutions.[174] In Finland, the duty of directors to 'promote the interests of the company', set out as a general principle in Part 1 of the Finnish Limited Liability Companies Act,[175] is interpreted broadly as the statutory basis of an unwritten duty of loyalty. Directors who take advantage of corporate opportunities may be judged as not having promoted the interests of the company. Similarly, in Sweden the lack of an explicit regulation of corporate opportunities or competitive behaviour is potentially compensated for by an application of the duty loyalty.[176]

The analysis shows that the jurisdictions in group 3 do not, *per se*, exhibit regulatory gaps compared with the legal systems in the other two groups. As was already mentioned in a different context,[177] the law seems elastic enough to be able to address conflicts where regulatory intervention is deemed necessary. It should also be noted that examples exist where jurisdictions with no express regulation of corporate opportunities and no comprehensively codified duty of loyalty have achieved results driven by case law and judicial innovation that are similar to UK law, which we regard as the paradigmatic case of the corporate opportunities doctrine.[178] The main difference with regard to outcomes seems to be the increased legal uncertainty due to the lack of clearly specified rules addressing different conflict situations. In most jurisdictions of group 3, the scope of the prohibitions to compete with the company and exploit corporate opportunities is evolving and authoritative case law is scarce. It should be emphasised that this is not a result of the lack of *codified* rules, but more generally of *clearly specified rules*, which may derive from statutory law or case law, as can be seen in the UK, where the corporate opportunities doctrine was, of course, entirely case-law based until 2006. Arguably, however, the distillation of rules tailored to specific conflict situations from general (and possibly unwritten) principles of law requires that certain conditions are satisfied, notably that the courts have the opportunity to adjudicate and refine the legal principles.[179]

The following table summarises the liability of directors according to different jurisdictions under the following stylized facts: The director sits on the board of Company A and is majority shareholder and managing director in Company B, which is active in the same line of business. Company B acquires an asset that would also be of economic interest to Company A.[180]

[172] M. Cozian et al., *Droit des sociétés* (Lexis Nexis, 20th ed. 2007), para. 617.
[173] Art. 527 of the Code des societies provides: 'Les administrateurs . . . sont responsables, conformément au droit commun, de l'exécution du mandat qu'ils ont reçu et des fautes commises dans leur gestion.'
[174] See for example Court of Appeals Arnhem, 29 March 2011, LJN BQ0581, JOR 2011/216, holding a director liable for starting a competing business on the basis of sections 2:8 and 2:9 Dutch Civil Code.
[175] Ch. 1, s. 8. An English translation of the Limited Liability Companies Act can be obtained at: http://www.finlex.fi/en/laki/kaannokset/.
[176] R. Dotevall, 'Liability of Members of the Board of Directors and the Managing Director – A Scandinavian Perspective', 37 Int'l L. 7, 20-21 (2003).
[177] See above 2.1.
[178] See n 171 above.
[179] For a discussion of this issue see already above 2.1.
[180] The information is based on the answers to Hypothetical IV, question 4, appended to the country reports.

Table 2.5.2.b: Liability for exploitation of corporate opportunities/ competing with the company

Country	*Legal rule*	*Liability*	*Code*[181]
Austria	Duty not to compete	If the director is member of the management board of A: liability, unless the supervisory board gives its consent. If the director is member of the supervisory board of A: no prohibition to compete.	L
Belgium	No binding regulation	The literature argued that the general duty of loyalty is implicated, but no established case law	U
Bulgaria	Duty not to compete	Liability if similar line of business, unless the general meeting or supervisory board (if any) give their consent	L
Czech Republic	Duty not to compete	Liability if similar line of business	L
Croatia	Duty not to compete	Liability unless the supervisory board gives its consent.	L
Cyprus	Corporate opportunities doctrine	Courts draw on the principles established by the English common law associated with the Companies Act 1948, but very little case law	U
Denmark	No binding regulation	The duties of care and loyalty may apply and prohibit the director from influencing the decision to exploit the opportunity	L/U
Finland	No binding regulation	According to the legal literature, the director is liable on the basis of the duty of care, which encompasses the duty of loyalty	L/U
France	No binding regulation	Directors of the *société anonyme* are generally allowed to run competing businesses; no corporate	N/U

[181] Refers to the perceived high likelihood of liability (L), low likelihood of liability (N), or unclear legal situation (U).

		opportunities doctrine. However, the case law is evolving and the courts may hold the director has breached the duty of loyalty.	
Germany	Duty not to compete	Violation both of the prohibition not to be managing director or member of the management board of another company and not to trade in the company's line of business. But no liability if the supervisory board gives its consent.	L
Greece	Duty not to compete	If the director is involved in the management of Company A he is prohibited from acting for rival Company B	L
Hungary	Duty not to compete	Liability if similar line of business, unless permitted in the articles or the supreme body of the company gives its consent	L
Ireland	Corporate opportunities doctrine	It is likely that the director would be held liable for breach of the corporate opportunities doctrine following principles of English case law, but no Irish judgments on the issue.	L
Italy	Both corporate opportunities doctrine and duty not to compete	Violation of the duty not to compete with the company, which prohibits directors to be appointed as directors or general managers in competing companies unless authorised by the shareholders. In addition, violation of the corporate opportunities doctrine.	L
The Netherlands	General provisions of ss. 2:8, 2:9 Civil Code and tort law apply	The mere fact that a director competes, through his stake in	L/U

		another company, with the company he is serving as director in itself does not constitute an act of tort. Additional circumstances must be put forward by the claimant.	
Poland	Duty not to compete	Liability, unless the supervisory board gives its consent	L
Portugal	Both corporate opportunities doctrine and duty not to compete	Liability for performing functions in a competitor company, unless the general meeting (or, if the company has opted for the two-tier model with an executive board and a general and supervisory board) has given its consent; in addition, liability under the unwritten corporate opportunities doctrine for acquiring the asset.	L
Romania	Duty not to compete	The duty not to compete is only violated if the defendant is an executive director or member of the management board in the two-tier system and the board has not given its approval. Possibly the duty of confidentiality applies.	U
Slovenia	Duty not to compete	Both members of the management board and the supervisory board are under the duty not to be director in another company. In addition, A member of the management board may not pursue an activity with a view to profit in the area of the company's activity without the consent of the supervisory board.	L

Spain	Both corporate opportunities doctrine and duty not to compete	Violation of the prohibition of competition, unless the general meeting authorises the competing directorships. In addition, violation of the prohibition to take advantage of business opportunities (provided that the company has not ruled out the investment).	L
UK	Corporate opportunities doctrine[182]	Liability for appropriation of a corporate opportunity; in addition liability for serving on the board of a competing company, provided that this gives rise to a conflict of duties (which is likely, given that the companies operate in the same line of business) and that the dual appointment has not been authorised by the directors of both companies.	L

The answers to the stylized facts indicate that most jurisdictions of above subsample would hold the director liable in the case of an actual, not only potential, conflict of interest where the director acquires directly or indirectly an asset that is of economic interest to the company. In the majority of jurisdictions liability is based on two grounds: the fact that the director holds the position of managing director in a competing company and that he/she indirectly takes advantage of a corporate opportunity by arranging for the competitor company to acquire the asset in question. In this scenario, the result does not depend on the strategy employed by the jurisdiction: application of the corporate opportunities doctrine or the duty not to compete with the company. If the director had not acquired the asset through Company B, but merely performed his/her functions as executive director of B, the corporate opportunities doctrine would possibly not apply. In the absence of a statutory or contractual duty not to compete, the director would be free to serve on the boards of both companies. Thus, in theory, jurisdictions that employ only the corporate opportunities doctrine may not prohibit conduct potentially detrimental to the interests of the director's company.[183] In practice, however, it is unlikely that the corporate opportunities doctrine leads to regulatory loopholes. If the companies operate in the same line of business, they will inevitably encounter business opportunities attractive to both companies. In addition, in jurisdictions following the English common law, the corporate opportunities doctrine is embedded in the general no-conflict rule, which is flexible in its scope of application and

[182] The common law did not expressly prohibit competing directorships. The Companies Act 2006 is somewhat more explicit, but continues to frame the issue in conflict-of-interest terms, see s. 175(7).
[183] This was indeed the position under early English common law, see *London and Mashonaland Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165.

may well be used by the courts to intervene and hold the director responsible where the companies engage in actual competition.[184]

In a number of countries (Belgium, France, Romania, the Netherlands, and the Nordic countries) corporate opportunities are less comprehensively regulated than in the other jurisdictions of the above subsample. In Belgium and France, this is a result of the general indeterminacy of the law with respect to the duty of loyalty and the lack of case law dealing with corporate opportunities. Romanian law does not address the problem of corporate opportunities, and the section of the Companies Law providing for a prohibition of competition applies only to executive directors. In addition, the prohibition can be disapplied relatively easily by a resolution of the board of directors. The Netherlands and the Nordic countries also do not provide for statutory rules specifically tailored to the corporate opportunities or competition scenario, but the answers indicate that general principles of, for example, the duty of care or tort law, can be utilised (and have been utilised in practice in some cases) to arrive at suitable solutions to the conflict.

We now vary the facts of the hypothetical. We assume that the director does not engage in a competitive activity as managing director or majority shareholder of a company active in the line of business of Company A, but that he/she acquires a business opportunity that would, in theory, be of economic interest to Company A for private purposes. We further assume that the board of Company A considers the business opportunity, but determines that the investment is not advisable at present because the company is experiencing financial difficulties.[185]

Table 2.5.2.c: Acquisition of a corporate opportunity for private purposes

Country	***Legal rule***	***Liability***	***Code***[186]
Austria	Duty not to compete	No liability if the company rejects the opportunity, and most likely also no liability if the company had not rejected the opportunity because the duty not to compete does not apply in the private sphere	N
Belgium	No binding regulation	No liability	N
Bulgaria	Duty not to compete	No liability	N
Czech Republic	Duty not to compete	No liability	N
Croatia	Duty not to compete	No liability	N
Cyprus	Corporate opportunities doctrine	Unclear, depends on the extent to which the Cypriot courts would draw on English common law associated with the Companies Act 1948. In any case, no liability if the fully informed board with the interested	U

[184] More recent English judgments (predating the Companies Act 2006) can be understood in this way, see *Bristol & West Building Society v Mothew* [1998] Ch. 1; *CMS Dolphin Ltd v Simonet* [2002] B.C.C. 600. Some Irish cases also suggest this approach, see *Spring Grove Services (Ireland) Ltd v O'Callaghan*, High Court, unreported, Herbert J., July 31, 2000.
[185] The information is based on the answers to Hypothetical IV, question 6, appended to the country reports.
[186] Refers to the perceived high likelihood of liability (L), low likelihood of liability (N), or unclear legal situation (U).

		director abstaining from voting gives its consent.	
Denmark	No binding regulation	Unclear, but probably no liability	N/U
Finland	No binding regulation	Unclear. If the company's financial position is too weak to take advantage of the business opportunity there may be no damage.	U
France	No binding regulation	No liability	N
Germany	Duty not to compete	No statutory regulation of the issue; probably no liability if the opportunity is offered to the company and the company declines it.	N
Greece	Duty not to compete	No liability	N
Hungary	Duty not to compete	No liability	N
Ireland	Corporate opportunities doctrine	The director is free to exploit the opportunity, provided that appropriate disclosure has been made. The conflicted director must abstain from participating in the board's decision.	N
Italy	Both corporate opportunities doctrine and duty not to compete	It is questionable whether the company must be able to take advantage of the opportunity. The prevailing view in the literature wants to hold directors responsible even if the company is not capable of exploiting the opportunity, but no case law.	U
Portugal	Duty not to compete; corporate opportunities doctrine possibly in analogy to the statutory rules	No liability if the board of directors decides not to pursue the opportunity. The conflicted director must abstain from participating in the board's decision.	N
Romania	Duty not to compete	No liability	N

Slovenia	Duty not to compete	No liability because the director does not pursue a competing activity for profit. In any case, the director can exploit the opportunity if the supervisory board gives its consent.	N
Spain	Both corporate opportunities doctrine and duty not to compete	If Company A is not interested in the investment the corporate opportunities doctrine does not apply. The conflicted director must abstain from participating in the board's decision.	N
UK	Corporate opportunities doctrine	Corporate opportunities doctrine applies. The lack of financial capacity by the company to exploit the opportunity does not absolve the director from liability. The board may be able to authorise the director to exploit the opportunity,[187] but the conflicted director's votes do not count.	L

The legal treatment of this scenario is markedly different from the hypothetical above. Three points are noteworthy. First, under such stylised facts the potential differences in outcome between the duty not to compete with the company and the corporate opportunities doctrine are more clearly visible than under the scenario discussed above in *Table 2.5.2.b*. In legal systems applying the duty not to compete, the director would not be held liable since competition is usually defined as entrepreneurial activity in the line of business of the company. Second, the answers also show that the corporate opportunities doctrine is not always wider than the duty not to compete, but that its scope depends on the precise formulation of the doctrine. The approach followed by the UK is the strictest. In Cyprus the legal situation is less clear, largely due to the lack of case law. Even though Irish law is influenced by English common law, the courts in Ireland apply more flexible rules and allow directors to exploit a business opportunity if the company has chosen not to pursue it. The civil law jurisdictions of the above sub-sample providing both for the duty not to compete and the corporate opportunities doctrine, (Italy and Spain) would come to the result that the director is free to take advantage of the opportunity if the company is not interested in the investment, or that the legal situation is unclear because the rules are not well developed. They therefore obscure the divide between the corporate opportunities doctrine and the duty not to compete.

Third, the Member States do not hold the director liable where the company, through its board of directors or supervisory board, authorises the director to exploit the opportunity. A number of legal

[187] In the case of a public company, the articles of association must explicitly allow board authorisation. For private companies, the default rule is that the board can authorise conflicted transactions unless the articles provide otherwise, Companies Act 2006, s. 175(5).

systems address the conflict of interest that this exception creates particularly in one-tier board systems by prohibiting the conflicted director from participating in the board's decision. Such a rule may alleviate the conflict of interest to some extent, but it does not take account of the possibility that the conflicted director, especially if he/she is the chief executive officer or chairman of the board, wields significant influence over the other board members, which may call into question the objectivity of the board's decision. This is the reason why English common law traditionally adopted a strict stance with regard to corporate opportunities. Financial incapacity of the company, as well as other (non-structural) impediments to exploiting the corporate opportunity, did not have the consequence of allowing the director to take advantage of the opportunity.[188] Furthermore, authorisation by the board was not sufficient; only the shareholders could approve the transaction.[189] The restrictive approach continues after the 2006 codification of the common law as far as the irrelevance of capability facts is concerned,[190] but now board authorisation is permitted. In two-tier board systems this problem is attenuated, but arguably not non-existent, and the effectiveness of the authorisation mechanism depends on the ability of the supervisory board to function as an independent and objective control organ.

The least specific rules can again be found in Belgium, France, Romania, and the Nordic countries. In France and Romania, the director is not required to procure board authorisation and, accordingly, rules requiring the abstention of the conflicted director in any board resolution deciding on the investment opportunity, do not apply. In Belgium, the interested director is not prohibited from participating in the deliberations and decision of the board, unless the company has issued securities to the public. As discussed above in the context of *Table 2.5.2.b*, the Nordic countries rely on general principles in regulating these issues, which makes it difficult to assess the case, but also gives the courts the flexibility to intervene where necessary.

Resigning directors: The last issue to be discussed in this context is the treatment of resigning directors. The resignation may invite regulatory intervention if the director resigns for the purpose of establishing a competing business and he or she makes use of information, business contacts, or general skills and expertise acquired while serving on the board of the company. Often this issue will be addressed in the service contract with the director, which will contain a non-compete agreement imposing the obligation on the director not to compete with the company for a number of years. Outside the scope of the contractual solution, the law in many Member States is not settled. The difficulty is that the codified law often does not deal with the problem of resigning directors explicitly and case law is scarce. Again, the most elaborate rules can be found in the UK, where the courts have developed a test to distinguish between the 'general fund of knowledge and experience' that directors acquire in the course of their work and that they are 'free to exploit … in a new position',[191] and the exploitation of a specific or 'ripe' business opportunity that they came across while serving on the board (so-called *maturing business opportunity*), which leads to liability for breach of duty.[192] While these principles are not spelled out in a similarly nuanced way in any of the other jurisdictions analysed, some legal systems have produced case law relying on the duty of loyalty to hold directors liable who set up a competing business and attract other employees of their former company to the new business (France,[193] Portugal[194]) or who resign to exploit a business opportunity that was offered to the director's company (Germany[195]). In other jurisdictions, it is argued by the literature that former

[188] For a discussion of the case law and the distinction between 'structural impediments' and practical inability' see D. Kershaw, *Company Law in Context* (OUP, 2nd ed. 2012), pp. 514-575, in particular 552.
[189] Davies and Worthington, n 169 above, para. 16-159.
[190] Companies Act 2006, s. 175(2).
[191] *Island Export Finance Ltd v Umunna* [1986] BCLC 460.
[192] Now s. 170(2)(a) of the UK Companies Act 2006 provides that resigning directors continue 'to be subject to the duty in section 175 (duty to avoid conflicts of interest) as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director'.
[193] CA Montpellier, 16 November 1999; Cass. Com. 12.02.2002: Rev. Sociétés 2002, p.702, L. Godon.
[194] Court of Appeal of Lisbon, decision in action no. 242/2009-7 of 12 May 2009; confirmed by the Supreme Court of Justice in action no. 242/09.3YRLSB.S1 of 31 March 2011.
[195] BGH WM 1985, 1443. In this case, the German Federal Court of Justice pointed out that the director's violation of the duty of loyalty was twofold: First, he did not take advantage of the business opportunity for the benefit of the company, and second, he

directors can be held liable if their post-resignation behaviour is tainted by prior breaches of duty (Ireland) or if a causal link exists between the resignation and the intention to exploit a corporate opportunity (Italy). However, the law is characterised by a great degree of uncertainty and the general rule is that directors' duties no longer apply after the director ceases to hold office.

2.6 Nature of liability

Summary of the country reports

Table 2.6.a: Miscellaneous provisions on the nature of liability of directors

Country	Liability of directors if board decision	Joint/several/joint and several liability	Showing of loss causation by whom?	Special cases
Austria	Primarily members who vote in favour of the proposal are liable; outvoted members may be under an obligation to prevent the implementation of the decision, e.g. by calling a supervisory board meeting or informing the chairman	Joint and several	Claimant	Burden of proof for loss and loss causation shifts to defendant for particular types of breach, usually involving a violation of the capital maintenance rules, s. 84(3)
Belgium	Art. 528 CC (liability for breaches of the CC and the articles): all members of the board are liable, unless (1) no fault; and (2) the director denounced the breach at the first general meeting or meeting of the board after becoming aware of the breach	Joint and several if common fault; *in solidum* if concurrent fault[196]	Claimant	Presumption of loss causation if the director fails to call a general meeting within two months after it was established that the company's net assets have fallen below half of the registered capital (Art. 633 CC) or the directors submits the company's accounts late for approval to the general meeting (Art. 92 CC) and *third parties* suffer a loss

caused a competitor to enter the market (by forming a new company after resignation to exploit the patent that was offered to him in his capacity as managing director of his former company).

[196] Joint and several liability and liability *in solidum* are for most purposes identical. Both lead to full liability of all parties and the right of the creditor to choose from whom to demand payment.

Bulgaria	A director who votes against a board resolution that gives rise to liability is not liable. A director who does not attend the board meeting in question or abstains from voting is required to try actively to prevent the breach of duty in order to escape liability.	Joint and several, s. 240(2)	Claimant	-
Croatia	Liability of directors is judged individually	Joint and several	Claimant	Burden of proof for loss and loss causation shifts to defendant for particular types of breach, usually involving a violation of the capital maintenance rules, s. 252(3)
Cyprus	Liability of directors is judged individually, but liability is collective if the directors unanimously resolve to adopt the relevant decision against the interests of the company; such collective liability may not apply to a director who expressly objects to the decision and takes the necessary steps to protect the company	Joint and several	Claimant	-
Czech Republic	Liability of directors is judged individually	Joint and several	Claimant	-
Denmark	No liability if the director does not participate in the board decision;	Joint and several, s. 363(2)	Claimant, but courts have reduced the requirements for	-

	but directors can be required to attempt to change a decision giving rise to a breach of duty; moreover, passivity does not discharge responsibility		showing causation in case of gross breaches (leading case: incorrect stock market announcement)	
Estonia	Only members who vote in favour of the proposal are liable	Joint and several	Claimant	-
Finland	No liability if an individual director was actively against a particular resolution and did not act negligently or with intent; however, as the directors have an obligation to act, being passive and not taking part in board decisions does not exculpate the director from liability	Joint and several	Claimant	-
France	French Supreme Court: each member of the board of directors who, by his action or abstention, participates in a wrongful decision of the board is liable unless it is established that he behaved as a cautious and careful director, notably by opposing such decision → rebuttable presumption that the director is liable for the wrongful decision	Joint and several	Generally on the claimant since directors are only subject to a best effort obligation in the management of the company (*obligations de moyens*). However, this may be different in case of a breach of the company's statutes or an infringement of legal or regulatory provisions. In these situations, directors enter into a commitment guaranteeing a certain result (*obligation de résultat*).	Directors are liable to third parties in case of *a faute séparable des fonctions*, see above 2.3.

Germany	Liability of directors is judged individually	Joint and several	Claimant	Burden of proof for loss and loss causation shifts to defendant for particular types of breach, usually involving a violation of the capital maintenance rules, s. 93(3)
Greece	- Liability for management fault attaches to the individual director - But duty to monitor all decisions made by the board as a collective corporate organ as well as on an individual level by each director - Collective duty of all board members to ensure that the annual accounts are correct	Joint and several	- Loss causation must generally be shown by the claimant - In case of a breach of the duty of non-competition, the mere conduct of the competitive action allows the company to bring an action against the director for damages (Art. 914 Civil Code (general tort law provision) in conjunction with Art. 23 of L.2190/1920)	-
Hungary	Any director who did not take part in the decision or voted against it is exempt from liability	Joint and several	Claimant	-
Ireland	Liability of directors is judged individually	Joint and several	Claimant	-
Italy	Liability is excluded if the director enters his dissenting opinion in the minutes and notifies in writing the chairman of the statutory board	Joint and several	Claimant	-
Latvia	Liability of directors is judged individually (but voting against a board decision does not	Joint and several	Claimant	

	automatically excuse the director)			
Lithuania	The regular rules on joint and several liability apply to board decisions (see right)	- Art. 6.279(1): Where several persons jointly take part in causing damage, they shall be jointly and severely liable for compensation - Art. 6.279(2): In order to determine the reciprocal claims of jointly and severally liable persons, the different degree of gravity of their respective fault shall be taken into consideration, except in cases when it is otherwise provided for by laws.	Claimant	-
Luxembourg	Distinguish between liability under Art. 59(1) (*responsabilité contractuelle*) and Art. 59(2) (*responsabilité légale*): in the former case, directors are only liable for individual wrongdoing, in the latter case fault is presumed and the director can only avoid liability under the following conditions: 1) he/she was not personally involved in the breach; and 2) has not committed any wrongdoing (the mere absence at a board meeting	Joint and several in case of Art. 59(2) Companies Act	Claimant	Directors are liable to third parties under Art. 59(2) for breaches of the Companies Act or the articles of association

	where such wrongdoing was authorised will not exonerate the director if the absence was not justified or was the result of the indifference of the director towards the company); and 3) he/she reports the breach at the next general meeting			
Malta	1) Art. 147(1): where a particular duty has been entrusted to one or more of the directors, only such director or directors shall be liable in damages 2) Art. 147(2): A director shall not be liable for the acts of his co-directors if he proves either - a) that he did not know of the breach of duty before or at the time of its occurrence and that on becoming aware of it he dissented in writing; or b) that, knowing that the co-directors intended to commit a breach of duty, he took all reasonable steps to prevent it NOTE: simply resigning is not sufficient to avoid liability in this case	Joint and several, Art. 147(1)	Claimant	-
Netherlands	s. 2:9 Civil Code: If a matter	Joint and several	Claimant	-

	belongs to the field of work of two or more directors, then each of them is liable for the full consequences of a failure in performance, unless he is not to blame for this failure and he has not been negligent in taking measures to avert the consequences thereof Example: a director was on holiday when the improper performance occurred and tried to mitigate the consequences after his return			
Poland	Liability of directors is judged individually	Joint and several, Art. 485	Claimant	-
Portugal	Directors are not liable when the losses arise from a decision of the management body and they did not participate in the decision because they were neither present nor represented or, although present, they were prevented from voting or were outvoted; an express vote against the decision is required (Art. 72(3))	Joint and several, Arts. 72(4), 73(1)	Claimant	-
Romania	The director can defend himself by recording his opposition to a business decision in writing and	Directors are jointly liable for meeting all obligations prescribed by the law and the articles of association, Art.	Claimant	-

	informing the auditors about it	73 Companies Act		
Slovakia	- Literature: The dissenting vote of a director at the board meeting as such does not relieve him/her of liability, if the board collectively proceeds with the action that gives rise to the liability	Joint and several, s. 194(6)	Claimant	-
Slovenia	Liability of directors is judged individually	Joint and several, Art. 263(2)	Claimant	-
Spain	s. 237: all members of the governing body adopting the detrimental decision are liable, unless they prove that having taken no part in its adoption or implementation, they were unaware of its existence or, if aware, took all reasonable measures to prevent the damage or at least voiced their objection thereto (note: this does not lead to a shift in the burden of proof)	Joint and several, s. 237	Claimant	-
Sweden	No liability if an individual director has made reservations against a decision by having his opinion recorded in the board minutes. However, the director will be liable if he subsequently participates in the implementation of the decision.	Joint and several, Ch. 29, § 6	Claimant	-

	Moreover, if the member participated in making decisions of a more general character at some earlier stage, he/she will unlikely avoid liability if the board makes more concrete decisions in his absence. Further, repeated absence from board meetings may mean that the director has neglected his monitoring duty and that he may be held liable for the loss suffered by the company			
United Kingdom	Liability only attaches to those directors who are in breach of their duties	Joint and several	Claimant	Breach of duty of loyalty: the director is considered to be a constructive trustee of the profits obtained

Discussion

The board of directors is a collegiate body,[197] but liability is in all Member States personal; it does not attach to the board as a corporate organ (which does not have legal personality), but to the individual director. This gives rise to the question how collegiate decisions that constitute a breach of duty translate into liability of the directors who participated in the decision by voting in favour of or against it, and directors who were absent but were later involved in the implementation of the decision or could have prevented its implementation. These questions have not been addressed in all Member States. In particular in those jurisdictions where case law on directors' duties is rare it may not always be clear which steps a board member should take in order to exculpate himself. In general, however, the principles developed by the legal systems that have dealt with this question show a high degree of coherence.

As a general rule, where the concurrent acts of several parties cause damage, the parties are jointly and severally liable to the injured person.[198] The concept of joint and several liability is applied in all Member States to the liability of directors for board resolutions (or other concurrent acts by more than one director) that violate directors' duties. The consequence is that the claimant (the company, shareholders, or third parties where personal right are infringed[199]) can claim compensation for the whole amount of the loss from any one of the directors, or various amounts from any and all of the

[197] The same consideration applies to the management and supervisory boards in two-tier systems.
[198] The definition of joint and several liability differs in the Member States, but for purposes of directors' liability these differences are not relevant.
[199] See 2.2.2. above.

directors. Internally the directors may then take recourse against each other on the basis of their proportionate fault.[200]

For board resolutions we can derive the following principles from the case law, disregarding the (limited) variations that may exist in the Member States.

First, directors who vote in favour of resolutions in violation of directors' duties are jointly and severally liable if they have acted with fault. As far as liability for negligent misconduct is concerned, this means that the assessment has to proceed on an individual level, since the applicable standard of care is defined in all Member States in consideration of circumstances that relate to the individual director.[201] However, some jurisdictions use the fact that the director has participated in a board decision as a rule allocating the burden of proof. Following a recent judgment by the French Supreme Court,[202] French law holds that once it is established that the resolution by the board constitutes a breach of duty (for which the claimant bears the burden of proof), the burden shifts to the director, who is required to show that 'he behaved as a cautious and careful director, notably by opposing the decision'.[203] Luxembourg,[204] Maltese,[205] and Dutch[206] and Spanish law[207] contain similar burden of proof rules.

Second, directors who vote against resolutions in violation of directors' duties are in principle not liable. However, several jurisdictions provide that voting against the resolution alone is not sufficient to exonerate the director. Rather, the director must have attempted to change the decision, have his or her objection recorded in the minutes, and may need to inform the auditor of the resolution. Furthermore, liability may arise if the board proceeds with the implementation of the decision and the director does not take reasonable steps to prevent the implementation.

Third, the director may even face liability if he or she was absent while the board resolved to take the challenged decision. According to the decision of the French Supreme Court mentioned above,[208] the rebuttable presumption of liability for the wrongful board resolution applies irrespective of the director's presence or absence. Another ground for liability may be the director's failure to attend the board meeting as such. In several Member States, it was emphasised that the directors have an obligation to participate in the decision-making by the board and that repeated absence may amount to negligence with regard to the director's monitoring duty.[209]

While these principles are not equally well developed in all Member States, we have not identified any approaches clearly in contradiction of them. The most significant variation in the Member States seems to be the procedural function that joint and several liability assumes in Luxembourg, Malta, the Netherlands, and Spain. This is in particular relevant for jurisdictions where the burden of proof is normally with the plaintiff.[210]

[200] This is expressly provided for by Lithuanian law, see Art. 6.279(2) Civil Code, but constitutes a general principle underlying the law of joint and several liability in all Member States.

[201] This holds also for jurisdictions that define the standard of care in a largely objective way. Individual elements such as the function and position of the director in the company or the director's experience and knowledge will always play a role in the evaluation of the case. For more details see the discussion above 2.4.2 'Variations in the standard of care and delegation'.

[202] Cass. Com. 30.03.2010 n°08-17.841, FP-P+B+R+I, n° 08-17.841, *Fonds de garantie des dépôts (FGD) c/ Sté Caribéenne de conseil et d'audit*: P. Le Cannu: RJDA 7/10 n°760. Revue des sociétés 2010 p. 304.

[203] For a more detailed discussion of this decision see the French Country Report, p. A 365. Luxembourg law contains a similar provision for so-called *responsabilité légale*, see the Luxembourg Country Report, p. A 672.

[204] In Luxembourg, the burden of proof shifts to the director in case of the so-called *responsabilité légale*, see the Luxembourg Country Report, p. A 672.

[205] Maltese Companies Act, Art. 147(2). See the Maltese Country Report, p. A 719.

[206] Dutch Civil Code, Art. 2:9.

[207] Spanish Corporate Enterprises Act, Art. 237.

[208] See n 202.

[209] For example, Finland and Sweden.

[210] See above 2.4.2 'Burden of proof'.

2.7 Limitation of liability

Summary of the country reports

Table 2.7.a: Possibilities to limit directors' liability

Country	*Exclusion in articles*	*Ex ante authorisation by shareholder*	*Ex post ratification by shareholders or waiver*	*Indemnification in third party lawsuits or for costs of proceedings and D&O insurance*
Austria	Not permissible	- Directors are not liable if they were acting in accordance with a lawful resolution of the general meeting, s. 84(4) AktG NOTE: this does not affect the creditors' ability to enforce the company's claims against the director - Approval by the supervisory board does not exonerate the directors	Waiver and settlement may be declared five years after the claim came into existence, provided that no minority of at least 20% registers an objection, s. 84(4). In waiving the claims or entering into the settlement, the company is represented by the supervisory board; the GM must give its consent. The five year restriction does not apply if all of the shareholders give their consent. NOTE: waiver or settlement are not effective with respect to creditors and in bankruptcy.	D&O insurance is available; coverage excluded for intentional misconduct and often also for gross negligence
Belgium	The validity of such clauses is disputed, since the law on liability of directors is mandatory law. In any case, such a clause cannot be relied on against third parties.	Some case law holds that directors are not liable when merely executing general meeting decisions. However, this does not free them from having to comply with the Companies Code and the articles of association and	Permissible, the conflicted director can vote as shareholder. However, the waiver does not affect the rights of third parties or the right of minority shareholders who do not approve the ratification to bring a derivative claim.	- Indemnification permissible - D&O insurance is available and becoming more common

		does not constitute a ratification of other managerial errors.		
Bulgaria	1) Duty of care: exclusion for intentional conduct and gross negligence not permissible 2) duty of non-competition, s. 237(4): can be excluded in the articles 3) duty of confidentiality, s. 237(5), and duty to disclose to the company facts which may be relevant to the activity as directors, s. 237(3): mandatory; exemption in the articles not permissible	The corporate organ responsible for appointing directors can exempt some or all of the board members from the duty of non-competition for specific transactions, for participation in specific companies, for certain periods, or generally	s. 221, no. 10: the directors may only be released from liability by the GM; according to common practice, this happens at the annual general meeting. The director in question can vote if he is also a shareholder.	D&O insurance available but not common
Croatia	Not permissible	Permissible, directors not liable if their actions were based on a resolution by GM; the conflicted director cannot vote as shareholder	1) Ratification not possible 2) Waiver: permissible a) after 3 years; b) GM gives its consent; and c) no objection from 10% minority shareholder The waiver is not valid to third parties, in particular the creditors	- Indemnification possible under some conditions - D&O insurance available but not common
Cyprus	Not permissible	No general power of shareholders to exempt a director from liability for breach of duty	The general meeting may accept agreements that are voidable pursuant to s. 191 (self-dealing); but no general power of shareholders to exempt a director from liability for	- The company may indemnify directors against the costs incurred in legal proceedings in which judgment is given in the director's favour or the director is

			breach of duty	acquitted - D&O insurance available but not common
Czech Republic	Not permissible, s. 194(5) Commercial Code	Directors are not liable for damage caused by their execution of a specific instruction of the general meeting, unless such instruction is illegal, s. 194(5)	No explicit provision; not permissible	D&O insurance available
Denmark	Not permissible	Not permissible	- The GM can grant a discharge or waive liability with simple majority; the waiver is binding on the company if the information received by the GM was essentially correct and complete, s. 364(2) - If 10% minority shareholders oppose waiver, any shareholder can commence legal proceedings to recover damages for the company, s. 364(3) - If the company is declared bankrupt, the waiver is no longer binding, provided that the bankruptcy petition is not presented later than 24 months after the waiver, s. 364(4)	D&O insurance available, but not common in small and medium-sized enterprises; even in large listed companies directors are not always covered by D&O insurance
Estonia	Restriction of liability to, for example, gross negligence in the articles is permissible (but not valid in relation to third	Breaches of the duty of care: the director is exculpated if he acts on the basis of a lawful resolution by the general meeting	Waiver valid if: - resolution of the supervisory board - all significant circumstances about the breach of duty were	D&O insurance is available, but not widely used due to the high insurance premium (except in international group companies)

	parties or the liquidator); in addition, limitation or waiver of liability for intentional breach of duty is not valid	or the supervisory board	disclosed and known to the supervisory board - explicit waiver with regard to a specific breach of duty BUT: creditors and the liquidator can enforce the claim in spite of the waiver	
Finland	- Possible, except for deliberate actions and gross negligence (Ch. 22, s. 9(1)). Exclusion applies only to liability against the company, not shareholders and third parties. - The right of the company to damages may otherwise only be restricted by the articles of association with the consent of all shareholders (Ch. 22, s. 9(2))	Unanimity of the shareholders required.	The annual general meeting decides on a discharge of the board of directors, which constitutes a waiver of the company's claims, provided that the information given to the AGM was materially correct and sufficient (Ch. 22, s. 6(2)). The director in question must abstain from voting as a shareholder. The discharge is not binding in bankruptcy and the administrator can file a suit if the proceedings have started within two years from the director's action.	D&O insurance available and fairly common, especially in listed companies, but also in a number of private companies
France	Not permissible, Art. L.225-253 Commercial Code (for public companies)	Not permissible, Art. L.225-253 Commercial Code (for public companies)	Not permissible, Art. L.225-253 Commercial Code (for public companies)	D&O insurance available and common in listed companies; infrequently used in non-listed companies
Germany	Not permissible	Exculpates directors for breaches of the duty of care, s. 93(4). As regards self-dealing and the duty not to compete with the	1) Waiver: s. 93(4) - requires a resolution of the general meeting not later than three years after the claim came	D&O insurance available and common in the public stock corporation (AG); mandatory retention of 10%, s. 93(2) sentence

		company, the supervisory board can give ex ante authorisation	into existence, and no objection by 10% minority shareholder - the waiver is not valid in relation to creditors, s. 93(5) 2) ex post approval of competitive conduct (s. 88) by the supervisory board is not permissible	3
Greece	Not permissible	No liability if the director's action was based on a lawful resolution of the GM, Art. 22a(2)	Waiver: possible pursuant to Arts. 22a(4), 35, but not earlier than two years after the claim was established; the GM must consent and there should be no objections from minority shareholders representing 20% of the capital	D&O insurance available, but not common
Hungary	Under principles of agency law, liability can be excluded, except for intent, gross negligence, or criminal behaviour. In addition, the director's salary must be reduced proportionally.	In single-member companies directors may be instructed in a written form by the shareholder; if the director acts according to such instructions, he/she is not liable. In other companies, directors are bound by the decisions of the GM and are supposed to act in compliance with them. Thus, a majority vote in GM can have the effect of ex-ante authorisation.	The general meeting decides on a discharge of the board of directors, which constitutes a waiver of the company's claims, provided that the information given to the GM was correct and sufficient.	D&O insurance available, but not common
Ireland	Companies Act 1963, s. 200(1): any provision in the company's articles of	- Shareholders can authorise conduct which would otherwise be a breach of	- Shareholders can ratify a breach - No conclusive judicial statement on the question of	- It is permissible for a company to indemnify a director against the costs in

	association or any contractual provision which exempts a director or indemnifies him/her against liability "in respect of any negligence, default, breach of duty or breach of trust" is void	duty - No conclusive judicial statement on the question of whether the conflicted director can vote; these matters are usually settled at board level. The conflicted director is entitled to vote in such cases	whether the conflicted director can vote	relation to proceedings which were successfully defended or in relation to a successful application for relief under s.391, see Companies Act 1963, s. 200(b) - D&O insurance available, but not common, except in large listed companies
Italy	Possibly permissible for breaches of negligible importance (*colpa lieve*)	No rules in the Civil Code, but the provisions on *ex post* resolution may apply by analogy	Waiver: by ordinary resolution of the GM, provided that there are no objections from minority shareholders representing 20% of the capital	D&O insurance available and common in large companies; rarely used in small and medium-sized enterprises
Latvia	Not permissible	1) No liability if the director acted *bona fide* according to a lawful decision of the general meeting (i.e. the resolution must have been legal and within the powers of the GM) 2) Supervisory board approval not sufficient	The GM may release directors from liability for specific actions after disclosure of such actions to the GM. NOTE: The release does not limit the right of minority shareholders to bring a derivative action or the rights of the creditors and administrator in insolvency proceedings	D&O insurance available, but not common
Lithuania	Permissible, except for intentional fault or gross negligence, Civil Code, Art. 6.252	- Art. 34(5) of the Law on Companies: The articles of association may provide that the board must obtain the approval of the general meeting of shareholders	Supreme Court: ratification by the shareholders does not exclude or limit the directors' liability	D&O insurance available, but not common

		before adopting the decisions referred to in subparagraphs 3, 4, 5 and 6 of paragraph 4. The approval of the GM shall not release the board from responsibility for the decisions adopted. - Generally, ratification by shareholders (even if ex ante) does not limit the responsibility of directors (as to any fiduciary duty)		
Luxembourg	Permissible in the articles of association or in particular agreements between the director and the company. Some limits apply (voluntarily agreed, without fraud, not prohibited by a particular legal provision, legal principles, or to protect creditors or the general interest)	There is no case law as to whether a director could be allowed ex ante by the shareholders to take a particular action and be absolved of liability. Belgian case law should be applied here and holds that such a vote would be effective.	- Discharge by the GM has the consequence that the company waives its right to enforce claims against the directors for management errors (provided the director did not act intentionally); this applies to liability under Art. 59(1) as well as 59(2) - In relation to third parties, the discharge has no effect	- Indemnification permissible, except for intentional fault, gross negligence, or criminal liability - D&O insurance is available and has become very common
Malta	Not permissible, Art. 148(1)	The shareholders can authorise related party transactions and allow the director to compete with the company	Shareholders can release a director from liability for a fully disclosed breach of duty	- Indemnification not permissible, Art. 148(1), with the exception of indemnity against liability incurred by the director in defending any proceedings in which judgment is given in his/her favour or in which he/she is acquitted - D&O insurance available, but not

				common
Netherlands	Exclusion of liability in the articles is contrary to binding law (s. 2:9) and accordingly void pursuant to s. 3:40	Ex ante exclusion of liability for serious mismanagement is not permissible	Discharge by the GM is valid if based on correct information in the annual accounts; furthermore, a discharge does not prevent individual shareholders from instituting proceedings	D&O insurance available and very common, also for mid-sized companies; usually combined with a clause providing for indemnification by the company
Poland	Not permissible	1) Duty of non-competition, Art. 380: consent can be given *ex ante* by the supervisory board 2) Duty of care: acting on the basis of a resolution by the GM does not exclude liability, because the GM cannot give the board binding instructions with respect to the management of the affairs of the company	1) Duty of non-competition, Art. 380: the consent of the supervisory board (see left) may also be given after the duty has been breached 2) Other duties: a) The company and the director may enter into an agreement releasing the director from liability, Art. 508 Civil Code b) Settlement is possible: the company is represented by the supervisory board, the GM must give its consent (Art. 395(3), discharge of duties) c) The GM can issue a resolution releasing the director from liability, provided that the GM was fully informed NOTE: waiver or discharge by the GM cannot be used as a defence in a derivative action or in bankruptcy, Art. 487	- Generally permissible, but not often concluded in practice (insurance is preferred) - D&O insurance available and fairly common in larger companies, but not so much in small and medium-sized enterprises

			3) Directors as shareholders shall not participate in a resolution regarding their liability, Art. 413	
Portugal	- Not permissible, Art. 74(1) - Some commentators argue that it is possible to exclude directors' liability for negligence; only gross negligence or intent could not be excluded	No liability if the act is based on a resolution by the shareholders, Art. 72(5). According to the legal literature, the provision has to be interpreted restrictively. Decisions based on false information do not exculpate the directors. If the decision is voidable and the directors understand that the potential loss of carrying out the resolution is relevant, they may be liable if they execute it.	- Art. 74(2): waiver is only possible by express resolution of the shareholders and no objection by a minority of at least 10%; the conflicted director must abstain from voting as shareholder - Art. 74(3): The resolution adopted by the general meeting to approve the accounts shall not imply a waiver of the company's claims, unless the facts that establish the liability were specifically made known to the shareholders and no 10% minority objects	- In principle, the general prohibition of provisions exempting or limiting the directors' liability also extends to any indemnity arrangements, i.e. provisions of the articles of association by which, directly or indirectly, the company assumes the financial costs of the liability of its own directors - D&O insurance available and relatively common
Romania	Permissible, except for violations of the duty to act in good-faith and for intentional misconduct or gross negligence	- It is unclear whether the shareholders can authorise a related-party transaction. It may be argued that a transaction that is contrary to the company's interests is void and can neither be authorised nor ratified. In any case, the conflicted director cannot vote on such a resolution (Art. 127). - Other *ex ante* authorisations of breaches of the	Ratification of the duty of care is permissible as long as long as the breach is generated by culpa levis only; no ratification of breaches of the duty of loyalty	- The articles of incorporation or the agreement with the director may provide that the company shall indemnify the director for the costs of defending against a liability claim. - D&O insurance is available and mandatory for joint stock companies

		duty of loyalty can presumably not be authorised		
Slovakia	Not permissible, Art. 194(8)	- s. 194(7): directors are not liable for any damage caused by their conduct in executing a decision of the general meeting. However, s. 194(7) does not apply if the general meeting's decision is contrary to the law or the articles of association. - Approval by the supervisory board does not relieve the directors of liability	- The company may waive claims for damages against directors, or may enter into a settlement agreement with the directors, only after three years from the establishment of such claims, provided that the GM gives its consent and no minority of at least 5% records a protest against such decision in the minutes at the general meeting - The waiver or settlement is not valid in relation to creditors	- Indemnification probably not permissible, but no regulation in the statute and no case law - D&O insurance available, but not common, except for large listed companies
Slovenia	Literature: rules on liability are mandatory and cannot be modified to the advantage of the director in the articles of association	Art. 263(3): directors are not liable if the act that caused the damage was based on a lawful resolution of the GM. Approval by the management or supervisory board does not exculpate the directors.	Art. 263(3): waiver is permissible three years after the claim came into existence if the GM gives its consent and no minority of at least 10% objects in writing	- Indemnification not permissible - D&O insurance available, but not common
Spain	Not permissible	Not permissible, s. 236(2)	Ratification not permissible, s. 236(2), but waiver is possible (if not opposed by 5% minority shareholders), s. 238	- Indemnification not permissible - D&O insurance available and common in large companies
Sweden	Not permissible	No liability if the director acts on the basis of an instruction by the GM	Discharge may be granted or a settlement entered into by the general meeting, provided that the owners of	- The company can indemnify directors for damages to third parties - D&O insurance available and

			not less than 10% of all shares in the company do not vote against the proposal, Ch. 29, §§ 7, 8	fairly common
United Kingdom	Not permissible, s. 232(1)	Permissible, s. 180(4)(a); the conflicted director can vote as shareholder	Permissible, s. 239; the conflicted director cannot vote as shareholder	- Indemnification not permissible, s. 232(2), unless provision is made for indemnity against liability incurred by the director to a person other than the company and it does not provide indemnity against criminal or administrative sanction (s. 234) - D&O insurance available and common

Discussion

We can identify five methods to limit or exclude the liability of directors for breach of duty in the Member States: Exclusion of liability in the articles; *ex ante* authorisation of certain types of conduct by the shareholders, i.e. before the conduct that gives rise to liability occurs; *ex post* ratification of breaches of duty or waiver of the company's claim; indemnification of the director against liability incurred not to the company, but to a third party, or against the costs of third party lawsuits; and directors and officers liability insurance (D&O insurance). We will give a brief overview of the trends in the Member States for each method in turn.

Exclusion of liability in the articles. As far as the exclusion of liability for breach of directors' duties in the articles of association is concerned, the common denominator in the Member States is as follows: Liability cannot be excluded for intentional conduct and gross negligence, and limitations in the articles are not effective in relation to third parties. Even though it is not always explicitly stated, it can be assumed that shareholders qualify as third parties where they do not enforce claims of the company, but personal rights.[211] Many Member States are stricter and consider the liability provisions to be binding law, with the consequence that articles (or contractually agreed clauses) limiting a director's liability or providing for indemnification are void. In Belgium and Luxembourg the approach is generally more flexible than in other Member States, but the precise rules are controversial. It is acknowledged that exclusion cannot go so far as to limit liability for fraudulent behaviour, to the detriment of third parties, or in violation of the corporate interest. Some commentators argue that exclusion clauses should be valid within these limits; others submit that the rules on directors' liability are binding and not subject to private ordering.

Ex ante authorisation. In order to assess the legitimacy and effects of *ex ante* authorisation of directors' conduct by the shareholders in general meeting or by the board of directors (supervisory board in two-tier systems), it is necessary to distinguish between behaviour falling within the scope of the duty of care on the one hand and the duty of loyalty on the other hand. As regards the former, the

[211] See 2.2.2. for the distinction between individual shareholder rights and claims of the company.

majority of Member States provide that directors are not liable if their conduct was based on a lawful decision by the general meeting.[212] In some Member States, it is specified that authorisation does not affect the creditors' right to enforce the company's claims against the directors.[213] We do not find such a rule in all Member States that allow for *ex ante* authorisation by the general meeting,[214] indicating that some gaps may exist with respect to creditor protection.

As far as the duty of loyalty is concerned, it is the view in most jurisdictions that *ex ante* authorisation must follow the procedures that the law sets out for the different scenarios analysed here under the rubric of the duty of loyalty.[215] For example, if directors can only enter into related party transactions, exploit a corporate opportunity, or compete with the company if the general meeting or the board of directors (supervisory board) give their consent, then liability of the director cannot be avoided by authorisation (or ratification) of the director's acts outside these procedures. In other words, the procedures regulating conflict of interest situations are generally seen as binding. This has traditionally been different in the common law jurisdictions, which is a function of the notion that corporate power originates from the shareholders and the articles of association are akin to a contract.[216] Consequently, the shareholders enjoyed contractual freedom to allow or disallow conflicted transactions as they saw fit. These rules are in principle still effective, but where codification of conflicted interest transactions has taken place,[217] the statutory procedures have to be followed unless the common law is preserved. Whether, and to what extent, this is the case is not always clearly expressed, which may give rise to legal uncertainty.[218]

Ex post ratification or waiver. A majority of Member States allow for *ex post* ratification of breaches of duty or the waiver of existing damages claims of the company under certain conditions. The most elaborate such mechanism would consist of the following elements: (1) The waiver or discharge must be based on a valid resolution of the general meeting; (2) the general meeting must have been fully and correctly informed; (3) the waiver or discharge cannot be declared earlier than a number of years after the company's claim has come into existence (typically three and up to five);[219] (4) minority shareholders holding a specified percentage of the share capital, which may be as low as 5%[220] and as high as 20%,[221] do not object; and (5) the waiver has no effect in relation to shareholders bringing a derivative action, creditors enforcing the company's claims, or in bankruptcy. The actual regulation in the Member States is fairly heterogeneous; no legal system contains all of these elements, and some legal systems follow an entirely different strategy. A typical provision in between these extremes would allow the general meeting to waive the company's claim after three years if it is fully informed, no minority holding at least 10% of the share capital registers an objection, and stipulate that the waiver is not valid in the company's insolvency.[222] Arguably, the last point is essential in order to avoid gaps with regard to creditor protection.

The common law jurisdictions employ a different approach. Conceptually, the respective rules are not concerned with a waiver or discharge by the company, but with ratification by the shareholders as part of the shareholders' ultimate authority to decide on company affairs. Consequently, the rules do not contain above provisos regarding minority shareholder or creditor protection.[223] Deviations from the basic principle of decision-making by majority voting, if any, deal with the disqualification of the votes

[212] Supervisory board approval in two-tier systems is not sufficient.
[213] Austria: s. 84(5) Stock Corporation Act; Germany: s. 93(5) Stock Corporation Act.
[214] See, for example, Art. 22a(2) Greek Codified Law 2190/1920 on Companies Limited by Shares.
[215] See above 2.5 for a detailed discussion of these procedures.
[216] See above 2.2.2.
[217] Cyprus: s. 191 Companies Act; Ireland: s. 194 Companies Act 1963; Part 3 of the Companies Act 1990; UK: ss. 175-177 Companies Act 2006.
[218] For Ireland see the Irish Country Report, pp. A 535-536. For the UK, see Companies Act 2006, s. 180(4).
[219] Typically the legal systems provide for three years (e.g., Croatia, Germany, Slovakia, Slovenia), but the period may be shorter (Greece: two years) or longer (Austria: five years).
[220] Slovakia, Spain.
[221] Austria, Greece, Italy.
[222] Croatia, Germany, Slovenia,
[223] See for example s. 239 UK Companies Act 2006.

of the liable director.[224] Under this approach, minority shareholder and creditor protection must be achieved through different routes, which may stem from concepts such as abuse of majority power[225] or from insolvency law.

Indemnification. Most Member States do not contain specific rules on indemnification of directors against liability incurred to third parties or against the costs of third party lawsuits. In this case, the general rules on exclusion and limitation of liability are applicable. Where the legal system provides for a regulation of indemnification, it follows often more lenient standards than the legality of exclusion clauses in the articles. For example, in Cyprus and Ireland the company may indemnify the director against the costs incurred in proceedings in which judgment is given in favour of the director. Luxembourg allows indemnification in all cases except intentional fault, gross negligence, or criminal liability. The UK invalidates an indemnification clause if it provides indemnity against criminal or administrative penalties or against the costs incurred in defending criminal proceedings in which the director is convicted.

D&O insurance. D&O insurance is available in all Member States. In some jurisdictions, the permissibility of this mechanism to limit the director's exposure was discussed controversially in the past, given that it may attenuate the deterrent effect of the binding liability provisions in the company legislation, in particular if the company pays the insurance premium, and encourage noncompliance with directors' duties. However, it has now been widely accepted that D&O insurance is legitimate and serves a useful purpose by enabling the company to attract high-quality managers and limit the directors' exposure to damages claims that will often exceed their financial capacity. This is particularly important where the jurisdiction provides for causes of action that give rise to liability of directors who act in good-faith, as is possible under most definitions of the duty of care. Furthermore, it should be noted that D&O insurance does not formally lead to an exclusion of liability. The director is liable for purposes of the law and administrative or criminal sanctions continue to apply. Liability risk is not shifted from the directors to the shareholders or creditors, but to the insurance undertaking against payment of a premium.

In most Member States, the company is party to the insurance policy. It is legally permitted and will in practice usually pay the premium.[226] Coverage for intentional misconduct is virtually always excluded in the insurance contract, coverage for gross negligence is often, but not always, excluded. We observe that insurance is common in countries with a large number of listed companies. In most countries, however, it is not widespread in small and medium-sized enterprises.

3. Enforcement

In order to ensure effective investor protection, enforcement of directors' duties is a necessary complement to the substantive rules on directors' duties and liability. In the following sections, we will focus on enforcement of the company's claims. Accordingly, we will not discuss personal claims, i.e. actions brought by shareholders or third parties in their own name for the infringement of individual rights owed directly to them. Enforcement of such rights generally does not pose problems. By definition, personal claims are characterised by a loss suffered by the claimant (shareholder or third party) personally and not shared with other shareholders (or third parties).[227] In addition, they arise from duties owed directly to them and not to the company.[228] Therefore, the two main problems beleaguering the enforcement of directors' duties do not apply. First, assuming that the duty is owed

[224] UK Companies Act 2006, s. 239(3), (4). The pre-2006 common law did not even contain this qualification of the majority principle, see *North West Transportation Co Ltd v Beatty* (1887) L.R. 12 App. Cas. 589.
[225] For English law see . [1916] 1 AC 554 (Privy Council).
[226] In Portugal, this sentence applies with the proviso that directors of listed companies have to give a guarantee of €250,000 for their potential liability and that the company is not permitted to pay the premium for liability coverage as regards this amount.
[227] Reflective loss principle, see above text to n 96.
[228] Se above 2.2.2.

to the company and the company is consequently the proper claimant, the organ authorised to act on behalf of the company may be conflicted. In particular, this is the case in the one-tier system if the authorised organ is the board of directors and the defendant director is still a board member. It may also be a problem in two-tier systems where the authorised organ is often the supervisory board because of the close practical link between the members of the two boards. Second, enforcement of the company's claim leads to recovery by the company, which accrues to all shareholders in proportion to their shareholdings. Therefore, enforcement of the company's claims through shareholders by means of a derivative action faces a collective action problem. The costs are borne by the shareholders who bring the action, while the passive shareholders benefit from the claimant's efforts.[229]

In the following sections, we will focus on both problems by analysing first who has authority to act on behalf of the company in enforcing the company's claims (*Table 3.1.a*) and second, under which conditions (minority) shareholders can bring a derivative action if the authorised organ does not act (*Table 3.2.a*). As far as the second issue is concerned, we will quantify the ease with which shareholders can bring a minority action along three dimensions that are, arguably, of equal importance in assessing the effectiveness of the minority shareholder suit: standing requirements, conditions for bringing the action, and cost rules (*Tables 3.2.b and 3.2.c*).

3.1 Standing to sue

Summary of the country reports

Table 3.1.a: Authority to represent the company in enforcing directors' duties

Country	*Company as claimant: represented by whom?*	*Shareholders in their own name*	*Third parties*
Austria	1) Management board (because of its general power to represent the company) 2) The supervisory board is required to enforce the claim if requested by the GM to do so, s. 134(1) 3) The supervisory board may enforce a claim without shareholder consent (and even contrary to a shareholder resolution) if non-enforcement would constitute a violation of its own duties (e.g., the duty of care, because as a consequence the company would incur a loss and be liable to its creditors), s. 97	Generally not, except where shareholders enforce personal claims (e.g., based on tort law) in their own name	1) Third parties enforce their own claims (e.g., based on tort law) in their own name 2) s. 84(5): the creditors can enforce the company's claims against the directors, provided that they cannot obtain satisfaction of their claim from the company and the directors have acted grossly negligently (negligence suffices in the cases of s. 84(3), i.e. in particular where capital maintenance provisions were violated)
Belgium	The general assembly has exclusive power to bring a liability claim	- Shareholders have standing to file a claim against the company for	- Creditors pursuant to Arts. 1166, 1382 Code Civil or Actio Pauliana

[229] In economic terms, the derivative action may for this reason be qualified as a public good, see A. van Aaken, 'Shareholder Suits as a Technique of Internalization and Control of Management. A Functional and Comparative Analysis' 68 *RabelsZ* 288 (2004).

	against a director (*actio mandati*). The board of directors or a specially appointed agent represents the company in the proceedings (Art. 561 CC).	annulment or suspension of a board decision under general rules of civil procedure law if they are an 'interested party', which is generally already accepted on the ground that they hold shares, provided that shareholder rights have been infringed (but no distinction between corporate and personal harm) - A shareholder can only bring a personal liability claim against a director if he/she has suffered a loss distinct from the loss suffered by all shareholders proportionally as a result of the decrease of the company's assets or the increase of liabilities incurred by the company. - A qualified minority of shareholders can bring a liability claim on behalf of the company (see derivative action).	(fraudulent conveyance) - Other third parties could theoretically bring a claim for annulment of a board decision under general civil procedure law (see left), but the only reported court decision rejected the standing of employees, arguing that the invoked rules were not designed to protect third party interests and that even a broad conception of the company's interests would not confer judiciable rights on third parties; it is unclear whether creditors are able to bring claims under this mechanism
Bulgaria	No clear regulation; it is argued that the general meeting has authority, possibly also the supervisory board in the two-tier model	If the claim is based on tort law	If the claim is based on tort law
Croatia	Supervisory board in claims against members of the management board	Shareholders can sue if they suffer damage that is independent from the damage caused to the company	Creditors if they cannot obtain satisfaction from the company and the directors acted with gross negligence, s. 252(5)
Cyprus	Board of directors	1) If their personal rights have been infringed (e.g., prohibition of a shareholder to vote at the general meeting) 2) The company's affairs are conducted in an oppressive manner (s. 202 CA = English unfair prejudice remedy)	No
Czech Republic	1) Management board 2) The supervisory board is required to enforce the	No	No

	claim if requested by minority shareholders holding more than 3% of the registered capital (if total share capital > CZK 100m) or 5% (if total share capital ≤ CZK 100m)		
Denmark	General meeting, s. 364(1) Companies Act	Possible if the shareholder has suffered a loss, but the company has not, s. 361(1)	Possible if the third party has suffered a loss, but the company has not, s. 361(1)
Estonia	Supervisory board	Only if the directors breach a duty established for the protection of the shareholders and the law provides expressis verbis for the possibility of the shareholders to enforce the claim (e.g. merger or division) or the director's liability is based on tort (see *Pere Leib* case)	Creditors can enforce claims of the company if the company's assets are not sufficient to satisfy their claims. Enforcement of claims in their own name if the director breaches a duty that is established for the protection of the creditor.
Finland	- Board of directors (part of the general duties and powers of the board, Ch. 22, s. 6); the director in question is disqualified from the consideration of the matter (Ch. 6, s. 4) - In addition, general meeting (Ch. 22, s. 6)	If the director is liable directly towards them	If the director is liable directly towards them
France	Board of directors for *action ut universi*	*Action individuelle* only possible if they claim compensation for the individual harm suffered. The individual harm must not be the consequence of a loss sustained by the company (reflective loss). Examples for individual harm: misappropriation by a director of dividends owed to the shareholders; overvaluation of a contribution in kind, which causes the dilution of existing shareholdings; investors buy shares on the basis of incorrect market information	Third parties can sue if the directors has committed a fault that is separable from his functions (*faute séparable des fonctions*), see above 2.3.
Germany	Supervisory board, s. 112; the general meeting can require enforcement	Generally not, but the law allows some exceptions, see, e.g., s. 117(1):	Creditors pursuant to s. 93(5), if they cannot obtain satisfaction from

	by simple majority, s. 147	shareholders have a claim for damages if a person uses his/her influence on the company to induce the directors to act to the detriment of the company and the shareholders suffer a loss different from the loss suffered by the company (i.e. no claim in case of reflective loss)	the company and the directors breached their duties grossly negligently
Greece	- Generally, the board of directors represents the company (Art. 22b); it must file the lawsuit in case of an intentional breach of duty or upon the request of the GM or 10% minority shareholders - If the claim is directed against all members of the board, the court or the GM may appoint a special representative to represent the company (Art. 22b(3))	Shareholders can bring a lawsuit in their own name (personal lawsuit) if they have suffered direct damage (and not the company), i.e. their individual rights are violated by the directors (based on general tort law in conjunction with Art. 71 Civil Code)	Subrogation action (plagiastiki agogi), Art. 72 Civil Procedure Code (creditors can enforce the claims of the company if they cannot obtain satisfaction from the company)
Hungary	Decision on enforcing the claim is supposed to be passed by the GM but there are no specific rules covering representation. It is assumed that at the time of submitting the claim the defendant is no longer a director or there is at least one director who is not sued. No specific rights of representation allocated to supervisory board. In case of claims under the minority protection regime the minority shareholder may represent the company.	Not for enforcement of directors' duties owed to the company	Creditors if the duties owed to them in the vicinity of insolvency have been violated
Ireland	Board of directors or resolution by the member, depending on how the authority to instigate legal proceedings is allocated in the articles. Very often, the power to seek enforcement will be with	1) Shareholders can sue in their own name if a breach of a personal duty owed to them is at issue 2) Statutory oppression remedy, Companies Act 1963, s. 205 (but damages are not	No

	the board. The members can overrule the board's decision in the case of fraud.	available as a remedy under s. 205)	
Italy	1) Board of directors 2) Shareholders can direct the board to commence litigation by ordinary resolution 3) Board of auditors by two-thirds majority 4) Two-tier model: supervisory board or shareholder resolution	- Yes, if the director's action did not harm the company's interests, but exclusively affected the rights of the shareholders (no recovery of reflective loss) - Example from case law: purchase of newly issued shares at a price based on misleading financial statements prepared by the directors	- Creditors can sue under Art. 2394 (liability of directors if the company's assets have not been preserved) - The creditors' action is autonomous from the company's claims, with the consequence that the creditors do not need to wait until the company has decided not to sue the directors (this is disputed)
Latvia	The general meeting decides whether the claim should be initiated. If members of the management board are sued, the supervisory board represents the company in the litigation. If members of the supervisory board are sued, the management board represents the company.	Only for claims according to general civil law and for loss suffered directly by the particular shareholder and not by the company	- Creditors pursuant to s. 170 Commercial Law if they cannot obtain satisfaction for their claims from the company. - The claim is enforced for the benefit of the company - This right exists even if the company has waived the claim, entered into a settlement with the director, or the losses have been incurred in the fulfilment of a decision of the GM or the supervisory board
Lithuania	Head of the company (who is a corporate organ)	No	No
Luxembourg	The general meeting decides on enforcement and represents the company	- Not for management errors - According to Art. 59(2) Companies Act for violations of the Companies Act or the articles of association - Under general tort law for specific, individual prejudice, which is different from the prejudice suffered by the company	- Not for management errors - According to Art. 59(2) Companies Act for violations of the Companies Act or the articles of association - Under general tort law
Malta	Board of directors	1) In the limited circumstances where duties are owed directly	In the limited circumstances where duties are owed directly

		to shareholders 2) Unfair prejudice remedy, Art. 402	to third parties
Netherlands	Board of directors (terminology according to the Dutch Civil Code, i.e. not the supervisory board)	Possible for claims under: 1) s. 2:8(1) (duty to act reasonably and fairly) 2) s. 2:139 (liability for misleading accounts) 3) Tort law	Possible for claims under: 1) s. 2:8(1) (duty to act reasonably and fairly) (for employees) 2) s. 2:139 (liability for misleading accounts) 3) Tort law
Poland	- The GM decides on the enforcement of claims, Art. 393(2) - The respective director is excluded from participating in the vote if he/she is also shareholder, Art. 413 - In the judicial proceedings, the company is represented either by the supervisory board or by a special attorney appointed by the GM	No (duties only owed under tort law directly to shareholders)	No (duties only owed under tort law directly to third parties)
Portugal	- General meeting, Art. 75(1); conflicted directors cannot vote as shareholders - Upon the request of shareholders representing at least 5% of the share capital, the court appoints a special attorney to represent the company in the action (cost rules: Art. 76(3))	- Possible pursuant to Art. 79 for direct loss caused by directors to the shareholders (e.g., refusal to pay a dividend lawfully approved by the general meeting) - The same provision applies to third parties if directors breached a provision designed to protect such parties	Creditors pursuant to Arts. 606-609 Civil Code if the company or the shareholders fail to enforce the company's claims (Art. 78(2))
Romania	General meeting, Art. 155	Only for claims under tort law	Only for claims under tort law or when the company is in insolvency proceedings
Slovakia	Supervisory board	No	Creditors if they cannot obtain satisfaction from the company, s. 194(9)
Slovenia	1) The GM decides by simple majority about the instigation of legal proceedings against the directors, Art. 327(1) 2) The chairman of the supervisory board (Art. 283) or a special	Generally not, but the law allows the following exceptions: 1) Art. 264(1): shareholders have a claim for damages if a person uses his/her influence on the company	- Creditors if they cannot obtain satisfaction from the company, Art. 263(4) - Initiation of the insolvency proceedings is not required as a pre-condition; rather, it is sufficient that the

	representative (Art. 327(3)) represents the company in the proceedings	to induce the directors to act to the detriment of the company and the shareholders suffer a loss different from the loss suffered by the company (i.e. no claim in case of reflective loss) 2) In cases of intra-group transactions where a controlling company causes damage to a dependent company	financial situation of the company is such that it does not allow the payment of the company's obligations as they fall due
Spain	General meeting, s. 238	Shareholders or third parties can bring a claim for damages against the directors in their own name if the directors have acted in a way that directly harms their interests and the loss suffered is not merely reflective of the company's loss, s. 241	Creditors can bring an action if the company or shareholders do not do so and when the company has insufficient assets to repay its debts, s. 240 LSC
Sweden	General meeting, Ch. 29, § 7	Shareholders may have a direct claim based on Ch. 29, § 1	Creditor who cannot be compensated may enforce claims of the company against the director, provided that the damaging action created or aggravated the company's insolvency
United Kingdom	Board of directors	1) Only if a personal right of the shareholders has been invaded 2) Unfair prejudice remedy, s. 994	No

Discussion

General comments. *Table 3.1.a* shows significant variation between the Member States. In a number of one-tier board systems (and legal systems allowing for a choice, but where the companies usually adopt the one-tier model[230]) the board of directors has the authority to instigate proceedings on behalf of the company.[231] A second group of such countries provide that the general meeting shall have the power to decide whether or not to enforce the claim. Once the decision on enforcement has been made, the company is represented by the board of directors or a specially appointed agent.[232] A third group of one-tier board model countries (as defined for present purposes) accord the right to bring an action both to the board of directors and the shareholders in general meeting.[233]

[230] See above 1.5 and 1.6.
[231] Cyprus, France, Ireland, Malta, UK.
[232] Belgium, Denmark, Greece, Portugal, Romania, Spain, Sweden.
[233] Finland, Italy.

Legal systems promulgating a two-tier board structure (or jurisdictions offering a choice, but where the companies usually adopt the two-tier model[234]) are characterised by a similar level of diversity. Several jurisdictions stipulate that the supervisory board has the authority to instigate legal proceedings and represent the company; in some legal systems the supervisory board is required to do so upon the request by the general meeting.[235] Alternatively, some jurisdictions allocate the power to decide on an enforcement action to the general meeting,[236] the managing director,[237] the board of directors,[238] or either the management board or the supervisory board.[239] In the ensuing litigation the company is then represented by the supervisory board, the chairman of the supervisory board, or a special representative.

It is difficult to assess which of these arrangements is the most effective in order to address the conflict of interest problem mentioned above. While some strategies clearly raise concerns regarding the authorised organ's possible conflict of interest, notably the allocation of authority to the board of directors in the one-tier system and to the managing director or management board in the two-tier system (for claims against the executive directors), the data indicate that enforcement levels are low in all Member States.[240] Where they are relatively higher in some jurisdictions than in others, e.g. the UK, this seems to be more a function of ownership structure, a sophisticated institutional environment, or simply the number and size of companies, rather than the success of the legal rules in dealing with the relevant conflicts of interest.

Class action. Class actions are now, in one form or another, available in a number of Member States, for example Denmark, Germany, Italy, Poland, Spain, or Sweden.[241] However, they do not play an important role in the context of directors' duties since the scope of these mechanisms is often restricted. In addition, it is a precondition for the admissibility of a class action that the claims that are put forward are based on similar interests. Since only personal claims of the shareholders can be the subject of a class action, but not the claims of the company, and personal claims require the infringement of individual rights, their practical relevance may be limited.[242]

3.2 Derivative action

Summary of the country reports

Table 3.2.a: Regulation of derivative actions

Country	*Threshold*	*Conditions*	*Cost rules*
Austria	10% minority shareholders (5% if the audit report identified facts that give rise to liability) can order the supervisory board to enforce a claim against a manager or assign a special representative to enforce the claim	-	The company can reclaim the litigation costs from the minority shareholders; where minority shareholders intentionally or grossly negligently cause the company to bring an unsuccessful claim against a director, the

[234] See above 1.5 and 1.6.
[235] Croatia, Estonia, Germany, Slovakia.
[236] Bulgaria, Hungary, Latvia, Luxembourg, Poland, Slovenia.
[237] Lithuania.
[238] The Netherlands (board of directors here refers to the management board, not the supervisory board).
[239] Austria, Czech Republic.
[240] See M. Gelter, 'Why do Shareholder Derivative Suits Remain Rare in Continental Europe?' 37 *Brook. J. Int'l L.* 843, 848-849.
[241] For a collection of country reports analysing the possibilities for collective redress in different jurisdictions and a translation of the relevant legislation into English see http://globalclassactions.stanford.edu/.
[242] Circumstances are, of course, conceivable under which the necessary similarity of interests is satisfied, and in the US they are relatively common. See Gelter, n 240, 847 (referring to *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), for the relevant test to distinguish between class actions and the derivative suit).

	NOTE: this is not a derivative action in the strict sense because the company is represented by the supervisory board or the special representative; the minority shareholder may only intervene according to civil procedure rules		minority shareholders are liable for the damage suffered by the defendant
Belgium	1% of voting rights or 1,250,000 EUR of the share capital in the public company; 10% of voting rights in the private limited company (must be held on the day the general meeting decides whether to acquit the directors)	If the general meeting resolved to acquit the director/waive the company's claim, the claimant shareholders with voting rights must not have voted in favour of acquittal	Claimants must advance the costs and are not reimbursed by the company if the claim is unsuccessful. Claimants are reimbursed if the action is successful.
Bulgaria	10% or 5% in case of listed companies	Court approval not necessary	The general cost rules of the civil procedure code apply
Croatia	10%	Shareholder for at least 3 months	General rules on costs apply, whereby the costs are allocated according to the success in the proceedings, i.e. if the claim is successful, the costs are borne by the person found liable
Cyprus	1 share	Foss v Harbottle[243] principles → derivative action permissible if: 1) the act complained of was ultra vires; 2) special majority 3) fraud on the minority and wrongdoer control	The award of the costs lies in the discretion of the court.
Czech Republic	> 3% of the registered capital (if total share capital > CZK 100m) or > 5% (if total share capital ≤ CZK 100m)	The minority shareholders must first request the supervisory board to enforce the claim (see above 3.1) and the SB must fail to do so	The general cost rules of civil procedure apply; since the company is the plaintiff and the shareholders sue in the name of the company, the company must pay the minority shareholders' court fees and the costs of legal counsel
Denmark	10% (for the derivative action under s. 364(3))	The claimant shareholders must have opposed a resolution to	The claimant shareholders must pay the legal costs involved,

[243] (1843) 2 Hare 461.

		grant exemption from liability or waive the company's claim, s. 364(3) OR: The company does not bring the legal action → this derivative action is not laid down in statute and its permissibility is controversial in the literature; no court decision	but may have such costs reimbursed by the company to the extent that they do not exceed the amount recovered by the company, s. 364(3)
Estonia	No derivative action	n/a	n/a
Finland	10% OR it is shown that a decision of the company not to enforce its claim would violate the principle of equal treatment, Ch. 22, s. 7	It is likely that the company itself is not going to sue	The shareholder bears the cost if he/she loses
France	1) General rule of the Civil Code: 1 share 2) The Commercial Code provides for an additional (not alternative) *action sociale ut singuli* for the SA: shareholders holding more than 5% of the share capital can act together in enforcing claims of the company	The *action sociale ut singuli* pursuant to the Commercial Code is of a subsidiary nature. It can only be initiated if the representatives of the company refuse to take legal action.	Normal cost rules apply. This has the consequence in practice that the derivative action is not commonly used because the shareholders bear the up-front costs of the proceedings.
Germany	1% or EUR 100,000	Claim admission procedure, s. 148(1). The court shall grant permission to pursue the claim if: 1) the shareholders acquired the shares before they knew, or should have known, of the breach of duty; 2) they requested the company to bring a claim, but the company failed to do so within a reasonable time limit; 3) prima facie the company suffered a loss due to dishonesty or gross violation of legal provisions or the articles; 4) pursuing the claim is not outweighed by the interests of the company	s. 148(6): the claimant has to bear the costs of the admission procedure if the application is dismissed, unless the dismissal is due to facts relating to the interest of the company that the company could have disclosed prior to the application, but did not disclose; if the application is successful, but the claim is dismissed in whole or in part, the company shall reimburse the claimants

Greece	10% minority shareholders can request the board of directors to bring a lawsuit, or 1 share if intentional conduct is alleged NOTE: this is not a derivative action in the strict sense because the company is the party to the lawsuit	The claimants must have been shareholders for at least three months before the action is brought	The company must cover the costs, Art. 22b(3)
Hungary	5%	The general meeting decided not to enforce the claim of the company	No specific rules. According to general rules on Civil Procedure, costs of submitting/enforcing the claim are to be born in advance by the claimant and finally allocated to the losing party. Party to the proceedings is the company, not the minority shareholder. Therefore, the company should pay or, if this does not happen, the shareholders have a claim against the company for reimbursement (based on restitution)
Ireland	1 share	*Foss v Harbottle* applies: 1) the action must be brought bona fide for the benefit of the company for wrongs to the company and not for an ulterior purpose 2) the persons against whom the action is taken must have majority control of the company and have blocked an action being brought in the name of the company 3) the claimant must show wrongdoing by those in control and have a good prima facie case	Case law shows that if the court decides to grant leave to maintain a derivative action, there is a high likelihood that the plaintiff will obtain an indemnity for the costs from the company
Italy	- 20% or a different percentage as set out in the articles (which cannot exceed one third of the corporate capital) - In the case of listed	No	If the claim is successful the company will indemnify the claimants against the costs incurred in bringing the proceedings, unless these are imposed on (or

	companies and companies whose shares, although not listed on a regulated market, are widely distributed among the public (*societa' che fanno ricorso al capitale di rischio*), the claim may be brought by a group of shareholders representing at least 2.5% of the outstanding share capital, Art. 2393(1), (2)*bis* Civil Code		recovered from) the losing party. If the claim is settled or not successful, the claimants do not have any right to be indemnified
Latvia	5% or LVL 50,000 (approximately EUR 71,144), Art. 172(2)	- Shareholders generally only have the right to request the enforcement of the claim by the company. Such request must be addressed to the competent corporate body, which is for claims against board members the council. If the company does not have a council, the GM decides. - If the company fails to bring the claim within a month from the day when the request was received, shareholders can bring the claim directly. However, the claim still has to be submitted in company's name. Shareholders act as representatives *dominus litis* of the company. Formally the company is the party to the lawsuit. - Shareholders must submit the claim within three months from the day when they initially requested enforcement. - See Art. 172(2)-(6) Latvian Commercial Law	Since the company is the party to the lawsuit, it bears the costs. However, the company has the right to reclaim the litigation costs if they can be considered as damages caused by an unjustified action. This is the case if the shareholders have acted with: 1) malice or 2) gross negligence. If these requirements are satisfied, the shareholders are jointly and severally liable for the damage caused, Art. 172(7) Latvian Commercial Law.
Lithuania	One share, Law on Companies, Art. 16(1)(4)	Limited case law; no restrictive conditions have been developed	No statutory rules or case law. As a general rule, claimant pays for the claim and all related legal expenses.
Luxembourg	Currently no derivative action	n/a	n/a

	A draft act is pending in parliament that would create a derivative action modelled after the Belgian *action sociale ut singuli*.		
Malta	Unclear whether a derivative action is possible following the English jurisprudence – no case law	-	-
Netherlands	- No derivative action - But shareholders holding at least 10% of the capital or a nominal value of EUR 250,000 can request the Enterprise Chamber of the Civil Court of Appeal of Amsterdam to conduct an enquiry into the policy and conduct of the business of the company. The court may order the suspension of directors, appointment of supervisory directors with special powers, suspension of resolutions of the management board or suspension of voting rights(Arts. 2:344 et seq. DCC) → this is of great practical relevance	n/a	n/a
Poland	1 share	Art. 486(1): Where the company has failed to bring action for relief within one year from the disclosure of the injurious act	The role of the derivative action is minimal in practice because of cost rules: 1) Upon application by the defendant, the court may order bail to be provided as a security for damage that the defendant stands to suffer, Art. 486(2) 2) The court may order the plaintiff to redress the damage caused to the defendant if it finds the action to be unfounded and the claimant acted in bad faith or flagrant negligence when bringing the action, Art. 486(4)

Portugal	5% (2% in case of stock exchange listed company, Art. 77(1))	The company decides not to bring an action (Art. 77(1)) or fails to bring it within six months	The claimants bear the legal expenses; no reimbursement is owed by the company (Art. 77(2)). If the defendant director alleges that the claimant brought the action to pursue interests not legally protected, he/she can ask for a ruling on the matter or for a guarantee to be given (Art. 77(5))
Romania	5% shareholders have the right to introduce an action in damages in their own name, but on account of the company, Art. 155	Refusal of the simple majority of shareholders to bring the action *ut universi*, and the claimants must have been shareholders at the time when the instigation of an action was debated in the GM	The claimants bear the costs of the proceedings, but can claim reimbursement from the company if the lawsuit is successful. This has led to a low number of derivative actions in practice.
Slovakia	5%	Failure of the supervisory board to enforce the rights of the company upon the request of minority shareholders without undue delay	Where minority shareholders bring a claim against a director in the name of the company the costs of the proceedings are borne by the shareholders bringing the suit. They will only be able to recover the costs if they succeed with the claim.
Slovenia	10% or a nominal amount of at least EUR 400,000, Art. 328(1)	1) Art. 328(1): the GM rejects the proposal for filing a lawsuit, it fails to appoint a special representative, or the management or the special representative do not act in accordance with the resolution adopted by the GM 2) Art. 328(2): a) the claimants must deposit their shares with the central clearing and depository house and may not dispose of them until the issue of a final decision on the claim b) the claimants must be able to prove that they were the shareholders at least three months prior to the GM which rejected	The legal costs shall be covered by the company, Arts. 328(3), 321

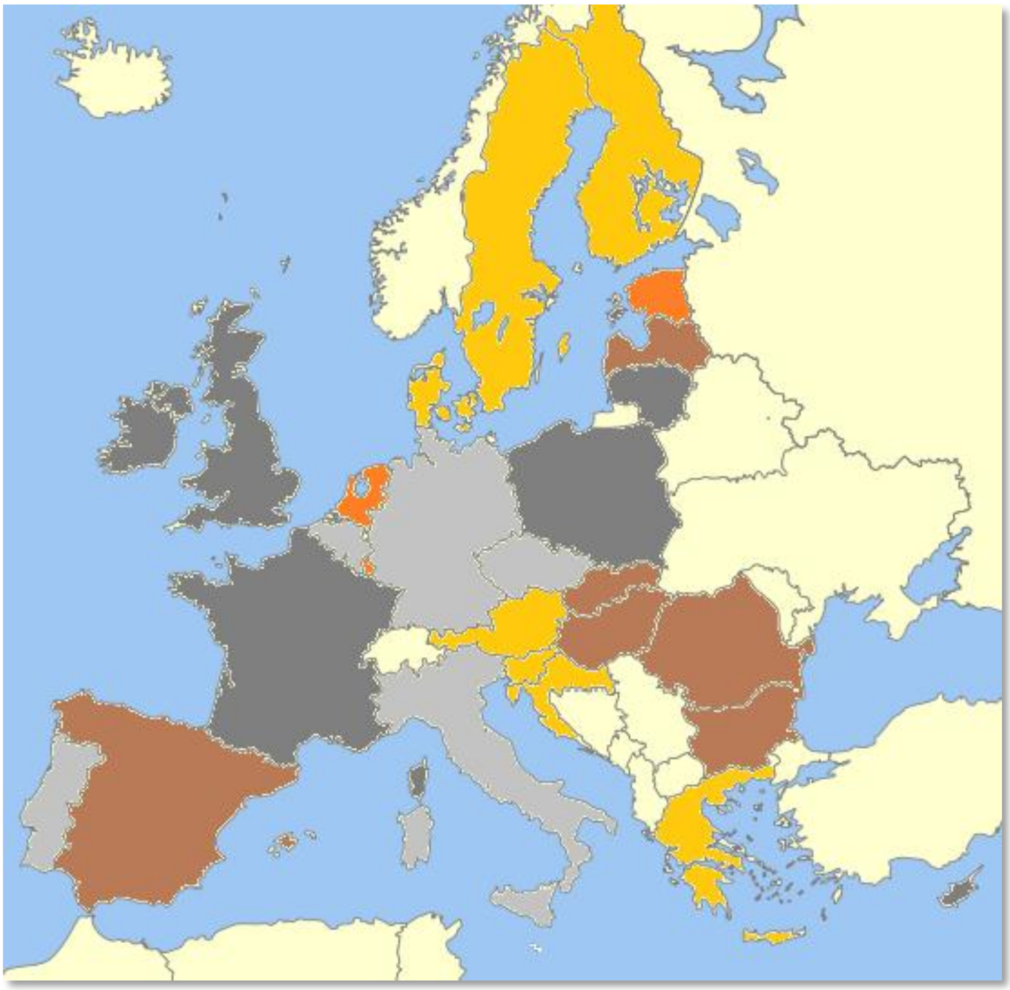
		their proposal	
Spain	5%	Derivative action is permissible if the general meeting decides not to claim liability, a resolution was adopted to file the claim, but it is not executed, or there is no decision by the general meeting, s. 239 LSC	The claimants can obtain reimbursement from the company if the directors are found liable; otherwise the claimants bear the costs of the proceeding
Sweden	10%, Ch. 29, § 9	-	The claimants shall bear the litigation costs but shall be entitled to reimbursement from the company for costs which are covered by damages awarded to the company in the proceedings, Ch. 29, § 9(2)
United Kingdom	1 share	Claim admission procedure, ss. 261-263: the court assesses several factors, inter alia whether a member acting in good faith would seek to continue the claim	Civil Procedure Rule 19.9E: The court may order the company to indemnify the claimant against liability for costs incurred in the permission application or in the derivative claim or both. The courts will grant an indemnification order where a shareholder has in good faith and on reasonable grounds sued as plaintiff in a minority shareholder's action, and which it would have been reasonable for an independent board of directors to bring in the company's name (Wallersteiner v. Moir) → this test should be satisfied where permission is given for the claim to continue under the statutory derivative action procedure

Discussion

In the following sections we analyse the rules regulating derivative actions in more detail along the three dimensions sketched in *Table 3.2.a*: Standing, i.e. rules that specify which shareholders can file a derivative action (anyone holding at least one share, or only shareholders that satisfy a holding threshold expressed in percentage or as a minimum nominal value amount); further conditions that must be satisfied to bring an action (for example that the defendant director must be in control of the general meeting or the claimants must have deposited their shares with the central depository); and cost rules, i.e. procedural rules determining whether the company or the claimant bear the costs of the proceedings and, if the latter is the case, when the claimant can claim reimbursement from the company. In order to judge whether the derivative action mechanism guarantees an effective enforcement of directors' duties all three elements are of importance and need to be considered concurrently (for such an assessment see *Tables 3.2.b* and *3.2.c* and *Map 3.2.d* below).[244]

Standing

Map 3.2.a: Derivative action – standing



Legend	Country
1 share	CY, FR, IE, LT, PL, UK
> 1 share, but < 5%	BE, CZ, DE, IT, PT

[244] In the following analysis, we do not classify Malta. While a derivative action mechanism does in principle exist, it plays a marginal role in practice. In theory, the English common law (the rule in *Foss v Harbottle*) should apply, but due to the scarcity of case law it is difficult to assess in which form the English rules would be transposed into the Maltese legal system. In practice, minority shareholders tend to rely on the unfair prejudice remedy pursuant to Art. 402 of the Maltese Companies Act, which is, however, more limited in its scope of application since it requires that the company's affairs have been conducted in a manner that is 'oppressive, unfairly discriminatory against, or unfairly prejudicial, to a member'.

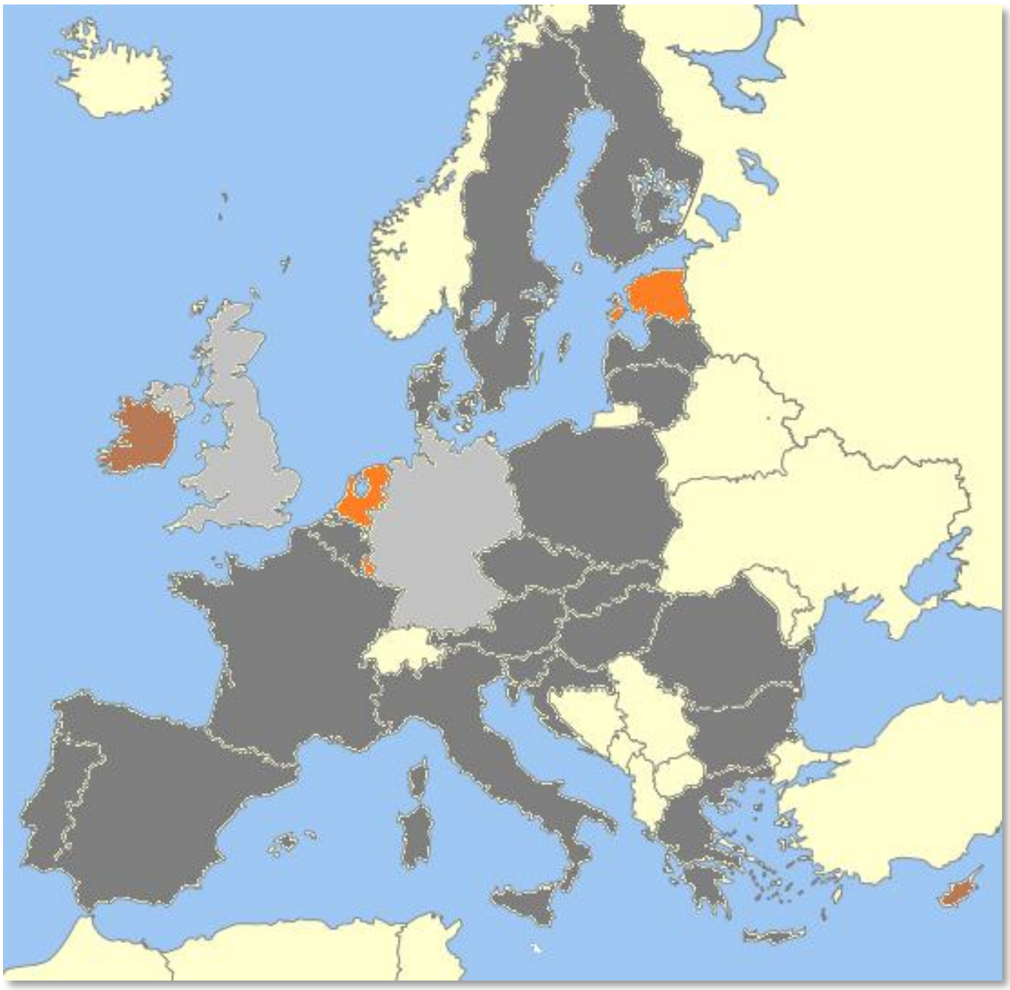
5% to ≤ 10%	BG, HU, LV, RO, SK, ES
10% or more	AT, HR, DK, FI, EL, SI, SE
No derivative action	EE, LU, NL

Not classified (white): MT

All figures above are based on the public, stock exchange listed company. In private companies the threshold to bring a derivative action is potentially higher.[245] The Member States vary greatly with regard to the relevant minimum. The requirements range from 1 share in Cyprus, France, Ireland, Lithuania, Poland, and the UK to 10% in Austria, Croatia, Denmark, Finland, Greece, Slovenia, and Sweden. If we also consider non-listed, closely held companies, the maximum threshold is even higher: 20% in Italy.

Conditions for bringing a derivative action

Map 3.2.b: Conditions for bringing a derivative action



[245] See, e.g., Bulgaria.

Legend		Country
	No further conditions (except possibly a minimum period of time during which the shareholder must have held the shares, or the responsible organ, e.g. general meeting or supervisory board, must have decided not to pursue the action)	AT, BE, BG, HR, CZ, DK, FI, FR, EL, HU, IT, LV, LT, PL, PT, RO, SK, SI, ES, SE
	The court has to grant permission to pursue the claim and considers a number of criteria to balance the interest of the shareholder in bringing the action and the interest of the company not to engage in litigation	DE, UK
	The shareholders can only bring the derivative action if restrictive requirements are satisfied (for example, following *Foss v Harbottle*, derivative actions are only possible if the directors have committed a wrong that benefitted them personally, i.e. they committed a fraud, and they have *de jure* or *de facto* control of the general meeting[246])	CY, IE
	Not applicable because no derivative action	EE, LU, NL

Not classified (white): MT

The vast majority of countries allow derivative actions, once the threshold for standing is passed, without particularly restrictive additional requirements. The four outliers are, on the one hand, Germany and the UK, which provide for a claim admission procedure and grant the court discretion in reviewing whether the interest of the shareholders in pursuing the claim is not outweighed by the interest of the company in avoiding litigation (for example because litigation would be disruptive, damage the reputation of the company, or come at a sensitive time when the dedication of the executives is more important), and on the other hand, Cyprus and Ireland, which apply with no significant modifications the rule in *Foss v Harbottle*.

Significant differences exist also within these groups. The German claim admission procedure is structured in a way that refusal by the court to grant permission should be the exception if the other requirements of the law are satisfied (the claimants must have been shareholders at the time they learned about the alleged breach of duty; they requested the company to instigate proceedings, and the company failed to do so within a reasonable time; and the claimants present a prima facie case that the loss suffered by the company is due to dishonesty or gross violation of legal provisions or the articles).[247] The limited discretion of the courts can be derived from the formulation of the statute: The

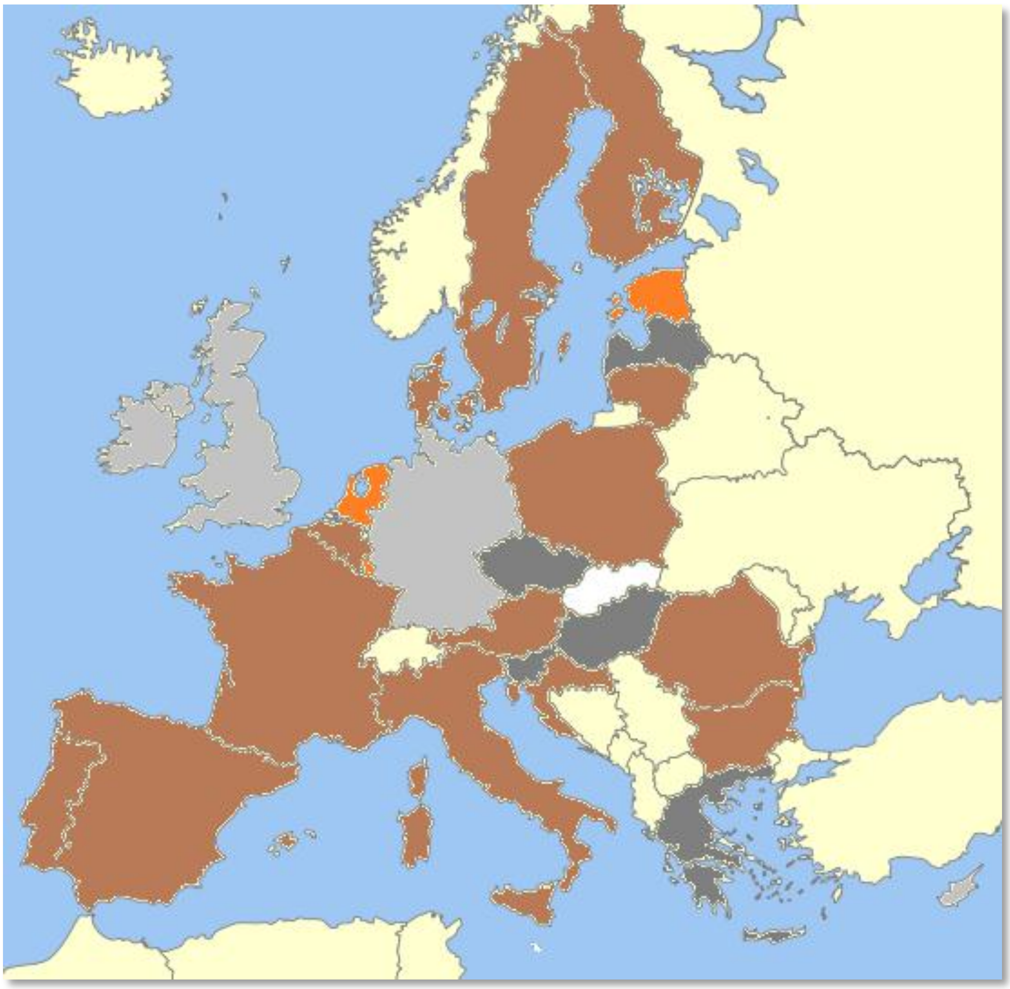
[246] This rule makes derivative actions for negligence or in widely held companies effectively impossible.
[247] German Stock Corporation Act, § 148(1).

courts shall reject the application only if enforcement of the claim is 'outweighed by the interests of the company'.[248] In contrast, UK courts enjoy a wider discretion. If one of the grounds of a mandatory refusal to grant permission is not present,[249] the courts shall, in considering whether to give permission, 'take into account' a number of factors listed non-exhaustively in the act, for example the good faith of the claimant or the importance that a director acting in good faith would attach to continuing the claim.[250]

In some countries in group 1, the additional requirements, while generally easy to satisfy, may be onerous depending on the position of the shareholder and the shareholder's intentions with regard to the investment. For example, in Slovenia, the claimants must deposit their shares with the central clearing and depository house and may not dispose of them until the issue of a final decision on the claim.

Cost rules

Map 3.2.c: Derivative action – cost rules



[248] ibid., sentence 2, no. 4.
[249] Companies Act 2006, s. 263(2).
[250] Companies Act 2006, s. 263(3).

Legend		Country
	The company pays all costs	CZ, EL, HU, LV, SI
	The shareholder has to advance some costs (for example those of the admission procedure, if any), but can claim reimbursement from the company under some conditions without bearing the litigation risk	CY, DE,[251] IE, UK
	The shareholder pays and bears the litigation risk; or the company pays but can reclaim the costs from the shareholder	AT, BE, BG, HR, DK, FI, FR, IT, LT, PL, PT, RO, SK, ES, SE
	Not applicable because no derivative action	EE, LU, NL

Not classified (white): MT

Ease of enforcement

It may be useful to integrate the three elements of derivative actions discussed above (standing, conditions to bring the derivative action, and cost rules) into a minority shareholder enforcement index in order to facilitate cross-country comparison and allow an appreciation of the overall ease with which shareholders can enforce breaches of directors' duties in each Member State if the authorised organs of the company fail to do so. We therefore quantify the three elements on a scale from 1 to 4, with 4 indicating the most advantageous rule for purposes of minority shareholder protection, and aggregate the scores. The assignment of the scores to different statutory rules regarding the three components of the derivative action mechanism is shown in *Table 3.2.b*, and the constituent as well as aggregate scores per country are listed in *Table 3.2.c*.

Two caveats are in order. First, in quantifying the regulation of derivative actions in this way, we make the assumption that the three components are of equal importance. This assumption is, in our view, warranted. Restrictive provisions on standing and the conditions for bringing a derivative action impose clear statutory limitations on the possibility of shareholders to enforce the claims of the company against the directors. Either element may have the propensity to render minority shareholders suits altogether impractical. For example, the very generous rule on standing that exists in Cyprus, Ireland, and the United Kingdom (1 share) is all but neutralised by the restrictive conditions of *Foss v Harbottle* (now superseded by a statutory derivative action mechanism in the UK, but still in force in the other two countries). On the other hand, a light regulation of the procedure of shareholder suits in Denmark, Greece, and a number of other countries is outweighed by the requirement that shareholders must hold at least 10% of the outstanding capital. This has, at least in large companies, the consequence that the derivative action will generally only be available to institutional shareholders. Furthermore, disadvantageous cost rules create practical, but no less effective, impediments.

Nevertheless, such schematic quantification inevitably involves simplifications and a value judgment, which is amplified by the division of the different regulatory approaches into only three (or, in the case of standing, four) groups (see *Table 3.2.b* below). Therefore, it must be emphasised that the

[251] In Germany, the claimant has to bear the costs of the admission procedure if the application is dismissed, unless the dismissal is due to facts relating to the interest of the company that the company could have disclosed prior to the application, but did not disclose. If the application is successful, but the claim is dismissed in whole or in part, the company shall reimburse the claimant, s. 148(6) Stock Corporation Act.

enforcement index is only intended as a rough approximation of the conduciveness of the regulatory environment to minority shareholder suits and that the availability of the derivative action in a given case will depend on a host of other factors that are not part of below calculus.

Second, a high or low score in the enforcement index should not be equated with a high or low level of minority shareholder protection in the respective jurisdiction. The jurisdiction may have developed substitute mechanisms that supplement private enforcement and give minority shareholders other avenues to complain of an alleged breach of duty or focus on public enforcement through administrative sanctions and criminal law. We will discuss the substitute mechanisms in the next section and show that a number of Member States, for example the Netherlands and the UK, use such functional substitutes to counteract the deficiencies of the derivative action.

Table 3.2.b: Minority shareholder enforcement index – quantification

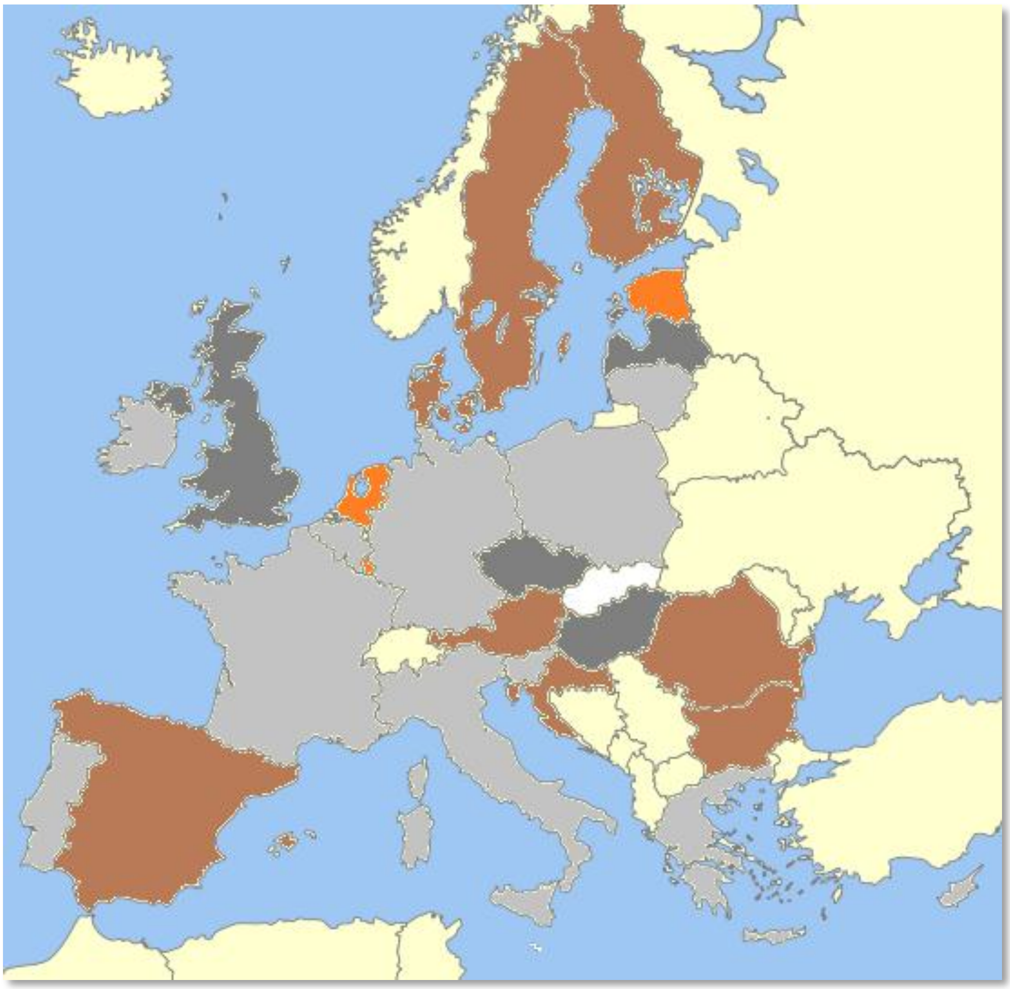
	Standing	***Conditions***	***Cost rules***
4 points	1 share: CY, FR, IE, LT, PL, UK	No further conditions: AT, BE, BG, HR, CZ, DK, FI, FR, EL, HU, IT, LV, LT, PL, PT, RO, SK, SI, ES, SE	Company pays all costs: CZ, EL, HU, LV, SI
3 points	> 1 share, but < 5%: BE, CZ, DE, IT, PT	The court has to grant permission: DE, UK	The claimant has to advance some costs, but can claim reimbursement under some conditions without bearing the litigation risk: CY, DE, IE, UK
2 points	5% ≤ 10%: BG, HU, LV, RO, SK, ES	-	-
1 point	10% or more: AT, HR, DK, FI, EL, SI, SE	The shareholders can only bring the derivative action if restrictive requirements are satisfied: CY, IE	The shareholder pays and bears the litigation risk: AT, BE, BG, HR, DK, FI, FR, IT, LT, PL, PT, RO, SK, ES, SE

Table 3.2.c: Minority shareholder enforcement index – scores per country

Country	***Standing***	***Conditions***	***Cost rules***	***Total***
AT	1	4	1	6
BE	3	4	1	8
BG	2	4	1	7
HR	1	4	1	6
CY	4	1	3	8
CZ	3	4	4	11
DK	1	4	1	6
FI	1	4	1	6
FR	4	4	1	9

DE	3	3	3	9
EL	1	4	4	9
HU	2	4	4	10
IE	4	1	3	8
IT	3	4	1	8
LV	2	4	4	10
LT	4	4	1	9
PL	4	4	1	9
PT	3	4	1	8
RO	2	4	1	7
SK	2	4	1	7
SI	1	4	4	9
ES	2	4	1	7
SE	1	4	1	6
UK	4	3	3	10

Map 3.2.d: Minority shareholder enforcement index



Legend		Country
	Total score of the enforcement index of 10-11	CZ, HU, LV, UK
	Total score of 8-9	BE, CY, FR, DE, EL, IE, IT, LT, PL, PT, SI
	Total score of 6-7	AT, BG, HR, DK, FI, RO, SK, ES, SE
	No derivative action	EE, LU, NL

Not classified (white): MT

Substitutes for weak private enforcement

Investigation procedures: In the Netherlands, shareholders holding at least 10% of the capital or a nominal value of EUR 250,000 can request the Enterprise Chamber of the Civil Court of Appeal of Amsterdam to conduct an enquiry into the policy and conduct of the business of the company. The court may order the suspension of directors, appointment of supervisory directors with special powers, suspension of resolutions of the management board or suspension of voting rights. This is of great practical relevance and compensates to some extent for the lack of a derivative action mechanism. Similarly, in a number of Member States minority shareholders holding between 1% and 10% of the share capital may request the court to appoint a special investigator who examines the conduct of the members of the company's management bodies.[252]

Disqualification of directors: Most jurisdictions provide for disqualification of the director as a sanction in the company's insolvency or where the director is convicted of a crime. However, as a substitute for weak private enforcement, disqualification is particularly effective where the sanction is also available outside insolvency and for management mistakes that do not amount to a criminal offence. This is the case in Finland if the director has *materially violated* legal obligations in relation to the business and in Ireland and the UK, among other reasons, if the conduct of the director 'makes him unfit to be concerned in the management of a company'.[253] In the latter two countries, disqualification of directors is of great practical relevance because of the strictness of the rule in *Foss v Harbottle* and has produced notable case law informing the interpretation of directors' duties not only for purposes of the disqualification procedure, but for directors' liability in general.[254]

Administrative and criminal sanctions: In all jurisdictions analysed, private enforcement is furthermore supplemented by administrative and criminal proceedings that may result in fines or, in serious cases, imprisonment. The breaches that give rise to such sanctions are enumerated in the company laws or penal codes and relate typically to the misappropriation of corporate assets, fraudulent misstatements in the balance sheet or the profit and loss accounts, unlawful preference of creditors, or the failure to file for the opening of insolvency proceedings. It has been pointed out by practitioners and commentators from several jurisdictions that administrative and criminal sanctions constitute the main

[252] For example, Austrian Stock Corporation Act, § 130(2) (10% if facts indicate a material violation of the law or the articles ('*grobe Verletzungen des Gesetzes oder der Satzung*')); German Stock Corporation Act, § 140(2) (1%, with the same proviso as under Austrian law); Lithuanian Civil Code, Art. 2.124 (10%).

[253] Irish Companies Act 1990, s. 160(2)(d); UK Company Directors Disqualification Act 1986, ss. 6(1), 8(2). In addition to disqualifications, Irish company law also contains a restrictions regime, i.e. the possibility to apply for a court order prohibiting directors of insolvent companies from acting as director of another company for a period of five years, unless the court is satisfied that the director 'has acted honestly and responsibly in relation to the conduct of the affairs of the company' (with the burden of proof resting on the director) or the company meets heightened capital requirements, see Irish Companies Act 1990, s. 150.

[254] For a discussion of the relevance of disqualification orders in the UK see Davies and Worthington, n 169 above, para. 10-2. The situation is similar in Ireland. Leading cases include *Re Tralee Beef and Lamb Ltd (In Liquidation); Kavanagh v Delaney* [2004] IEHC 139, [2005]1 ILRM 34; *Re CB Readymix Ltd (In Liquidation); Cahill v Grimes* [2002] 1 I.R. 372; *Re Lynrowan Enterprises Ltd*, unreported, High Court, O'Neill J., July 31, 2002, discussed in the Irish country report.

deterrent to misconduct by directors. This assessment indicates that the private enforcement of directors' duties in the respective jurisdictions is hampered, given that the scope of application of administrative and criminal sanctions is more restrictive than directors' duties under civil law, the evidentiary burden is higher under criminal law, and public enforcement authorities are often subject to resource constraints that do not apply in the same way to private actors. Private litigation should, therefore, be the more frequently observed enforcement mechanism. In addition, in some countries neither criminal nor civil sanctions are applied regularly. For example, it was submitted that in Cyprus discretion whether to instigate criminal proceedings lies in the hands of the Attorney General, but that these powers are used rarely and that civil liability for breach of directors' duties, while also only litigated sparingly, is more important.

4. Directors' duties and liability in the vicinity of insolvency

This section summarises the findings in relation to directors' duties in companies approaching insolvency. In most jurisdictions, directors' duties have primarily been designed to address managerial agency problems and – partly depending on the prevailing ownership structures – conflicts between majority and minority shareholders. Underlying this approach is a notion of shareholders as residual risk-bearers within the corporation.[255] This view is economically justified as long as the company possesses a substantial amount of equity capital, which is the value at risk from the shareholders' perspective. However, once a company approaches insolvency – i.e. the equity capital "evaporates" – the economic risk borne by shareholders also disappears; this changes the incentives of both directors and shareholders.[256] In this situation, the economic risk is mainly borne by the company's creditors, who assume the role of residual claimants.[257] All EU Member States have developed legal responses to address the problems associated with changed incentives (and roles) as companies approach insolvency.[258]

In the following sections we describe the strategies adopted by Member States in relation to this problem, focussing in particular on the legal framework applicable in situations where a company attempts to trade its way out of insolvency. Our findings in relation to the insolvency-related duties seem to be of particular importance when combined with the private international law framework of different Member States. This will be addressed in more detail in Section 5, dealing with cross-border issues.

[255] See J Winter et al., *Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe* (Brussels, 2002), available at http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf; see also PL Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency', (2006) 7 *European Business Organization Law Review* 301.
[256] See e.g. Davies, ibid; T Bachner, 'Wrongful Trading – A New European Model for Creditor Protection?' (2004) 5 *European Business Organization Law Review* 293; H Eidenmüller, 'Trading in Times of Crisis: Formal Insolvency Proceedings, workouts and the Incentives for Shareholders/Managers' (2006) 7 *European Business Organization Law Review* 239.
[257] Davies, *ibid*, at 324.
[258] See also S Kalss and G Eckert, ‚Generalbericht' in: S Kalss (ed), *Vorstandshaftung in 15 europäischen Ländern* (Vienna: Linde 2005).

4.1 Duty to file for insolvency and wrongful trading prohibitions

Summary of the country reports in tabulated form

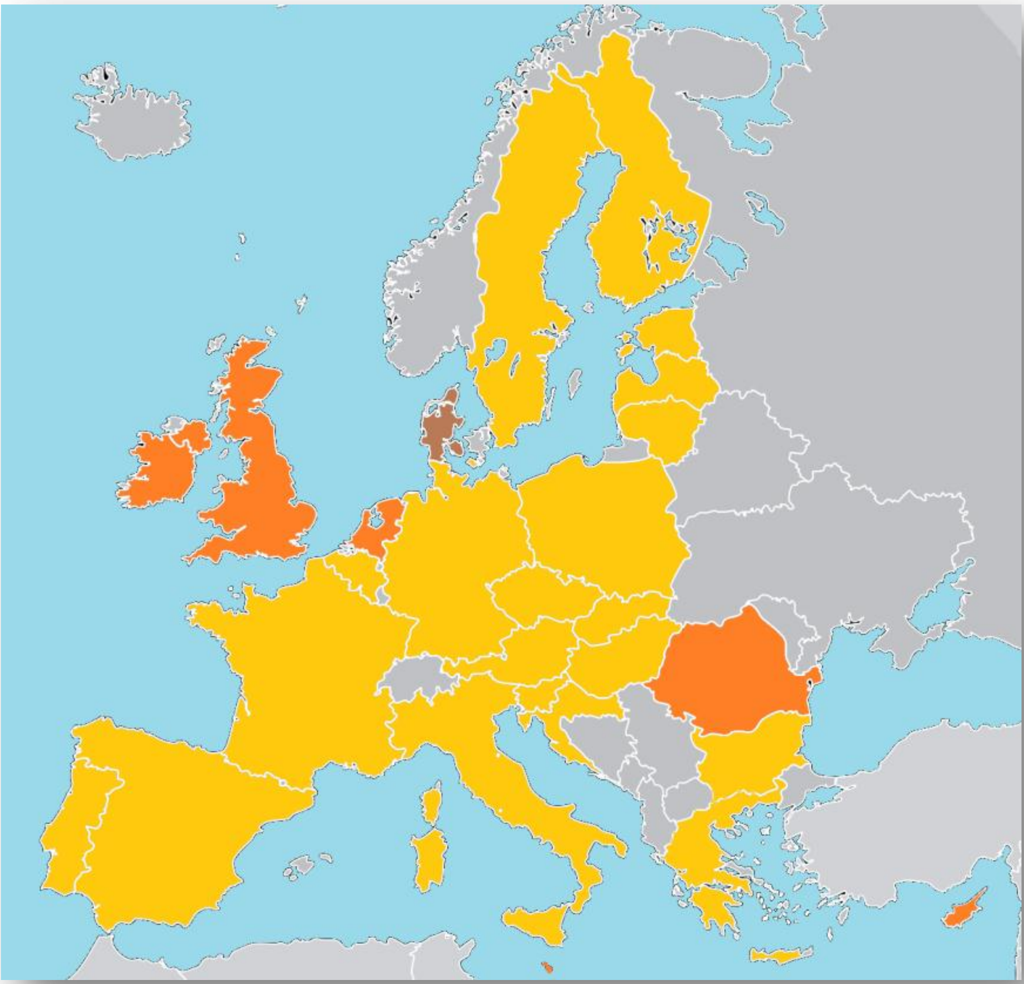
Table 4.1.a: Duty to file for insolvency and wrongful trading prohibitions

Country	*duty to file for insolvency or wrongful trading*
Austria	duty to file
Belgium	duty to file
Bulgaria	duty to file
Croatia	duty to file
Cyprus	wrongful trading prohibition
Czech Republic	duty to file
Denmark	hybrid approach (both)[259]
Estonia	duty to file
Finland	duty to file
France	duty to file
Germany	duty to file
Greece	duty to file
Hungary	duty to file
Ireland	wrongful trading prohibition
Italy	duty to file
Latvia	duty to file
Lithuania	duty to file
Luxembourg	duty to file
Malta	duty to file
Netherlands	wrongful trading prohibition
Poland	duty to file
Portugal	duty to file
Romania	wrongful trading prohibition
Slovakia	duty to file
Slovenia	duty to file
Spain	duty to file
Sweden	duty to file
United Kingdom	wrongful trading prohibition

[259] Case law has established a rule similar to the UK wrongful trading prohibition. Directors who know (or ought to know) that the company has no reasonable prospect of avoiding insolvency must minimise the potential losses to creditors, or else will be held liable. In addition, a duty to file for insolvency also applies.

Discussion

Map 4.1.a: Duty to file for insolvency and wrongful trading prohibitions in Europe



Legend	Countries
Duty to file	AT, BE, BG, DE, EE, EL, ES, FR, FI, HR, HU, IT, LV, LT, LU, MT, PL, PT, SE, SI, SK
wrongful trading	CY, IE, NL, RO, UK
Both	DK

All Member States examined by us employ one of two main legal strategies to ensure creditors' interests are properly taken into account in near-insolvent companies.[260]

First, the vast majority of Member States provide for a duty on the part of a company's directors to timely file for insolvency. Typically, this strategy is then buttressed by a consequential liability of directors for any depletion of the company's assets resulting from the delayed insolvency filing. In most Member States employing this strategy, this liability can only be enforced by the liquidator, and thus results in a proportional satisfaction of all creditors' claims.

[260] Denmark combines the two approaches; see the Danish Report in Annex I.

The second main strategy is very similar in nature. Instead of setting a legal requirement for the insolvency filing, some Member States provide for a duty to *cease trading* at a particular point in time where creditors' interests are at risk.

The first regulatory strategy is clearly more widely spread. It is triggered by the insolvency of the company, rather than merely a threat of insolvency. The "wrongful trading" strategy, on the other hand, differs in so far as it does allow companies, for at least a limited time, to continue trading in a state of (balance sheet) insolvency.[261] At the same time, the wrongful trading remedy can – at least in theory – be triggered *even before* the company is formally insolvent. The remedy is based on a realistic assessment of a company's prospects. Thus, directors of a formally insolvent company that has a realistic chance to trade its way out of its situation may be justified in continuing the business, while directors in a not-yet insolvent company may be obliged to cease its operations where the avoidance of a (future) insolvency seems highly unlikely.

The two legal strategies clearly constitute functional equivalents, and – based on our assessment of the Country Reports and or discussions with the Country Experts – the two remedies seem to have at least similar effects on the behaviour expectations towards of directors in pre-insolvency situations.

Differences exist, however. In practice, courts mainly tend to enforce the wrongful trading prohibition in relation to companies that are already insolvent.[262] This may suggests that, in practice, the wrongful trading prohibition tends to be triggered at a later stage than duties to immediately file for insolvency once the relevant triggering event has occurred.[263] At the same time, however, empirical research suggests that recovery rates in the United Kingdom – a jurisdiction relying on the wrongful trading prohibition – are higher than in France and Germany – two jurisdictions adopting the "duty to file"-strategy.[264]

It is also worth noting in this context that most jurisdictions adopting the "duty to file"-strategy do allow the continuation of trading *beyond the point where the company is balance-sheet insolvent*. In addition, the rules in the examined countries also differ significantly regarding the "triggering event" that defines insolvency, which further complicates the analysis. The differences are further highlighted by the responses we received to our Hypotheticals.[265]

4.2 Change of directors' duties

Summary of the country reports in tabulated form

Table 4.2.a: Change of directors' duties

Country	*Do the core duties of directors change as the company approaches insolvency?*
Austria	*no*
Belgium	*no*
Bulgaria	*no*
Croatia	*no*
Cyprus	*yes*

[261] See e.g. PL Davies, "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 *European Business Organization Law Review* (EBOR) 301, 311.

[262] See e.g. the analysis by T Bachner, "Wrongful Trading – A New European Model for Creditor Protection?" (2004) 5 *European Business Organization Law Review* (EBOR) 293-319.

[263] T Bachner (ibid) exemplifies this by comparing German and English law in this respect.

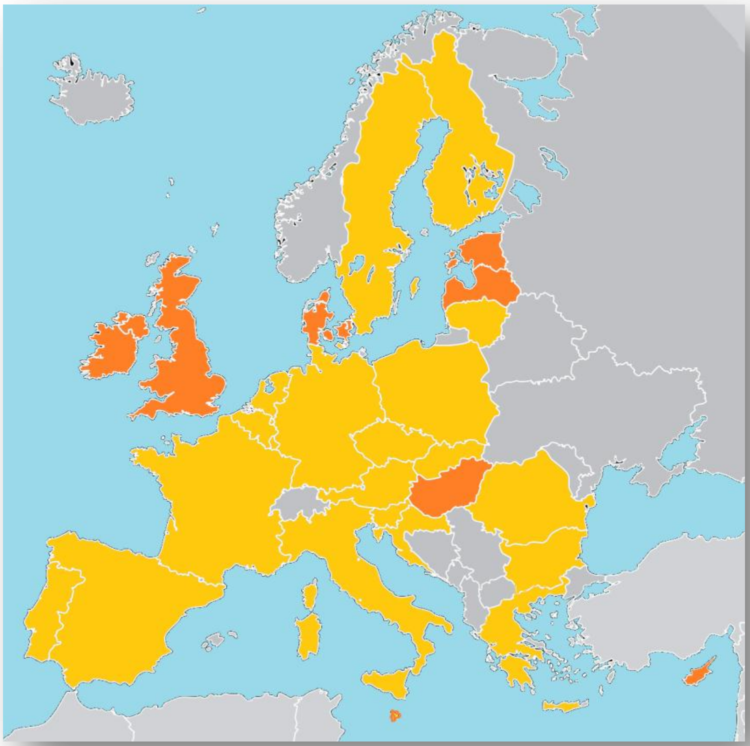
[264] See SA Davydenko and JR Franks, "Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany, and the U.K." (2008) 63 *The Journal of Finance* 565-608, who examine over 2000 SME-insolvencies. See also H Eidenmüller, "Trading in Times of Crisis: Formal Insolvency: Proceedings, Workouts and the Incentives for Shareholders/Managers" (2006) 7 *European Business Organization Law Review* (EBOR) 239, 248.

[265] See Section 4.4 below.

Country	Do the core duties of directors change as the company approaches insolvency?
Czech Republic	*no*
Denmark	*yes*
Estonia	*yes*
Finland	*no*
France	*no*
Germany	*no*
Greece	*no*
Hungary	*yes*
Ireland	*yes*
Italy	*no*
Latvia	*yes*
Lithuania	*no*
Luxembourg	*no*
Malta	*yes*
Netherlands	*no*
Poland	*no*
Portugal	*no*
Romania	*no*
Slovakia	*no*
Slovenia	*no*
Spain	*no*
Sweden	*no*
United Kingdom	*yes*

Discussion

Map 4.2.a: Change of directors' duties



Legend	Countries
No change	AT, BE, BG, CY, CZ, DE, EL, ES, FR, FI, HR, IT, LT, LU, NL, PL, PT, RO, SE, SI, SK
Some changes in core duties	DK, EE, HU, IE, LV, MT, UK

In some Member States, the definition or the scope of the main duties changes as the company approaches insolvency. This is true for Denmark,[266] Estonia, Hungary,[267] Ireland,[268] Latvia, Malta, and the United Kingdom.[269] In general, this implies a change from a more shareholder-centric towards a more creditor regarding set of objectives, or a change in the application of the general standard of care.[270]

The change in the duties should thus be seen, at least in part, as a consequence of our findings regarding the corporate objective (including the definition of the interests of the company) and the general scope of directors' duties.[271]

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[266] The standard of care appears to be heightened in case of decisions taken in the vicinity of insolvency.
[267] See the description of the factors mentioned below, section 4.4.
[268] Duty to consider creditors' interests can be triggered before company is insolvent.
[269] Where the company is approaching (cash-flow) insolvency, the duties owed to the company (s172 Companies Act 2006) become duties to promote the success of the company for the benefit of both creditors and shareholders.
[270] As seems to be the case in relation to Denmark.
[271] See also the analysis by PL Davies, "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency" (2006) 7 *European Business Organization Law Review* (EBOR) 301.

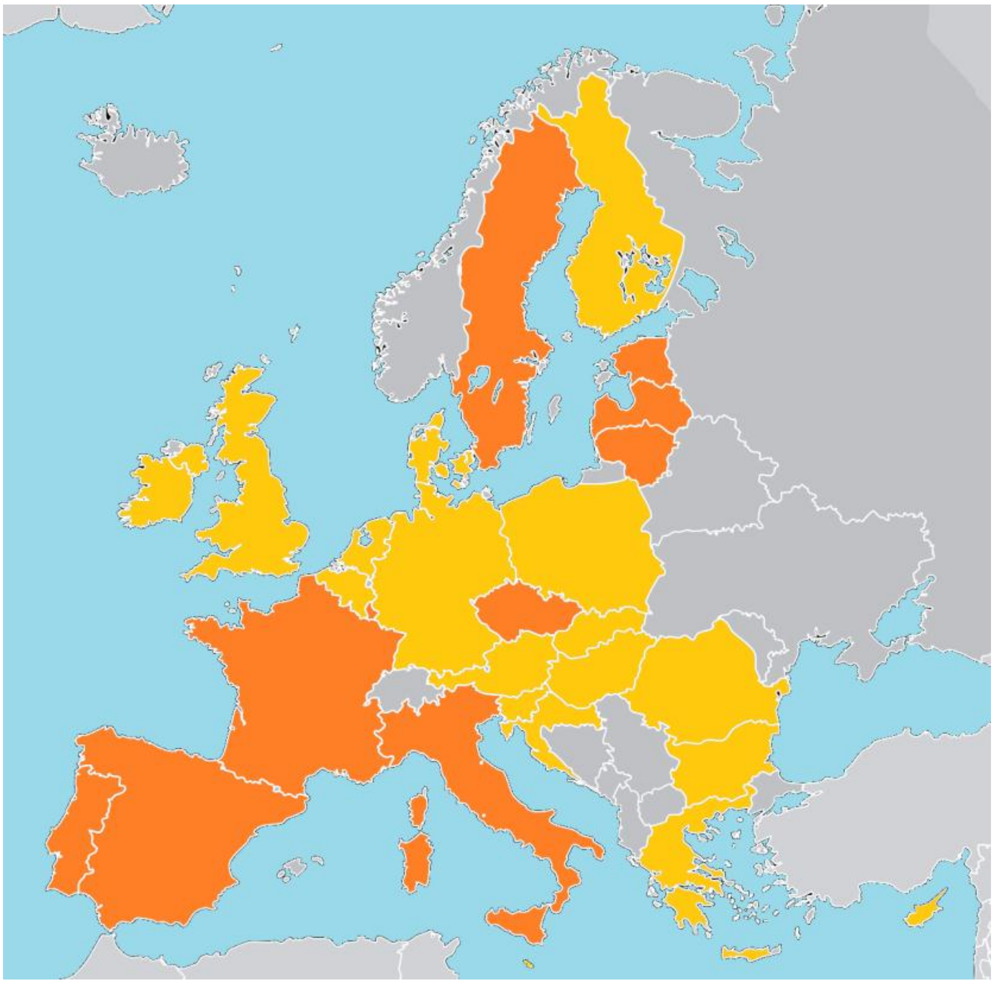
4.3 Re-capitalise or liquidate

Summary of the country reports in tabulated form

Table 4.2.a: Change of directors' duties

Country	*Re-capitalisiation rule or mere duty to convene meeting?*
Austria	*Convene GM*
Belgium	*Convene GM*
Bulgaria	*Duty to re-capitalise*
Croatia	*Convene GM*
Cyprus	*Convene GM*
Czech Republic	*Duty to re-capitalise*
Denmark	*Convene GM*
Estonia	*Duty to re-capitalise*
Finland	*Convene GM*
France	*Duty to re-capitalise*
Germany	*Convene GM*
Greece	*Convene GM*
Hungary	*Convene GM*
Ireland	*Convene GM*
Italy	*Duty to re-capitalise*
Latvia	*Duty to re-capitalise*
Lithuania	*Duty to re-capitalise*
Luxembourg	*Duty to re-capitalise*
Malta	*Convene GM*
Netherlands	*Convene GM*
Poland	*Convene GM*
Portugal	*Duty to re-capitalise*
Romania	*Convene GM*
Slovakia	*Convene GM*
Slovenia	*Convene GM*
Spain	*Duty to re-capitalise*
Sweden	*Duty to re-capitalise*
United Kingdom	*Convene GM*

Discussion



Legend	Countries
Duty to convene only	AT, BE, HR, CY, DK, FI, DE, EL, HU, IE, MT, NL, PL, RO, SK, SI, UK, BG, CZ
Recapitalise or liquidate	EE , FR , IT , LV , LT, LU , PT, ES , SE

An additional regulatory strategy at least *indirectly* affects the duties in the vicinity of insolvency is the so-called “re-capitalise or liquidate” rule. Throughout the European Union, the Second Company Law Directive[272] provides for a duty to call a general meeting in case of a “serious loss”, which is defined as a loss of half[273] of the subscribed share capital (i.e. the reduction of the company’s net assets to less than half the share capital).[274]

[272] See now Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent, OJ 2012 L 315/74.

[273] See *ibid*, Art. 19; Member States can also set the threshold for serious losses at a lower level, *ibid* Art. 19(2).

[274] This is assessed on a cumulated basis; see Jonathan Rickford, *Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance,* 15 European Business Law Review 919, 940 (2004).

But while the Second Directive requires the calling of a general meeting in these circumstances, it does not require companies to take any specific action. In so far as Art 19 of the Second Directive only requires a meeting of the shareholders, the rule does not seem to follow a clear economic rationale.

First, the reference to the subscribed capital is, in itself, not a meaningful triggering event. The subscribed share capital will not be a particularly useful reference point, as this figure says virtually nothing about the assets or capital needs of a company.[275] Second, even (or particular) where the event of losses amounting to more than 50% of the subscribed share capital *is* a significant point in time in the company's life, it is at least questionable to rely on shareholders intervening at this point in time. In fact, to the extent that this event coincides with the company becoming significantly undercapitalised, shareholders' incentives are distorted, since limited liability will often mean that an increase in the company's risk profile also leads to an increase in the value of their shares.

A majority of the Member States have implemented Art 17 of the Second Directive as a mere duty to call a meeting. The interviews with the practitioners in these jurisdictions suggested that shareholders do not usually resolve on any significant matters in the general meeting called under the implementing national company law provisions. It seems, therefore, that – at least in these Member States – the rule produces costs without offering any significant benefits to companies, shareholders or creditors.

A third of the Member States, however, goes beyond this minimum requirement. These Member States require companies to choose, upon loss of half of their subscribed share capital, between either re-capitalising the company or winding down its operations and liquidating the company. This position is taken by the Czech Republic, Estonia, France, Italy, Latvia, Lithuania, Portugal, Spain, and Sweden. The effect of the "re-capitalise or liquidate" rule on near-insolvency trading is twofold. First, it aims at making it less likely for companies with significant nominal share capital to trade in a state of capital depletion. Second, duty-related enforcement mechanisms are directly linked to this strategy, as failure to ensure that appropriate capital measures are taken at this very early stage lead to the liability of board members. Our findings suggest that enforcement of duties related to the "re-capitalise or liquidate" rule mainly happens once insolvency proceedings have been opened, but the existence of the rule may have a significant impact on directors' incentives as the company approaches insolvency.

4.4 Other strategies

In the preceding sections, we have identified the four main legal strategies used by Member States to address the problem of inefficient risk-shifting in the vicinity of insolvency: the duty of company directors to file for the opening of insolvency proceedings; liability attached to a "wrongful trading" prohibition; changes to the content of directors' duties as a company approaches insolvency; and the "recapitalise or liquidate" rule. These strategies are of course complemented, in all jurisdictions, by a number of additional elements.[276]

As "general" duties of directors continue to apply in the vicinity of insolvency, the effectiveness of a regulatory framework will also depend on the effectiveness with which these *general* duties can be enforced. Since most analysed jurisdictions additionally subject managerial decisions that may have led to insolvency to scrutiny based on their general directors' duties-framework, business decisions in near-insolvency situations are also influenced by the standards of review as well as the enforcement mechanisms applicable under the general framework. For example, to the extent that the liability of directors can be limited through the articles, and provided that such limitation remains valid in insolvency,[277] the liability risk of directors may also be reduced for actions taken as the company

[275] See e.g. J Rickford et al., 'Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance' (2004) 15 *European Business Law Review* 919; J Armour, 'Legal Capital: an Outdated Concept?' (2006) 7 European Business Organization Law Review 5.

[276] This complementarity may potentially create frictions in cross-border situations, which will also be addressed in more detail in section 5.

[277] See section 2.7. above. Lithuania and Romania, for instance, permit a limitation of liability for certain types of conduct (but not in cases of gross negligence or intent).

approaches insolvency. Likewise, the possible liability-reducing effects of the business judgement rule[278] also affect the liability risks in near-insolvent firms.

A number of Member States use general civil law (especially tort law) remedies cumulatively with the directors' duties-centred strategies mentioned above. For example Art 1382 French Civil Code provides that *"[a]ny act whatever of man, which causes damage to another, obliges the one by whose fault it occurred, to compensate it."* The same is true for other jurisdictions of French legal origin such as in Belgium[279] and Luxembourg.[280] Countries of other legal origin also often use open-ended tort law provisions that allow for flexible interpretation and may also be applied to establish liability of directors of insolvent or near-insolvent companies. For instance the Dutch,[281]; German[282] and Austrian Civil Codes[283] contain open-ended provisions that may and have been[284] used to hold directors liable in such circumstances. Moreover, such general tort law concepts also inform the interpretation of the relevant company law remedies.

These alternative remedies are typically not linked to the incorporation of the company, but follow different classifications for private international law purposes. This potentially subjects corporate directors to claims in multiple jurisdictions; this will be addressed in Section 5 below.

Apart from tort law-based remedies, Member States differ significantly in their use of criminal law sanctions in relation to conduct resulting in damages for corporate creditors. Rigid criminal law enforcement of insolvency-related misconduct by company directors often also plays a role in producing the evidence that may then be used in civil actions. From the creditors' perspective, the advantages are, first, that the investigations producing the evidence are the publicly funded, and second that prosecutors have more powers to conduct the investigation. This is particularly relevant where criminal law mirrors, or is linked to, the relevant company and insolvency law provisions. In relation to the duty to file this is true, for instance, in Poland, where the failure to file for insolvency itself is a criminal offence.[285] Based on the interviews conducted with practitioners in France, for example, the combination of criminal investigation and subsequent private enforcement of directors' duties is of high practical relevance in small and mid-sized companies.[286]

Moreover, some jurisdictions require the competent insolvency administrators or liquidators to bring or examine potential claims the insolvent company may have against its directors.[287] This can help overcome the problem that in most small and mid-sized companies, directors are typically also major shareholders, and will often have invested a significant portion of their available assets in the (now insolvent) firm. Thus, from a creditors' perspective the enforcement of duties against insolvent companies' directors will often not be economically viable, given the limited assets the defendants possess. Likewise, the evidence provided by the practitioners suggests that incentives of administrators or liquidators often play an important role: where administrators do not sufficiently benefit from bringing legal actions against company directors, even where these actions are successful, this may contribute to perceived low levels of enforcement.

Finally, the director disqualification and eligibility provisions also affect the incentives of directors in near-insolvent firms. However, the effectiveness of these remedies is to some extent inhibited by the mobility of companies across the EU, and the resulting choice of applicable company law. This problem will be addressed in section 5.2.3 below.

[278] See Section 2.4.3 above.
[279] Belgian Civil Code, arts 1382, 1383.
[280] Luxembourg Civil Code, arts 1382, 1383.
[281] See s 6:162(1): "A person who commits a tortious act (unlawful act) against another person that can be attributed to him, must repair the damage that this other person has suffered as a result thereof".
[282] See s 823(2): "a person who commits a breach of a statute that is intended to protect another person" is liable for damages.
[283] See s 1311 of the Austrian Civil Code.
[284] See for example the German Federal Court of Justice (BGH), judgment of 06 June 1994, II ZR 292/91, BGHZ 126, 181.
[285] See s 586 of the Polish Criminal Code; see also M Zurek in M Siems and D Cabrelli (eds) *Comparative Company Law – A Case-Based Approach* (Oxford: Hart 2013) 45.
[286] See also P-H Conac in: M Siems and D Cabrelli (eds) *Comparative Company Law – A Case-Based Approach* (Oxford: Hart 2013) 35.
[287] This is true, for instance, in Spain, where claims against directors are brought in more than 80% of the cases.

4.5 How and at what point in time do the remedies operate

Our findings suggest that significant differences exist in relation to the existence of special vicinity of insolvency duties as well as, where applicable, the relevant "triggering event" for such duties in the vicinity of insolvency to apply.

First, the divergence in Member States' laws can be attributed to general differences in the applicable insolvency laws. Although all examined jurisdictions attach importance to both, balance-sheet and cash-flow insolvency, differences exist in the relative emphasis any given jurisdictions puts on these two criteria. While the general insolvency law framework lies outside the main scope of our Report, questions relating to the duties in the vicinity of insolvency cannot fully be separated from the general insolvency law framework.

Moreover, a closer examination is necessary, including in relation to those jurisdictions that do not provide for a formal change to the core duties of directors as the company approaches insolvency.[288] Although most Member States do not adapt the formal definition of the behavioural standards against which to assess directors' actions in "near-insolvent" companies, the application of the general duties may have similar effects in practice, depending on the interpretation of the legal rules by local courts.

To capture this effect and in order to gain a better understanding of the application of duties in the vicinity of insolvency, we designed a hypothetical case[289] and asked our Country Experts to give us feedback on the likely outcome of a case of this nature under their national law. In addition, we used the context created through our cases to ask related questions about the rules applicable to near-insolvent companies. The answers we have received are summarised in the table below.

As can be seen from the summary, the Member States differ in their approaches to resolving the case described, as do the likely outcomes.

The case[290] involves a thinly capitalised[291] company whose directors enter into a derivative contract. Under that contract, the company faces the risk of losses that would wipe out the company's remaining equity, although the directors consider the risk to be low. Overall, the situation described involves the directors taking a business decision favourable to the company's shareholders and potentially detrimental to creditors. Under the laws of most Member States, the actions of the directors would not result in the liability of directors.[292]

Table 4.4.a Answers to questions covered by Hypothetical II

Country	*Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?*	*What is the relevant "triggering event"?*	*Likely outcome in cases covered by H-II*
Austria	Yes, if there is a substantial risk of wiping out remaining equity. Based, *inter alia*, on criminal law liability for harming	No particular "triggering event" referring to equity ratios or the like Generally recognized that fewer risks may be taken once the	Given that the company is not insolvent, although weakly capitalised, at the time the decision to trade is made, and taking into account that the company's business model is not *per se* unsustainable, liability under "duty to file" rules

[288] See Section 4.2 above.
[289] See Hypothetical II, Annex.
[290] The full text made available to our Country Experts can be found in the Annex.
[291] We used equity ratios of 1%, 5%, or 10%, and stated that on average comparable companies in the same line of business operate with an equity ratio of about 25%.
[292] Liability would, however, be likely under the laws of the Czech Republic, France, Greece, and Hungary.

Country	Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?	What is the relevant "triggering event"?	Likely outcome in cases covered by H-II
	creditors.	company's financial situation becomes "critical".[293] Directors should be discouraged from "gambling way out of insolvency"	would not apply. Directors may be liable depending on *ex ante* assessment of riskiness of the transaction. Even though they still had some equity cushion, they would not have been allowed to take a "substantial risk" of wiping out the company's remaining equity.
Belgium	Relevant question is whether "reasonable director" would have entered into the transaction Where business is "unreasonably" continued after company is insolvent, liability attaches based on Art. 527 CC (enforceable by the company/liquidator) and Art. 1382 Civil Code (enforceable *directly* by any injured party)	Unclear whether duties change at all. In any case, no clear triggering event Duty to convene would, however, apply	Disputed whether (and if, when) duty of loyalty (to act in good faith and have regard to the company's interest) changes in the vicinity of insolvency. Relevant question here is whether "reasonable director" would have entered into the transaction. If so, business judgement falls within the acceptable margin of discretion. Company will have lost half of its capital before entering into transaction. In case the relevant formalities have not been complied with, presumption that this caused damage to company and creditors.
Bulgaria	No duty that prevents directors from entering into particularly risky transactions *per se*, even if thinly capitalised	No specific vicinity of insolvency duties apart from duty to convene meeting of shareholders when equity falls below registered capital or where losses exceed 25% of the registered capital, but no change of duties at that point	Probably no liability if directors complied with duty to convene the general meeting, as company was neither cash-flow insolvent nor over-indebted at the time of entering into the transaction.
Croatia	No specific rules that would prevent risky transactions in companies with thin equity cushion Only general duty of care and business judgement apply	No specific vicinity of insolvency duties apart from duty to convene meeting of shareholders when half of the company's share capital is lost, but no change of duties at that point	Duties of directors remain unchanged despite the thin equity cushion. Thus, the relevant question is whether the business decision to enter into transaction was taken with due care and in good faith for the benefit of the company
Cyprus	Possible that English case law regarding the intrusion of creditor interests apply in	Duty to convene meeting of shareholders when half of the company's share capital is lost,	Unlikely that director would be held liable absent fraudulent preference vis-à-vis certain creditors

[293] See generally C Nowotny in: P Doralt, C Nowotny, and S Kalss (eds.), *Commentary to the Stock Corporation Act* (2nd ed; Vienna: Manz 2012) § 84 No 9.

Country	Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?	What is the relevant "triggering event"?	Likely outcome in cases covered by H-II
	specific circumstances, but uncertain due to lack of case law	but no change of duties at that point	
Czech Republic	Application of general duty of care, but fact-specific assessment, taking into account the company's financial position	No clearly defined, separate concept of vicinity of insolvency (but duty to convene applies)	Directors would most likely be liable because the application of the duty of care suggests that company's equity cushion is too thin for the transaction in question.
Denmark	No specific prohibition of, or restriction in relation to risky transaction. However, a generally heightened standard of care applies in thinly capitalised companies	No clear definition of triggering event Case law suggests that the relevant point in time is defined by there not being a reasonable prospect for saving company	Most likely no liability provided that decision was taken bona fide and with sufficient information. Danish version of the business judgement rule would likely apply
Finland	Application of general duty of care, but situation-specific assessment, taking into account the company's financial position	Duty to convene meeting of shareholders when half of the company's share capital is lost, but no change of duties at that point	Absent criminal conduct (dishonesty, fraudulent conveyance, etc.), directors would probably not be liable based on their entering into the transaction before company is insolvent
France	Application of general duty of care, but situation-specific assessment, taking into account the risk involved in transaction	No specific pre-insolvency duty	Given the circumstances, directors would likely be held liable for causing insolvency of the company in breach of their (heightened) duty of care
Germany	Companies must not enter into particularly risky transactions if they pose an existential risk to the company Directors may not enter into transactions that entail a substantial risk of the company not surviving	No specific definition of a triggering event Duty of directors to keep company appropriately capitalised for activity pursued	Directors are not likely to be held liable in the described situation, since company is not yet insolvent (albeit weakly capitalised) Directors may be liable, if assessment of riskiness of the transaction means that company is not appropriately capitalised for the activity pursued. However, it is accepted that directors, even directors of thinly capitalised companies, are not under an obligation to act in the primary interest of creditors instead of the interest

Country	Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?	What is the relevant "triggering event"?	Likely outcome in cases covered by H-II
			of the company.
Greece	Yes. "Prudent businessman" standard continues to apply in adapted form. Prevailing view is that, as the company approaches insolvency, directors must take care of creditors' interests in priority to those of the company and the shareholders	No clear definition of triggering event Prevailing view is that the relevant point in time is defined by there not being a reasonable prospect for saving company with "prudent management" (i.e. without taking excessive risk)	In the case at hand. directors will probably face liability towards creditors under Article 98 of the Bankruptcy Code, i.e. for causing insolvency. In addition, internal liability towards the company will also apply.
Hungary	No specific rule on risk-taking. Relevant question is compliance with business judgement standards, and here the determining factor is whether risks taken were unreasonable	No clear triggering event Relevant test is threat of insolvency, to be assessed on the basis of a liquidity forecast. Factors, like the status of the company's markets, business trends, and various economic factors play a role, too.	The directors prepared the transaction with the reasonable care, but left the company unprotected against a risk. Although risk was judged to be low company was threatened with insolvency. Risk could have been mitigated/insured against The decision involving such a risk would presumably be held as exceeding "normal business risks". Thus, directors are to be held failing to act in compliance with the required duty of care and their liability may be established vis-á-vis the company. If the company entered liquidation , direct liability vis-á-vis the creditors.
Ireland	Yes - duty to consider the interests of creditors will displace the duty to act in the interests of the company	No clear definition of the vicinity of insolvency. Case law suggests that a formal declaration of insolvency or initiation of insolvency processes need not have occurred for duty to consider creditors' interests to be triggered. Courts are, however, pragmatic and recognise that the directors should not be under a duty to cease trading immediately provided that *there is a chance* that the	It is likely that a sympathetic approach would be taken considering the exceptional nature of the fall in oil prices. Judges are careful not to second-guess business decisions with hindsight.

Country	*Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?*	*What is the relevant "triggering event"?*	*Likely outcome in cases covered by H-II*
		company could trade its way out of its difficulties.	
Italy	With the exception of gross negligence (eg. Cass.8 May 1991 n. 5123 in Foro it, 1992, I, 817), Italian courts will not second-guess managerial decisions. However, duty of care standard applies.	There is no definition of 'vicinity of insolvency' under Italian law and it is unlikely that a director can be considered to have a duty to protect the interests of creditors before (some or all of) the requirements for an insolvency declaration are present.	Based on the facts of the case, the conditions for a duty to apply for insolvency proceedings had not been met. The directors' decision was difficult and risky, but would probably be acceptable on the basis of the market conditions at the time when it was made.
Netherlands	There is no specific regulation in Dutch law preventing directors from entering into particularly risky transactions.	No formal change of duty of company directors from shareholder interests to creditors' interests, in the vicinity of insolvency. Case law suggests, however, that at a moment where directors should have realised that the company will not be able to meet its future obligations, the directors are liable under tort law principles	In this case the risk seems to be rather calculated and it is unlikely that directors would be held liability for the consequences of the sudden sovereign debt crisis and the worldwide economic crisis following from that. This, however, depends on the level of predictability of the crisis, as assessed by a careful company director at the time the transaction was entered into.
Poland	This is being discussed in legal literature. The current consensus seems to be that even very risky transactions entered into by a still-solvent company do not lead to liability of directors	No specific new duties or rules that apply in the vicinity of insolvency (apart from duty to convene the general meeting)	Most likely no liability based on facts described in Hypothetical II
Portugal	Duties of directors only prevent them from entering into transactions or taking decisions involving disproportionate or unreasonable risks	No express acknowledgement of vicinity of insolvency duties No specific legal provision directly providing for a shift of directors' duties towards creditors	Most likely no liability, if decision was taken in an informed way, free of any personal interest and according to the standard of "entrepreneurial rationality"
Romania	No	Romanian law does	No liability. Provided the other

Country	Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?	What is the relevant "triggering event"?	Likely outcome in cases covered by H-II
	Business judgement rule continues to apply. As long as risk-taking is not unreasonable, no *prima facie* restrictions in relation to risk-taking, even in near-insolvent companies	not modify directors' duties in the vicinity of insolvency. Remedies operate only upon company is insolvent. Law does not require directors to act in the interest of creditors before company enters into insolvency	conditions are met, directors will be protected by business judgement rule as long as risk-taking was not "unreasonable". Liability will not arise unless and until the company is insolvent. Directors may, but are not obliged to file for insolvency proceedings where insolvency is "imminent"
Slovenia	No specific rule on risk-taking. Relevant question is compliance with duty of care, and liability arises where insolvency has been caused in breach of this duty	Slovenian company law does not define a point in time after which duties are applied differently	Unclear whether liability would exist – this depends on the assessment of the directors' action against the general care standard.
Spain	No specific rule on risk-taking general duty of care continues to apply	Spanish law does not provide additional duties in situations of financial distress. Duties continue to apply in the vicinity of insolvency without significant adjustments A so-called "suspicious period", is, however, recognised, covering the two years preceding the opening of the insolvency. A special liability applies for certain actions during that time, but no liability is created for actions that would not also have been illegal in solvent company.	Liability would most likely not arise, unless "recapitalise or liquidate" rule has not been complied with.
United Kingdom	Yes - when a company is operating in the <u>zone of / approaching cash-flow insolvency</u> the duties owed to the company (s172 Companies Act 2006) become duties to promote the success of the	The law remains somewhat unclear on what is the "verge" of insolvency and in what ways creditors interests are taken into account in this zone (priority versus plurality).	On these facts the risk of failure that is apparent would mean that the interests of creditors would intrude. However, the business judgment taken to buy the futures would be judged according to the section 172 standard which is a subjective standard (in practice a rationality standard). There appeared at the time to be a sound basis for this decision,

Country	*Do fiduciary duties prevent directors from entering into particularly risky transactions as the one described in H-II?*	*What is the relevant "triggering event"?*	*Likely outcome in cases covered by H-II*
	company *for the benefit of both creditors and shareholders* and to take due care in so doing. Once company is insolvent those duties are then to promote the interests of the *creditors alone* and to take care in so doing		accordingly there would be no breach. In relation to the duty of care the facts suggest that due care was taken which would comply with the UK's dual subjective / objective care standard. Wrongful trading: although wrongful trading could provide a remedy when taking risky decisions in the zone of insolvency, the facts suggest (low probability of price drop) that this would not provide a remedy in this context. The remedy imposes creditor regarding obligations when a director should have realised there was no way of avoiding insolvent liquidation. The law has not attempted to define the probability of avoidance required by this provision. The low probability suggested in the facts would not be sufficient.

5. Cross-border issues

The findings in Sections 1 through Section 4 of this Part highlight the significant differences in the substantive law as well as in the enforcement of directors' duties and liabilities throughout the European Union. This section aims at highlighting the areas where these differences may create particular challenges as a consequence of cross-border operation or administration of companies.

5.1 Real seat and incorporation theories

Summary of the country reports in tabulated form

Table 5.1.a: Private international law rules and "connecting factors" in Europe

Country	*Primary connecting factor?*	*Did the position change as a consequence of the jurisprudence of the Court of Justice of the European Union?*	*Rule dependent on company falling under Art 54 TFEU?*	*Remarks*
Austria	real seat (headquarter, jurisdiction in which central business decisions are made and implemented)	no explicit change, but direct applicability of Treaty leads to changed result	effectively yes, since courts cannot apply statutory rules to Art 54-companies	statutory rule; not applied by courts to companies falling under Art 54 TFEU since Centros decision of the ECJ
Belgium	real seat ("principal establishment")	no explicit change, but direct applicability of Treaty leads to changed result	effectively yes, since courts cannot apply statutory rules to Art 54-companies	statutory rule; *renvoi* possible; courts will not normally apply the statutory rule to companies falling under Art 54 TFEU (disputed) The transfer of a company's "real seat" in combination of a re-registration without dissolution (as required by the Treaty) is recognised.
Bulgaria	incorporation / registration	no	no	incorporation doctrine had already applied before Bulgaria joined the EU
Croatia	incorporation / registration	no	no	Croatia applies the incorporation doctrine to all foreign entities
Cyprus	incorporation / registration	no	no	Follows the common law tradition in referring to the country of incorporation; National companies are not restricted in moving their

				administrative seat out of Cyprus.
Czech Republic	incorporation / registration	no	no	While the applicable law is determined based on the place of incorporation, certain substantive law rules apply to foreign incorporated entities. National companies are not restricted in moving their administrative seat out of the Czech Republic.
Denmark	incorporation / registration	not in relation to the private international law rule	no	"Scandinavian version" of incorporation theory, but Danish companies are required to have and maintain a "real link" with Denmark for Danish company law to apply; Centros, which concerned a UK company established by Danes, rendered inapplicable an "outreach"-type[294] statute
Estonia	real seat	yes	Yes	Traditionally applied real seat doctrine
Finland	incorporation / registration	no	no	"Scandinavian version" of incorporation theory.
France	mixed	unclear; no change of the statutory rule, and depending on interpretation of the rule by the courts, the application of French law to foreign companies may be compatible with the Treaty	no, although this may ultimately depend on the courts' interpretation of the "no escape" doctrine	The primary connecting factor is the statutory seat. Specific provisions of French law can apply to companies having their real seat in France (based on residence of directors and place of decision-making), however. This is decided on a case by case basis. The few cases so far dealt with criminal law liability. The main reasoning behind the application of French law to foreign entities seems to be an attempted "escape" from French law; as such, this may also apply to directors' duties. In any event, moving the real seat into France does not lead to automatic dissolution, but may trigger requirement to re-register
Germany	real seat (headquarter, jurisdiction in which central business decisions are made and	yes	yes, but some lower courts have applied this to non-EU companies, too	No explicit codified rule, but prevailing view in both court opinions and scholarly writing. Not applied by courts to companies falling under Art 54 TFEU since Centros decision of the ECJ

[294] I.e. a statute that lays down specific additional substantive law rules applicable to companies incorporated abroad, but maintaining a close connection with another jurisdiction.

	implemented)			German private limited companies may locate their real seats outside Germany while remaining subject to German law.[295]
Greece	real seat	yes	yes, but also applies to companies formed under the laws of certain other countries (including the US) and to companies in certain business sectors - in particular to shipping companies	shipping companies and companies formed in certain countries with which special treaties have been concluded are exempted from the application from the real seat doctrine. This also applies to Art 54-companies due to the direct applicability of the Treaty; no change of statutory law. National companies can still move their real seat out of Greece
Hungary	incorporation / registration	no	no	Hungary applies the incorporation doctrine to all foreign-incorporated companies Hungary previously required that companies established under Hungarian law maintain their real seat in Hungary.[296] This requirement has since been abolished.[297]
Ireland	incorporation / registration	no	no	Generally follows the common law tradition in referring to the country of incorporation. In relation to some matters, position is somewhat unclear: The duty of care in tort (but not the equitable duty of care) will be governed based on the proper law of the tort based on the place where the substance of the tort arose, and may thus apply to companies incorporated abroad. National companies are not limited in moving their administrative seat out of Ireland.
Italy	mixed	yes	yes	The primary connecting factor is the statutory seat. However, Italian company law applies to companies having their real seat ("principal activity) in Italy, irrespective of the state of incorporation. This does no longer apply to Art 54-companies, although certain mandatory Italian

[295] See s.4a German Private Limited Company Act; s.5a German AktG.
[296] See the *Cartesio* judgment of the Court of Justice, Case C-210/06 [2008] ECR I-09641.
[297] See V Korom and P Metzinger, "Freedom of Establishment for Companies: the European Court of Justice confirms and refines its Daily Mail Decision in the Cartesio Case C-210/06" (2009) 6 *European Company and Financial Law Review* 125.

				law rules may continue to apply to such entities (where compatible with the Treaty), including criminal law rules. No change of statutory rules as a consequence of *Centros*, but courts will not apply Italian company law to foreign EU companies
Latvia	real seat	yes	yes	
Lithuania	real seat	yes	yes	
Luxembourg	real seat	yes	yes	National companies can move their administrative seat out of Luxembourg despite real seat approach.
Malta	Incorporation theory	no	no	Follows the common law tradition in referring to the country of incorporation. National companies are not limited in moving their administrative seat out of Malta.
Netherlands	incorporation / registration	not in relation to the private international law rule	no	Adopted incorporation theory in 1959.[298] The Foreign Companies Act continues to apply, but since Inspire Art no longer applicable to Art 54-companies. The conflict of law rule has not been affected by the jurisprudence of the ECJ
Poland	unclear	yes	unclear	Polish private international law has recently been changed (2011). The new provisions define the seat of the company as the connecting factor, but do not define the concept of the "seat". The emerging consensus among legal scholars seems to interpret the "seat" as a reference to the place of incorporation, which would mark a deviation from the traditional real seat doctrine applied in Poland. However, this has not yet been tested in the courts. In relation to Art 54-companies, the consensus among legal scholars is that only the place of incorporation should be taken into account in determining the applicable law
Portugal	real seat	yes	yes	No change of statutory law, but accepted by courts that real seat doctrine cannot be used to impose Portuguese company law on Art 54-companies. Third parties may rely on the

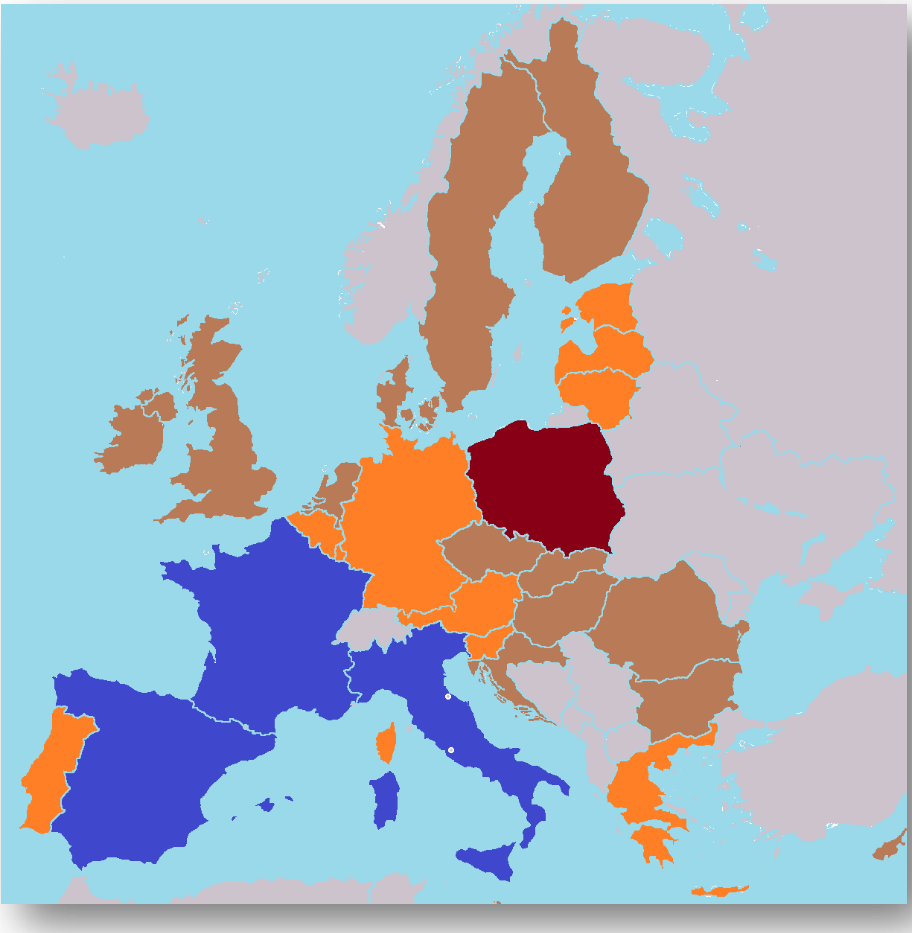
[298] See S Lombardo, "Conflict of Law Rules in Company Law after Überseering" (2004) 4 *European Business Organization Law Review* (EBOR) 301, 311.

				application of the law of incorporation irrespective of the real seat. Companies have to accept being subjected to incorporation law in dealings with third parties. In addition, companies with their real seat in Portugal are under an obligation to incorporate under Portuguese law.[299]
Romania	incorporation / registration	no	no	
Slovakia	incorporation / registration	no	no	
Slovenia	real seat	probably yes	yes	not applied to Art 54-companies
Spain	mixed form	probably yes	yes	The position of Spain is not entirely clear. The majority opinion seems to be that the *domicilio* of a company – the determining factor for the applicable law – is equivalent to the country of incorporation. Some scholars take the view, however, that the *domicilio* is to be interpreted as the location of its central administration. Companies incorporated in Spain are subject to Spanish law irrespective of the location of their central administration.
Sweden	incorporation / registration	no	no	"Scandinavian version" of incorporation theory.
United Kingdom	incorporation / registration	no	no	Incorporation doctrine tradition based on common law

[299] See in more detail Section 5 of the Portuguese Report, Annex I.

Discussion

Map 5.1.a: Private international law approaches to foreign incorporated entities across Europe



Legend	Country
Real seat doctrine	AT, BE, BG, HR, EE, EL, DE, LV, LT, LU, MT, SI
Incorporation doctrine	CZ, DK, FI, HU, IE, NL, RO, SE, SK, UK
Mixed approach	FR, ES, IT, PT
Unclear	PL

The Court of Justice of the European Union, with its decisions in *Centros*[300] and subsequent cases,[301] has in effect significantly increased the availability of foreign company law forms to incorporators across Europe. As a result, a growing number of companies headquartered – and sometimes

[300] Case C-212/97 *Centros Ltd. v Erhvervs- og Selskabsstyrelsen*, [1999] ECR I-1459.

[301] See, in particular, Case C-208/00, [2002] ECR I-9919 *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)* ("Überseering"); Case C-167/01, [2003] ECR I-10195 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd* ("Inspire Art"); Case C-210/06, [2008] ECR I-9641 *Cartesio Oktató és Szolgáltató bt.*("Cartesio").

exclusively operating – in a particular jurisdiction will be subject to the company laws of another Member State.[302]

At its core, the jurisprudence of the European Court of Justice ensures that companies formed in accordance with the law of one Member State (i.e. the "home state") will not be subjected to the substantive *company* law provisions of another Member State (the "host state") merely because the company's headquarters, central management, principal establishment or the directors' residence is located in the host state.

As can be derived from the Court of Justice's decision in *Segers*[303] and in line with the relevant European legal literature, the exclusive application of the home Member States' company law mandated by the *Centros* line of cases also applies, in principle, to the regulation of both duties and liability of board members.[304] This primarily means that incorporators, when choosing between the available company laws, also choose the legal framework for directors' duties and liabilities.[305] Host Member States cannot "impose" on companies incorporated in another Member State their domestic legal rules about directors' liability; a core area of company law, the main duties of directors are subject to the law of the Member State of incorporation only. The alternative approach would potentially subject directors to claims under multiple substantive laws and, as such, be 'liable to hinder or make less attractive' the exercise of freedom of establishment. At least when applied generally to all companies, the imposition of domestic rules on directors' duties and liability will typically not be justifiable, and thus be incompatible with the Treaty.

The table above outlines the main connecting factors used by the private international law of the jurisdictions assessed in this report. As the Court of Justice has held in *Cartesio*,[306] Member States are effectively free to restrict the *availability of their company laws* to businesses that mainly, or at least exclusively, operate outside their territory. Accordingly, Member States are free to restrict the transfer of the central management of a company formed in accordance with its laws. This Member State right is in so far qualified as all Member States, irrespective of their private international law rules, are obliged to permit a transfer of the "incorporation seat" to another jurisdiction. Accordingly, a company may decide to subject itself to another Member State's company law, and the (original) home Member State must not prevent or restrict such a transfer resulting in a change of the applicable law.[307]

Traditionally, the ability of a company to have its centre of operations outside the jurisdiction it is incorporated in was closely correlated to the private international law framework adopted by the relevant jurisdiction. Countries following the incorporation doctrine generally allowed companies to incorporate in their jurisdictions, irrespective of whether a substantial link existed between the operations of the company and this jurisdiction. Countries following the real seat doctrine, on the other hand, traditionally required from their own companies that they maintain their central administration within their jurisdiction. As can be seen from the table above, this situation has somewhat changed, as a number of countries traditionally applying the real seat doctrine now permit a transfer of "their"

[302] For a discussion of the effects, see e.g. J Armour and WG Ringe, 'European Corporate Law 1999-2010: Renaissance and Crisis' (2011) 48 *Common Market Law Review* 125; J Rickford , 'Current Developments in European Law on the Restructuring of Companies: An Introduction' (2004) 6 *European Business Law Review*1225; WG Ringe, 'Company Law and Free Movement of Capital' (2010) 69 *Cambridge Law Journal* 378; C Gerner-Beuerle and M Schillig, 'The Mysteries of Right of Establishment after Cartesio' (2010) 59 *International & Comparative Law Quarterly* 303; V Korom and P Metzinger, "Freedom of Establishment for Companies: the European Court of Justice confirms and refines its Daily Mail Decision in the Cartesio Case C-210/06" (2009) 6 *European Company and Financial Law Review* 125; F Mucciarelli, 'Company 'Emigration' and EC Freedom of Establishment: Daily Mail Revisited' (2008) 9 *European Business Organization Law Review* 267; WF Ebke, 'The European Conflict-of-Corporate-Laws Revolution: Uberseering, Inspire Art and Beyond' (2004) 38 International Lawyer 813; G Eckert, *Internationales Gesellschaftsrecht* (Vienna: Manz 2010); P Paschalidis, *Freedom of Establishment and Private International Law for Corporations* (Oxford: Oxford University Press 2012).

[303] Case 79/85 [1986] ECR 2375 *D. H. M. Segers v Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen.*

[304] See also the discussion in P Paschalidis, *Freedom of Establishment and Private International Law for Corporations* (Oxford: Oxford University Press 2012).

[305] See the extensive discussion in G Eckert, *Internationales Gesellschaftsrecht* (Vienna: Manz 2010) particularly pp 356 et seqq.

[306] Case C-210/06, [2008] ECR I-9641.

[307] See, to that effect, Case C-210/06, *Cartesio* [2008] ECR I-9641, especially para. 110-112.

companies' central management to another jurisdiction. The historical link between the two questions (i.e. private international law in relation to foreign-incorporated companies and company law requirement to maintain the "real seat" of a domestic company within a jurisdiction) has thus been significantly weakened.

The consequence of the above is twofold. First, the jurisprudence of the Court of Justice effectively requires all Member States, irrespective of their private international law approach, to accept foreign-incorporated companies to establish their central administration within their territory. Second, a large variety of different company laws, including company laws of Member States still applying a real seat-approach to foreign companies,[308] are available to businesses across Europe. As mentioned above, this also includes the legal frameworks dealing with directors' duties and liabilities.

5.2 Potential conflicts

We identify a number of potential conflicts that can arise between different national rules in the area of directors' duties and liability.

5.2.1 Employment law and directors' duties

National Member State law in some cases applies special employment law rules to directors, sometimes aimed at mitigating liability of such employees. While the liability of the director has to be determined, in effect, based on the law of the Member State of incorporation, the applicable labour law has to be determined applying Art 8 of the Rome I Regulation.

Art 1 (2) (f) of the Rome I Regulation generally excludes from its scope matters relating to directors' liability, but some Member States' company laws seem to permit, under certain circumstances, the application of less stringent employment legislation mitigating the liability of directors.

Our interviews with corporate law practitioners as well as the additional input we received from our Country Researchers and Country Experts suggest that no major problems arise in relation to this point. This is mainly due to the fact that, where mitigation of liability is accepted, such mitigation mainly seems to apply in relation to claims based on the relevant employment or service contracts with the relevant directors.

5.2.2 Directors' duties and general civil liability

As discussed in Sections 2 through 4, we find a significant degree of variation among Member States regarding the legal mechanisms for subjecting directors to liability. Not all Member States exclusively rely on company law mechanisms in this regard. Thus, rules which in a national context merely operate as functional substitutes for company law-based liability provisions can have the effect of subjecting directors to multiple and conflicting obligations. Where a Member State, for example, contains provisions regarding the liability for harming creditors' interests in its *general civil law*, such rules may expose the director to liability under both the applicable company law and the "foreign" general civil law.

The problem is similar to that described in Section 5.2.3 below, as it mainly plays a role in circumstances where the company operates outside the jurisdiction of its incorporation. This problem may thus potentially affect all companies with cross-border operations.

[308] These Member States are, of course, restricted in applying this approach to EU companies, as discussed immediately above. See also G Eckert, *Internationales Gesellschaftsrecht* (Vienna: Manz 2010).

5.2.3 Directors' duties in the vicinity of insolvency

Summary of the country reports in tabulated form

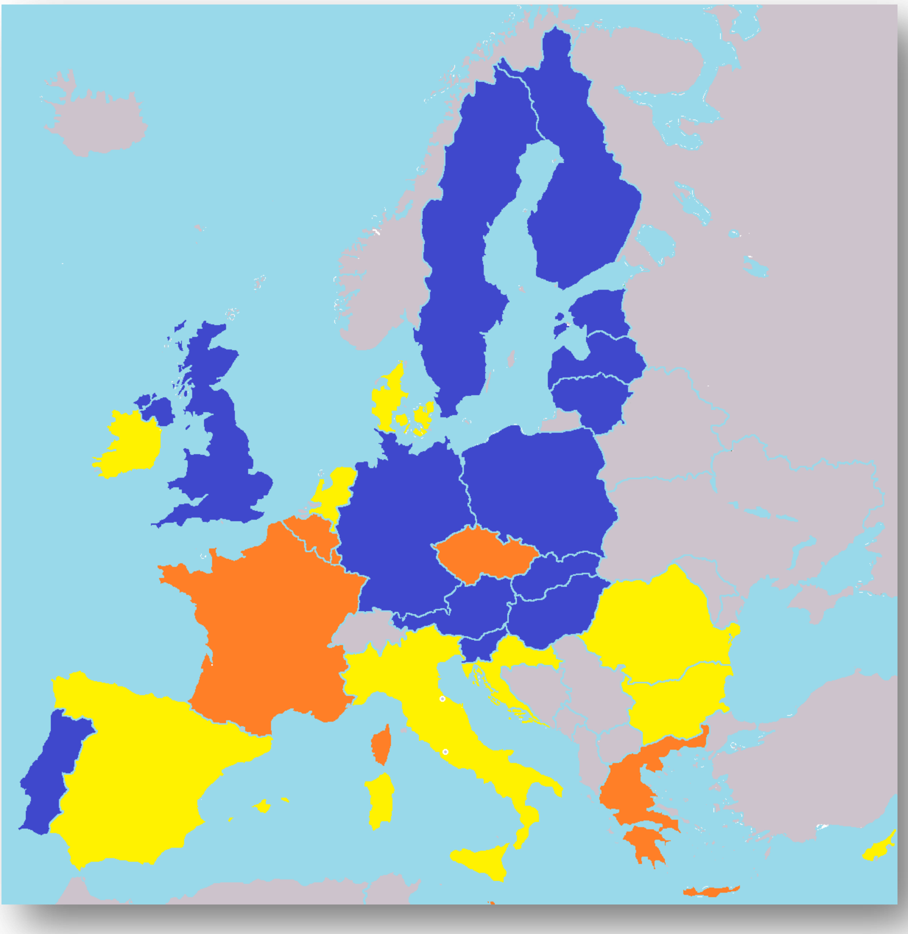
Table 5.2.3.a: Classification of directors' duties in the vicinity of insolvency for purposes of private international law

Country	*Classification*
Austria	partly company law, but disputed for duty to file for insolvency as well as duty to reorganise/recapitalise
Belgium	insolvency law regulates managerial conduct that aggravates or contributes to insolvency; unclear as to late filing duty, but majority view seems to classify this duty as part of insolvency law and thus following the COMI-approach; in addition, general duty of care in tort law may apply in certain circumstances (also to foreign companies)
Bulgaria	main duty is "re-capitalise or liquidate", which clearly only applies to companies incorporated in Bulgaria; the duty to file for insolvency, which does not seem to play an important role in practice, is probably to be classified as insolvency law and thus will apply to companies having their COMI in Bulgaria
Croatia	mainly company law
Cyprus	mainly company law, including criminal sanctions contained in Cyprus Companies Act
Czech Republic	currently classified as insolvency law, but recent changes appear to re-enact equivalent rules as part of company law; once the amended legislation comes into force, it appears that foreign-incorporated companies and their directors will not be subject to the main Czech pre-insolvency duties
Denmark	company law
Estonia	classification not entirely clear, but probably a combination of company, insolvency and tort law
Finland	core duties are part of company law, but important parts are contained in criminal law which could also apply to foreign-registered companies
France	insolvency law
Germany	disputed; probably insolvency law for the duty to file for insolvency
Greece	mainly insolvency law
Hungary	This point is not entirely clear; the position seems to be that the main liability rules form part of company law and are thus only applicable to Hungarian companies. Hungarian law does, however, contain a special duty of loyalty towards creditors for directors of near-insolvent companies, and attaches liability to the breach of this duty. The latter liability may also apply to foreign-registered companies having their COMI in Hungary
Ireland	mainly company law, but not entirely clear for specific liability heads such as reckless trading under s297 of the Companies Act 1963.
Italy	mainly company law
Latvia	classification not entirely clear, but probably a combination of company, insolvency and tort law
Lithuania	classification not entirely clear, but probably a combination of company, insolvency and tort law

Country	Classification
Luxembourg	mainly insolvency law
Malta	mainly insolvency law, but situation not entirely clear
Netherlands	mainly company law, but nevertheless specific liability rules apply to companies domiciled in the Netherlands
Poland	combination of company law and insolvency law rules
Portugal	unclear; both company law rules and insolvency rules govern the duties in the vicinity of insolvency, but classification is unclear in relation to specific rules such as, in particular, Article 84 of the Portuguese Code of Commercial Companies, which provides for the unlimited liability of the sole shareholder of a limited company that has become insolvent.
Romania	mainly company law
Slovakia	combination of insolvency and company law
Slovenia	mainly company law, but insolvency law also plays important role in this area
Spain	mainly company
Sweden	combination of company law and insolvency law
United Kingdom	core duties, including intrusion of creditors' interests, are classified as company law, but wrongful trading applies on COMI-basis

Discussion

Map 5.2.3.a: Classification of rules aimed at restricting or regulating near-insolvency trading for private international law purposes



Legend	Country
Mainly insolvency law	FR, BE, CZ, EL, LU, MT
Mainly company law	IT, IE, BG, RO, CY, ES, DK, NL, HR
Mixed approach or unclear/disputed	UK, PT, AT, DE, FI, SE, LT, LV, EE, SK, SI, HU, PL

As Table 5.2.3.a shows, virtually all Member States employ one or more of the following legal instruments to address problems in relation to managerial conduct where the company is in the vicinity of, or once it reaches, insolvency:

- traditional company law duties: i.e. in particular the duty of care and the duty of loyalty;
- additional duties that apply in the vicinity or upon reaching insolvency: e.g. a duty to file for the opening of insolvency proceedings, wrongful trading prohibitions; and
- general or special tort law rules that are used to hold directors liable in case they cause or contribute to the company's insolvency;

- rules of criminal liability, sometimes linked with tort law liability towards creditors where the director is found guilty.

The exact "classification" of such rules is of little concern in purely domestic settings, and often legislators will thus not have paid much attention to the location of the rules within the national legal order as long as the rules are effective when applied in cumulatively.

For companies exercising their freedom of establishment under the Treaty, however, such classification may play a significant role.

A number of Member States use a combination of two or more of the strategies mentioned above.[309] In addition, there often is no coherent view in the legal literature and in case law whether to classify a particular legal instrument as part of company law, insolvency law, or tort law. It is also possible that functionally related instruments are classified differently under private international law and, accordingly, are subject to different connecting factors.[310]

Map 5.2.a above highlights the private international law classification for the most important legal strategies employed by Member States in relation to the managerial behaviour in near-insolvent firms. Not all Member States have rules explicitly dealing with this issue, but in the vast majority of Member States at least a subset of the problematic cases is dealt with by company law, insolvency law, and/or tort law rules.[311]

In countries highlighted in *blue*, the exact private international law classification of the rules we consider to be particularly important cannot be determined, is disputed, or differs across a range of inter-connected legal remedies relating to near-insolvency situations. In addition, all countries highlighted in yellow rely mainly or exclusively on company law mechanisms.

The consequence of this is that a coherent set of interconnected rules on the national law level may be dissected by virtue of the private international law. As outlined above, company law is now essentially determined according to the state of incorporation across the EU, while insolvency law applies on the basis of the COMI.

In combination with the "scattering" of legal strategies across multiple private international law categories across the EU, this may result in the partial application of different legal systems whenever a company has its COMI in a location that differs from its jurisdiction of incorporation. If companies and directors are subject to other regulatory regimes in addition to the state of incorporation, which of course determines liability of the directors under the general rules on directors' duties, they may be dissuaded from exercising their free movement rights under the Treaty.

Consequently, the likely disadvantages of the current legal situation in many Member States are as follows:

(1) The uncertain scope of the private international law rules and the criteria for classification of the substantive provisions on directors' duties in the vicinity of insolvency creates legal uncertainty.

(2) Where two or more legal instruments function as legal complements in a jurisdiction, but these instruments are subject to different connecting factors and these connecting factors lead to the application of different national laws, the lack of coordination in the conflict of law rules may result in regulatory gaps.

[309] See e.g. the wrongful trading prohibition under English law, s.214 Insolvency Act 1986 and the "intrusion" of creditor interests in the definition of the core duties under s172 Companies Act 2006. See also the answers to the Hypotheticals in Section 4.5.

[310] An example are the duty of directors under German law to file for the opening of insolvency proceedings (s. 15a Insolvency Act) and liability for the failure to file (liability to the company is based on s. 93(2) Stock Corporation Act and to creditors on s. 15a Insolvency Act in conjunction with s. 823(2) Civil Code (protective law)), which are classified as insolvency law for purposes of private international law (disputed); liability for fraud pursuant to s. 263 Criminal Code in conjunction with s. 823(2) Civil Code, qualified as tort; and the reclassification of shareholder loans as equity in the vicinity of insolvency, classified as company law for purposes of private international law (disputed). It may be argued that these legal instruments *in combination* form what constitutes a significant part of the German creditor protection regime and that their dissection through conflict of laws is neither efficient nor conducive to legal certainty.

[311] See Section 4. above for details.

(3) It is unclear whether, and under what conditions, the application of additional duties and liability provisions, for example pursuant to the *lex loci delicti commissi*[312] to directors of companies incorporated under a different jurisdiction is compatible with Arts. 49, 54 TFEU.

The second point may be illustrated by an example. In most jurisdictions, directors' duties under company law and insolvency law or in the vicinity of insolvency are functional complements. The level of shareholder and creditor protection can only be appreciated if mechanism derived from company law, insolvency law, and possibly also tort and contract law, are taken into consideration and considered as complementing each other. In this way, deficiencies in one area of the law may be compensated for by more comprehensive and stringent regulation in another. However, if we assume that general duties such as the duty of care and the duty of loyalty are commonly classified as company law and duties in the vicinity of insolvency as insolvency law, which may be a simplifying, but for most purposes accurate description,[313] the two connecting factors of the registered seat and the COMI apply cumulatively to the case. As discussed above,[314] these connecting factors will not always lead to the same applicable law. It is possible that this division of the applicable law will result in a *weak selection*, i.e. the selection of the two sets of substantive rules that are the weak components of the investor protection regimes of their respective jurisdictions.

For example, we have observed clear differences in the scope and deterrent effect of the rules on liability for wrongdoing in the vicinity of insolvency. In some Member States, if the insolvency is declared wrongful, which is the case if intentional or grossly negligently acts of the director have caused or aggravated the state of insolvency, the bankruptcy court may order the director to cover all or parts of the deficiency in the company's assets.[315] Thus, a causal connection between the wrongful act of the director and the depletion of the company's assets does not need to be shown. In addition, the director may be disqualified for a period ranging from 2 to 15 years.[316] In other Member States, the liability of the director in a comparable case, the failure to file, may be restricted to the difference between the insolvency dividend that the creditor could have obtained if insolvency proceedings had been opened in time, and the actual dividend.[317] If at the same time the enforcement of directors' duties under company law is weaker in the first jurisdiction and stronger in the second jurisdiction (or if other company law or tort law mechanisms function as functional complement in the second jurisdiction), the weak selection of the company law of the first jurisdiction on the basis of the company's registered seat there and the insolvency law of the second jurisdiction on the basis of the company's COMI in that Member State may lead to regulatory gaps. Such gaps may invite regulatory arbitrage.[318] While we have not found any evidence in practice that regulatory arbitrage takes place, the theoretical possibility exists and may warrant a modification of the applicable rules on private international law so that the weak selection of multiple regimes is avoided.[319]

[312] Regulation (EC) 864/2007 on the law applicable to non-contractual obligations (Rome II), Art. 4(1).
[313] See above *Table 5.2.3.a*.
[314] Section 5.2.3.
[315] Spanish Insolvency Act, Art. 163. For a more detailed discussion see the Spanish Country Report, pp. A 968-969.
[316] Spanish Insolvency Act, Art. 172. For a more detailed discussion see the Spanish Country Report, p. A 969.
[317] For example Germany: liability pursuant to s. 93(2) Stock Corporation Act and s. 15a Insolvency Act in conjunction with s. 823(2) Civil Code (so-called *Quotenschaden*), see already n 327 above.
[318] See on this problem also J Armour, 'Who Should Make Corporate Law? EC Legislation versus Regulatory Competition' (2005) 58 *Current Legal Problems* 369; W-G Ringe, 'Forum Shopping under the EU Insolvency Regulation' (2008) 9 *European Business Organization Law Review* 579; F Mucciarelli, "The Hidden Voyage of a Dying Italian Company, from the Mediterranean Sea to Albion" (2012) 9 *European Company and Financial Law Review* 571
[319] Likewise, it can be argued that the *strong selection* of multiple regimes, i.e. the cumulative application of the most stringent components of more than one regulatory regime, should be avoided, since the cumulation of directors' duties in cross-border situations may exert a deterrent effect on the free movement of companies.

6. Summary and conclusion

6.1 Lack of enforcement of directors' duties in solvent companies

Based on our research, and combining the information gathered from our Country Experts, Country Researchers, the interviewed practitioners, and our review of the relevant literature, we conclude that gaps and deficiencies exist less with regard to the substantive rules on directors' duties, and more in relation to enforcement. In the vast majority of Member States, breaches of directors' duties do not normally lead to judicial enforcement of claims against directors as long as the company continues to operate as a going concern.

There are several factors that contribute to what may be seen as under-enforcement of directors' duties. We find that the most important of these factors cannot easily be addressed by changes to the national law rules concerning directors' duties; rather, the relevant obstacles are of a structural nature.

First, in most jurisdictions covered by this report, share ownership, including share ownership in listed public companies is highly concentrated. This typically leads to a situation where the most important business decisions are taken by, or with the formal or informal approval of, the controlling shareholders or group of shareholders. Consequently, it may be said that the issue in need of regulatory intervention is not so much wrongdoing by the directors that affects the shareholders as a class, but rather the minority/majority shareholder conflict. Where the law allows for *ex ante* authorisation or *ex post* ratification of the directors' conduct by the shareholders in general meeting, a breach of duty may be healed from the point of view of the substantive rules. Where authorisation or ratification is not permissible, for example because interested parties must abstain from voting, the company's claim may be frustrated because the independence of the authorised organ is implicated, with the consequence that the organ refrains from bringing a lawsuit on behalf of the company. For this reason, it is important that the law provides for the possibility of minority shareholders to instigate legal proceedings. However, the derivative action comes with its own problems, which call into question its usefulness.[320]

Second, irrespective of the problems in connection with the prevalent ownership structures, the rules on standing do not seem to be working well. If the board of directors in companies with a one-tier board structure has authority to instigate proceedings on behalf of the company, the conflict of interest is apparent, in particular where incumbents are sued. Data on enforcement activity, as far as available, indicate that the problem is not alleviated by allocating the power to enforce the company's claims to another organ, for example the general meeting or, in companies following the two-tier board model, the supervisory board. As regards the general meeting, the reason may be a collective action problem. Until recently, the supervisory board also does not seem to have been vigilant in enforcing breaches of directors' duties. It was suggested by legal practitioners that the personal connections between the two boards, with retiring members of the management board often receiving a position on the supervisory board, may have implicated the supervisory board's enthusiasm to bring an action. This may be in the process of changing in the wake of the financial crisis and a number of high-profile corporate scandals in some Member States, but it is too early to tell whether we are witnessing a sustained change in the enforcement climate or the increase in enforcement activity will abate.

Third, the institutional preconditions may not always be conducive to enforcement. Even where the law on the books seems to be, in principle, satisfactory, enforcement is perceived in some Member States as being lengthy, expensive, and fraught with uncertainties. In addition, the perception of the competence and efficacy of the judicial system does not seem to be unreservedly positive in all Member States. Shareholders may prefer to remove the incumbent directors and appoint new ones, rather than applying to the courts. In this context, it is worth noting that the degree of legal certainty

[320] See below 6.2.

and in general the sophistication of the legal system, which in turn influence the preparedness of the corporate actors to engage the judiciary, may be a function of the availability of published legal opinion. It is our impression that the development of the legal rules depends to a significant extent on the availability of such material. In the Member States where court decisions are not published as a matter of course, unresolved legal issues are more numerous and uncertainty regarding the scope and extent of directors' duties greater than in jurisdictions where judgements, also those of lower courts, are easily accessible.

As a consequence of these factors, enforcement in most jurisdictions is confined to cases of fraudulent conduct and particularly grave breaches of directors' duties. In some cases, claims against directors are also brought following a change of control, although such claims are often excluded in the relevant agreements leading to the change of control. Enforcement activity occurs where the duty of loyalty is implicated and directors have engaged in self-dealing or misappropriated corporate assets. Often, enforcement starts with a criminal investigation. In some jurisdictions, notably France, minority shareholders can file a criminal complaint,[321] thus triggering an investigation by the public prosecutor, and attach their claim to the criminal proceedings. This allows the minority shareholders to overcome the informational asymmetry between them and the controllers of the company. Liability for mismanagement, on the other hand, is virtually non-existent. However, even in cases of self-dealing or misappropriation of corporate assets bordering criminal liability enforcement is more likely once the company becomes insolvent, rather than at the going concern stage.

It should be noted, however, that our findings do not, in itself, call into question the effectiveness of the relevant legal rules. The level of compliance with directors' duties, particularly in larger companies, is perceived to be very high in some of the Member States that do not exhibit high levels of litigation activity.

6.2 Incentive problems in relation to enforcement by (minority) shareholders

Derivative actions are rare in Europe. An explanation may be that virtually all Member States exhibit deficiencies with respect to one or more of the three dimensions along which we test the effectiveness of the shareholder suit, as the ease of enforcement index presented above shows (see *Tables 3.2.b and 3.2.c*). A particularly important issue are cost rules. A rule that requires the shareholders to advance the costs of the proceedings and imposes the litigation risk on them aggravates the collective action problem mentioned above.[322] In many countries where the claimant bears the costs of the proceedings, the relevance of the derivative action is minimal.[323] Minority shareholder friendly cost rules are an advantage of the English derivative action mechanism.[324] They may have alleviated to some extent the very restrictive admission requirements under the rule in *Foss v Harbottle*, which was applicable before the reform of the shareholder suit in the Companies Act 2006.[325] Nevertheless, even in the UK enforcement through minority shareholders suits is not widespread and many judgments interpreting directors' duties were rendered in disqualification proceedings, which accordingly perform the function of an important substitute mechanism under UK law. We find similar effects in other Member States,[326] where public enforcement – in the form of criminal investigations – alleviates the incentive problems as well as informational disadvantages of shareholders.

We submit that for an effective regulation of derivative actions all three elements analysed in *Table 3.2.a*, standing, admission conditions and cost rules, should be conducive to minority shareholder enforcement. Absent that, private enforcement is unlikely to act as a meaningful deterrent against

[321] Of central importance is the offence of *abus de biens sociaux*.
[322] Text to n 229.
[323] For example, this is the case in Austria, France, and Poland.
[324] Based on *Wallersteiner v. Moir (No 2)* [1975] QB 373 (Court of Appeal). See
[325] For a brief description of the rule see above 3.2 'Conditions for bringing a derivative action'.
[326] E.g., in France.

breaches of directors' duties. This may be seen as particularly relevant in jurisdictions with concentrated share ownership, where related party transactions and "tunnelling", more generally, are of concern.

6.3 Incentive problems with enforcement of claims against directors of insolvent companies

In most Member States, judicial enforcement of directors' duties mainly or almost exclusively takes place after the company has filed for insolvency. Nevertheless, the feedback we received from both the interviewed practitioners and our Country Experts suggests that in most Member States only a small fraction of claims against an insolvent company's directors are enforced in practice.

Member states differ significantly in their procedural rules applicable in the insolvency stage of the company, but in most cases a court-appointed liquidator or administrator is responsible for the enforcement of claims against directors for breaches of their duties.

We identify the following three problems in relation to enforcement of directors' duties after the company has entered insolvency proceedings.

First, depending on the national law provisions, liquidators may often not be properly incentivised to bring claims against directors, even where clear evidence of wrongdoing exists and where the claims could also be enforced against the director in question. This may be a consequence of the liquidators' remuneration structures, in particular where liquidators do not personally benefit from the augmentation of the insolvent company's assets, or only do so to an insignificant degree. Consequently, an agency-related conflict between the liquidator and the company's creditors may arise.

Secondly, most companies that enter insolvent liquidation are small or medium-sized businesses. In most of these companies, the directors are at the same time major shareholders of the company. This typically means that a significant part of the director's personal assets will have been tied up in the company, and hence lost in its insolvency. Consequently, the enforcement of claims against director-shareholders, even claims for clear breaches of directors' duties, will often not be enforced in the courts due to a lack of assets on the part of the director. Rather than further depleting the assets of the insolvent company by litigating against a director with limited personal assets, liquidators and creditors often prefer to distribute the remaining assets. In the Netherlands, the ministry of justice may finance the proceedings of the liquidator, which has been commended by practitioners from other countries as an effective strategy to address this problem.

Third, practitioners from a number of Member States emphasised the problems relating to the costs and duration of court proceedings. In addition, and more relevant to this report, practitioners highlighted the legal uncertainties resulting from the scarce case law on directors' duties in most jurisdictions. This situation may well be a self-perpetuating and inefficient equilibrium that may be attributed to the public good-nature of litigation of that sort.

6.4 Gaps relating to companies with cross-border operations

As *Table 5.2.3.a* shows, in all Member States directors' duties consist of a mix of traditional company law duties, i.e. in particular the duty of care and the duty of loyalty, and additional duties that apply in the vicinity of insolvency, notably the duty to file for the opening of insolvency proceedings. As far as the latter are concerned, in most Member States some uncertainty exists as to their classification for purposes of private international law. Often there is no coherent view in the legal literature and in case law whether to classify an instrument as company law, insolvency law, or tort law. It is also possible that functionally related instruments are classified differently under private international law and, accordingly, are subject to different connecting factors.[327] The consequence is that a coherent set of interconnected rules of substantive national company law may be dissected by virtue of the private international law and allocated to different legal systems. If foreign law is applicable to some aspects of the case and no substitute legal mechanism is available under that country's substantive company law, parts of the case may be left unregulated. Finally, if companies and directors are subject to other regulatory regimes in addition to the state of incorporation, which of course determines liability of the directors under the general rules on directors' duties, they may be dissuaded from exercising their free movement rights under the Treaty.

To summarise, the likely disadvantages of the current legal situation in many Member States are as follows:

(1) The uncertain scope of the private international law rules and the criteria for classification of the substantive provisions on directors' duties in the vicinity of insolvency creates legal uncertainty.
(2) Where two or more legal instruments function as legal complements in a jurisdiction, but these instruments are subject to different connecting factors and these connecting factors lead to the application of different national laws, the lack of coordination in the conflict of law rules may result in regulatory gaps.
(3) It is unclear whether, and under what conditions, the application of additional duties and liability provisions, for example pursuant to the *lex loci delicti commissi*[328] to directors of companies incorporated under a different jurisdiction is compatible with Arts. 49, 54 TFEU.

The second point may be illustrated by an example. In most jurisdictions, directors' duties under company law and insolvency law or in the vicinity of insolvency are functional complements. The level of shareholder and creditor protection can only be appreciated if mechanism derived from company law, insolvency law, and possibly also tort and contract law, are taken into consideration and considered as complementing each other. In this way, deficiencies in one area of the law may be compensated for by more comprehensive and stringent regulation in another. However, if we assume that general duties such as the duty of care and the duty of loyalty are commonly classified as company law and duties in the vicinity of insolvency as insolvency law, which may be a simplifying, but for most purposes accurate description,[329] the two connecting factors of the registered seat and the COMI apply cumulatively to the case. As discussed above,[330] these connecting factors will not always lead to the same applicable law. It is possible that this division of the applicable law will result in a *weak selection*, i.e. the selection of the two sets of substantive rules that are the weak components of the investor protection regimes of their respective jurisdictions.

For example, we have observed clear differences in the scope and deterrent effect of the rules on liability for wrongdoing in the vicinity of insolvency. In some Member States, if the insolvency is declared wrongful, which is the case if intentional or grossly negligently acts of the director have caused or aggravated the state of insolvency, the bankruptcy court may order the director to cover all or parts of the deficiency in the company's assets.[331] Thus, a causal connection between the wrongful act of the director and the depletion of the company's assets does not need to be shown. In addition, the director may be disqualified for a period ranging from 2 to 15 years.[332] In other Member States, the

[327] An example are the duty of directors under German law to file for the opening of insolvency proceedings (s. 15a Insolvency Act) and liability for the failure to file (liability to the company is based on s. 93(2) Stock Corporation Act and to creditors on s. 15a Insolvency Act in conjunction with s. 823(2) Civil Code (protective law)), which are classified as insolvency law for purposes of private international law (disputed); liability for fraud pursuant to s. 263 Criminal Code in conjunction with s. 823(2) Civil Code, qualified as tort; and the reclassification of shareholder loans as equity in the vicinity of insolvency, classified as company law for purposes of private international law (disputed). It may be argued that these legal instruments *in combination* form what constitutes a significant part of the German creditor protection regime and that their dissection through conflict of laws is neither efficient nor conducive to legal certainty.
[328] Regulation (EC) 864/2007 on the law applicable to non-contractual obligations (Rome II), Art. 4(1).
[329] See above *Table 5.2.3.a*.
[330] Section 5.2.3.
[331] Spanish Insolvency Act, Art. 163. For a more detailed discussion see the Spanish Country Report, pp. A 968-969.
[332] Spanish Insolvency Act, Art. 172. For a more detailed discussion see the Spanish Country Report, p. A 969.

liability of the director in a comparable case, the failure to file, may be restricted to the difference between the insolvency dividend that the creditor could have obtained if insolvency proceedings had been opened in time, and the actual dividend.[333] If at the same time the enforcement of directors' duties under company law is weaker in the first jurisdiction and stronger in the second jurisdiction (or if other company law or tort law mechanisms function as functional complement in the second jurisdiction), the weak selection of the company law of the first jurisdiction on the basis of the company's registered seat there and the insolvency law of the second jurisdiction on the basis of the company's COMI in that Member State may lead to regulatory gaps. Such gaps may invite regulatory arbitrage. While we have not found any evidence in practice that regulatory arbitrage takes place, the theoretical possibility exists and may warrant a modification of the applicable rules on private international law so that the weak selection of multiple regimes is avoided.[334]

6.5 Gaps relating to director disqualification

Director disqualification as an administrative law substitute for private enforcement of directors' duties[335] creates similar cross-border frictions due to the unaligned nature of the respective private international law rules as those discussed in the previous section. Director disqualification requires some connection of the director's company with the territory where the disqualification order is issued. The UK rules, for example, apply to directors of companies that are either registered under the Companies Act 2006 or that may be wound up under the UK Insolvency Act 1986 without being registered in the UK, i.e. that have their COMI in the UK.[336] The disqualification order prevents the director from acting as director of any company falling within that definition, also companies registered in other Member States, provided that they may be wound up in the UK.

Such rules give rise to two concerns. First, in case of foreign companies they may lead to strong selection as outlined above,[337] since they apply in addition to any sanctions that may be applicable under the law of the company's home Member State. In general, they are foreign elements that may disturb the balance of the domestic system of sanctions and liability.

Second, and maybe more importantly, disqualification orders do not apply on an EU wide basis, but only capture companies that have the necessary connection to the territory where the disqualification order is issued. Even where a Member State extends the applicability of its disqualification statute, this extension will not prevent the valid appointment of a director in another jurisdiction. Partly due to the case law of the European Court of Justice,[338] Member States may find it difficult to enforce their national law rules against disqualified directors who are then appointed by foreign-incorporated companies, even where the relevant foreign-incorporated company operates within its territory.

Thus, directors may attempt to either avoid a disqualification (or more severe sanctions, for example under criminal law) in the Member State where their main activities are located by attempting to satisfy the necessary connecting factor in another country before the opening of insolvency procedures. Anecdotal evidence indicates that such forum shopping takes place. They may also hamper the effectiveness of a disqualification order issued by one state by operating 'through' a company incorporated abroad.

[333] For example Germany: liability pursuant to s. 93(2) Stock Corporation Act and s. 15a Insolvency Act in conjunction with s. 823(2) Civil Code (so-called *Quotenschaden*), see already n 327 above.
[334] Likewise, it can be argued that the *strong selection* of multiple regimes, i.e. the cumulative application of the most stringent components of more than one regulatory regime, should be avoided, since the cumulation of directors' duties in cross-border situations may exert a deterrent effect on the free movement of companies.
[335] See above 3.2 'Substitutes for weak private enforcement'.
[336] Company Directors Disqualification Act 1986, s. 22(2).
[337] See n 334.
[338] See Section 5 above.

HYPOTHETICALS

Austria

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

In order to answer the question one would probably have to distinguish between liability according to company or civil law.

Under company law the answer depends on the provision in the articles which would be possible for a private limited company (albeit not for a public one, for which one would use a so-called “domination agreement” for these purposes). Generally, such directions would not by itself lead to liability. However, in one stray decision the Supreme Court has held that the parent company may become liable as a de facto director if it continually influences the decisions of its subsidiary (6 Ob 313/03b); the decision provoked vociferous criticism and may not be upheld.

Additionally, members may become liable for directions, which cause damage, if such damage could have been foreseen beforehand; this is generally understood to be an application of the fiduciary duties of the members against the company. The simple fact that the parent company induced the directors to speed up the process for regulatory approval by awarding bonuses will by itself will most probably not be sufficient to establish liability.

In order to establish liability under civil law rules the parent company would have to be an accessory to the acts of its subsidiary. As long as there is no proof that the parent company wilfully induced its subsidiary to circumvent the necessary tests such a liability would again be hard to establish.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

If there is a liability of the parent company due to negligent actions by its directors, they in turn may face liability. This would be the case if the parent violated its fiduciary duties towards its subsidiary or if it were accessory to the acts of its subsidiary.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company’s equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalize the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalize the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

Generally speaking, under Austrian law this would be an issue of the duty of care. Although it is generally recognised that managers should not become liable if they exercise their business judgement even though the outcome is detrimental to the company (cf. Austrian Supreme Court 1 Ob 144/01k), excessive risk taking with a <u>substantial</u> risk of wiping out the company's assets would not be protected by applying some sort of business judgement. This may be deduced inter alia from Sec. 159 Penal Code (cf. below the answer to question 3).

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

There is no particular point in time which provides for additional duties in the vicinity of insolvency (cf. the different equity-to-assets ratios above). However, it is generally recognized that less risks may be taken once the company's financial situation becomes critical (cf. *Nowotny* in Doralt/Nowotny/Kalss, Commentary to the Stock Corporation Act, 2nd Edition, 2012, § 84 No. 9). Directors should be discouraged from gambling the company out of insolvency to the detriment of the creditors.

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

As there does not seem to be any immediate risk of insolvency before the transactions mentioned above (equity cushion is still available, although thin, plus sustainability of business model), the directors would be under no obligation to open insolvency proceedings. Therefore, they would not become liable under insolvency law for belatedly opening insolvency proceedings.

Apart from that the critical issue in my view is whether the directors were taking a substantial risk of wiping out the company's equity during a critical time for the company; however, according to their judgment this risk, although present, was "very low". Should that judgement have been correct, I do not think that the directors would face liability.

If, however, in fact as opposed to their judgement there was a substantial risk of the company becoming insolvent due to the transactions in derivatives, they would face liability on the basis of

Sec. 84 para 2 Stock Corporation Act, which would be enforced by the insolvency receiver on behalf of the company.

An additional liability may result from criminal law, in particular from the protective rule on grossly negligent encroachment on creditors' interests (Sec. 159 Penal Code), which will be applicable if the directors have caused the inability to meet mature debts in a grossly negligent way, especially by depleting the company's assets through extremely risky transactions. This penal law provision may lead to a direct civil liability towards the creditors as it aims at protecting their interests.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

I assume that this question only refers to the decision to continue investing in CDOs, not to the issue of self-dealing, for which the liability under Sec. 84 Joint Stock Corporation Act is clear.

As to the CDOs I do not believe that the facts as given above would lead to a liability. On the one hand, Austrian courts are aware of the danger of hindsight bias when deciding on the negligence of managers' behaviour when making business decisions. Although the BJR is not part of Austrian law, judges generally defer to business decisions which have been taken with due preparation of the facts as long as there is no conflict with the duty of loyalty. However, according to the majority of commentators and along the lines of the German BGH's ARAG/Garmenbeck decision this does not apply if the decision is "absolutely untenable". I do not think that this would be the case with CDOs, at least not until the first half of 2007. Even for 2007 judges probably would analyse the behaviour of comparable banking institutions and will conceivably base their decision on whether the misconceptions as to the CDOs were shared by other market participants.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

The decision by the board (in Austria: the board of supervisors) on the agreement with the outgoing CEO most probably would not have constituted a violation of duties. The Austrian Supreme Court in a seminal judgement has set a remarkably low standard for this type of decisions (7 Ob 58/08t). The judgement argues that it lies within the discretion of the board to enter into such agreements even in cases where the directors may have given cause for dismissal as it is in the best interest of the company to avoid negative publicity. In the case decided the payment on departure was a substantial part of the company's yearly profits. Although this judgement does not exclude such decisions from liability in principle, applying its standards liability of the board members is very unlikely.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

Members of the audit committee are subject to the general liability rules for members of the board of supervisors. Thus, they may become liable if they do not fulfil their duty to the full. Their duty under Austrian law, however, is not the preparation of the accounts (which is the duty of the CEO and the other members of the managing board), but controlling them. The requisite standard of diligence therefore refers to the standards of care for controlling the books. If the members have violated this duty (which cannot be ascertained on the basis of the facts given above), they can become liable. This would not necessarily lead to the liability of other members of the board of supervisors not members of the audit committee.

Additionally one would have to ask whether other members of the managing board apart from the CEO (if any) have violated the duty of diligently preparing the accounts and thus may become liable. Again, the facts given above do not indicate such a liability.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

A minority shareholder by itself cannot enforce the claim, as long as he does not hold 10 percent of the share capital (for details cf. Sec. 134 et seq. Joint Stock Corporation Act).

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

Director A has violated his duty of loyalty towards Bidder by promoting the acquisition of Target. According to legal literature A would have had to disclose his interest in the transaction to the board. The fact that he promoted the transaction provides sufficient causality for liability; it is not relevant that his vote was not decisive.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

As A only discloses his interest, but apparently not the fact that the true value of Target lies below the purchase price, A's actions still to violate his duty of loyalty. Therefore, he will be liable.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

The ratification by the general meeting will remove liability against the company if the approval is given before the transaction has been closed. However, this removal is only valid against the company, not against individual creditors who may try to enforce Bidder's liability claim against A if Bidder does not fulfil its obligations (sec. 84 para 1 Joint Stock Corporation Act). Consequently, approval should not remove the liability in the case of A's insolvency either as the receiver acts in the creditors' interests; the issue has not been addressed to my knowledge.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

I assume that A is member of the management board. As such he is under a prohibition to compete without approval by the supervisory board. The mere fact that he is a managing director of Rival would lead to liability and to a duty to disgorge any profits to the company (sec. 79 Joint Stock Corporation Act). If the board of supervisors approved A's boar position he will probably escape liability, but he may, in my opinion, still be removed from office for cause.

If A were a member of Bidder's supervisory board the situation is even less clear as members on that board serve typically part time and there is no prohibition to compete. He most certainly would not be allowed to vote on the issue; if Rival is actually a rival in Bidder's core business A would have to renounce his board position in Bidder (cf. also No. 45 Austrian Code of Corporate Governance). Apart from that he would probably not be subject to liability.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

Cf. above.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

I do not see a case for liability under Austrian law.

Belgium

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

  In principle, the parent company is a shareholder of the relevant subsidiary so that it benefits from limited liability. There is no group liability under Belgian company law.

  However, since the subsidiary is a private limited company, its shares may not be held solely by a legal person (parent company; art. 213 § 2 CC: within the year, another shareholder needs to be found or the subsidiary needs to be dissolved). This is enforced by considering the 100% parent company a guarantor for all liabilities of the subsidiary of which it holds all shares.

If the parent company is not the sole shareholder of the relevant subsidiary (anymore) (this situation is often remedied by transferring one share to an affiliated company), it can only be held liable if i) use is made of the technique to consider its legal personality to be abused (so that it loses the benefit of limited liability, or ii) considering the parent company itself a de facto director of the subsidiary. Both options are not likely. As regards ii), one must also note that the application of directors' liability to de facto directors is contested as regards art. 527-529 CC.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

It will not be easy to classify the parent company's director as a de facto director of the relevant subsidiary since application of directors' liability to de facto directors is contested as regards art. 527-529 CC, and, were such application to be accepted, this would require the director to actually manage the relevant subsidiary. It is currently unclear whether mere influence would lead to liability as a de facto director.

In case the parent company's director breaches the general duty of care (art. 1382 Civil Code), injured parties will be able to claim compensation after they prove fault, damage and causation.

ADDENDUM: It is not clear from the assignment whether the two project managers are employees of the parent company. If they are, two more issues potentially arise:

- The employment relationship may conflict with their directorship, as the parent company, as an employer, will be entitled to instruct how they perform their directorial mandate. The latter is, however, to be exercised independently and free from external instructions.
- The parent company may be held liable as an employer if errors committed by its employees are not to be considered as serious errors or repetitive light errors.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

1. *Do fiduciary duties prevent directors from entering into particularly risky transactions?*
2. *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*
3. *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders, or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

Entering into risky transactions is not specifically prohibited, but regard must be had to whether any other reasonable director, placed in similar circumstances, would have entered into the respective transaction; if so, the business judgement falls within the permitted margin of discretion. Given the low equity ratio and on-going financial crisis, it could be argued that the decision to invest in oil derivatives was not opportune, and thus constituted a managerial error (art. 527 CC), although this is a matter of judicial interpretation.

It is disputed whether the duty of loyalty (to act in good faith and have regard to the company's interest) changes in the vicinity of insolvency. The unreasonable continuation of an obviously insolvent company can be considered, however, to be both a managerial error (art. 527 CC, enforceable by the company/liquidator) and/or a breach of the general duty of care (art. 1382 Civil Code, enforceable by any injured party).

It must also be noted that, when the company's net assets have fallen below half of the company's registered capital, directors face certain formalities (art. 633 CC). The law also rebuttably presumes that any loss incurred by third parties will be due to having failed to comply with these formalities. Moreover, when not complying with these sections, directors face liability for breaching the Companies Code (art. 528 CC, enforceable by both the company and third parties, including shareholders that claim personal harm).

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

<u>Questions</u>:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  There are no specific guidelines for judging liability in case of risky transactions and warning signs. Regard must only be had to whether any other reasonable director, placed in similar circumstances, would have entered into the involved transaction; if so, the business judgement falls within a margin of discretion. Of course, considering the ample presence of warning signs, the CEO (either as an executive director, day-to-day manager or both) can be held liable for overstepping this margin and causing managerial errors in continuing the investments (art. 527 CC, enforceable by the company).

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  Transactions inflicted with conflicts of interest are decided upon by the board of directors. There is only an abstention requirement (from deliberation and voting) for the interested director when the company has issued securities to the public (including when the company is listed). Art. 523 CC contains further formalities (annual report, auditor report).

  If the formalities of art. 523 CC (conflict of interest) are complied with, all incumbent directors can still be held liable (severally and jointly) for any damage done to the company and/or third parties to the extent that the transaction has resulted in an unjustified, i.e. excessive, advantage to the director to the detriment of the company (art. 529 CC). The possibility of art. 528 CC to rebut liability, however, still stands.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  As of 2010, listed companies only need to install audit and remuneration committees comprised of directors (art. 526*bis* and *quater* CC). In general, a director's competences or membership of a committee are not formally elements of the judicial determination of liability, although it cannot be ruled out that courts will take the membership of audit or remuneration committees into account when determining what 'similar given circumstances' are.

  Directors are not required to monitor their colleagues, but systematic absenteeism or other negligent behaviour is considered to be a managerial error when overstepping the margin of appreciation (art. 527 CC). That there is no general legal requirement to supervise other directors can be inferred from the possibility for directors to rebut liability for breaching the Companies Code and articles of association/conflicts of interest regime (art. 528/529 CC) by demonstrating that the director:

  (i) did not participate in the contested decision (e.g. by remaining absent from the meeting (where this absence was excusable) or by having voted against the decision);
  (ii) is not blameworthy; and
  (iii) challenged the decision at the earliest general assembly meeting (or, in case of members of the executive committee, the earliest meeting of the board of directors).

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

  Annulment/suspension claims: any interested party can bring this action, including minority shareholders, irrespective of their holdings.

Liability claims (art. 527-530 CC): Minority shareholders can only bring derivative claims (for company harm on behalf of the company) if the following conditions are satisfied:

(i) the shareholders bringing the action must hold securities that represent at least 1% of the votes; or

(ii) hold securities representing a part of the capital of at least EUR 1,250,000.00; and

(iii) the shareholders with voting rights must not have voted for the acquittance of the directors.

Minority shareholders will have to mandate a special administrator to continue the claim. There is no specific procedure for checking whether claims can be continued, but general procedural law must be followed (the claimant must prove a legitimate interest in bringing the claim; claimants can abuse their right to bring a claim according to the general abuse of right doctrine).

Minority shareholders must advance the costs. In case of a successful claim, judgement is given in favour of the company, without direct personal benefit for the claimant, and the claimant is reimbursed with respect to litigation costs. When the claim is not successful, claimants can be condemned to pay all outstanding litigation costs (and in some events complementary damages).

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

1. *Director A is also majority shareholder in Target, holding 60 per cent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

Belgian company law contains a specific regime addressing conflict of interest situations for board members: when a director has a proprietary conflict of interest as regards a decision the board is about to take, certain formal requirements have to be fulfilled. According to art.

523 CC, the conflicted member has to inform the board beforehand and must inform the company's auditor. The conflicted director has to report in the minutes of the board about the transaction and explain its justification. There is only an abstention requirement (from deliberation and voting) for the interested director when the company has issued securities to the public (including when the company is listed). For other companies, interested directors can vote and it does not matter whether the vote was decisive.[1]

[1] In addition, a specific conflicts of interest regime exists for intra-group transactions: art. 524 CC (see country report).

When these formalities are not complied with, each director[2] (including A) can be held liable for unjustified (excessive) benefits accrued by one/more director(s) to the detriment of the company (art. 529 CC), and the involved decision/transaction can be annulled at the request of the company (and the company alone, but only if the persons dealing with the company in respect of the involved decision or transaction were or ought to be aware of the breach). In the case at hand, Target will most likely be aware of the conflict of interest (although this depends on whether director A's knowledge can be attributed to Target).

2. *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

See answer sub 1. However, compliance with art. 523 CC formalities does not affect the potential liability under art. 529 CC. Therefore, directors can still be held liable to both the company and/or third parties for unjustified benefits.

3. *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

Ex post ratification in this respect can be interpreted to constitute a waiver of the company's (general meeting's) right to bring a claim against the directors, request annulment of the decision/transaction or liability on the grounds of art. 529 CC. Directors can vote as shareholders for such ratification, as there are no conflict of interest rules for shareholders.

However, such ratification will not affect third parties, who can still bring a claim based on art. 529 CC for any damage they have suffered as a result of the unjustified benefits accrued by the interested director. Moreover, minority shareholders that do not approve the ratification can still bring a derivative claim (that is: they can only bring a derivative claim if they have not approved the ratification).

4. *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

We refer to the country report on directors' duties in Belgian corporate law, and stress the following points:

- There is no specific corporate opportunities regulation in the Companies Code.
- The literature has worked out a corporate opportunities doctrine based on the general duty to act in good faith (which comprises, for directors, a duty of loyalty) and inspired by Anglo-Saxon tests (business line, etc.). Opinions, however, still differ, and there is certainly not clearly established case law.

[2] Art. 529 CC leaves untouched the possibility given by art. 528 CC (for the remaining directors) to state that they have not participated in the contested decision to transact with Target. They will have to show the elements required by art. 528 CC and listed in the answer to question III.3 *in fine*.

- This means that recourse has to be made to the general enforcement mechanism of the duty of loyalty (art. 527 CC, enforceable by the company or derivative action), and, if applicable, the conflicts of interest regime (art. 523 CC).
- A duty not to compete is also derived from the duty to act in good faith, and is similarly vague with respect to its exact scope and borders.

5. *As in scenario 4 but A resigns from his position as director of Bidder before Rival makes the competing offer.*

As directors' duties are based on contract (the contractual norm to act in good faith, art. 1134, 3 Civil Code), the duty of loyalty ends when the service contract ends. Towards the company, this is so as from resignation. After resignation, non-compete contracts can, of course, be constructed.

Resignation can in itself be a basis for liability only if it is given in an untimely and harmful way. Even though we are not aware of any case law on this point, we think one could probably argue that, before resigning, the director should have notified the company of the corporate opportunity on the basis of his duty to act in good faith (see the doctrine indicating such duty referred to in the country report).

6. *As in scenario 4 but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

If the board of directors decides not to usurp the corporate opportunity, the director can principally not be held liable anymore for giving the opportunity to another company. However, he must still act loyally to all companies he serves, and must thus equally distribute his time and effort among these companies.

The interested director can vote, unless it involves a company that has issued securities to the public (which includes listed companies). In the latter case, there is an abstention obligation (*supra*).

Bulgaria

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

1. Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?

Under Bulgarian law companies are delictually liable (art. 45 of the Obligations and Contracts Act). Hence, the subsidiary company shall be held delictually liable for the health damages, caused to the injured persons.

The parent company, though, cannot be held responsible. The doctrine of “piercing the corporate veil” is not applicable under Bulgarian law. A parent company, under Bulgarian law, is allowed to register a subsidiary company and to become its single owner, but the responsibility of the two companies remains completely separate.

If from the facts of the case can be concluded that there has been an assignment of the work from the parent company to the subsidiary, only then the parent company shall be considered responsible (art. 49 of the Obligations and Contracts Act). But there has to be proven the existence of the following additional legal requirements: the assignee (the subsidiary company in the discussed case) has to act in the interest of the assignor and for the benefit of the assignor. “For the benefit” means that the profit from the distribution of the medicine shall be received only by the assignor (the parent company in the discussed case), while the subsidiary company has to receive only a payment for the fulfillment of the assigned task.

The discussed case, though, does not reveal any facts from which can be concluded that the parent company has assigned work to the subsidiary company. Hence, the parent company shall not be considered liable for the damages, caused to the injured persons.

2. Under which circumstances would the directors of the parent company face a liability risk in those circumstances?

The directors are not delictually liable for the damages, caused to the injured persons, because there is no proximate causation between their act of establishment the subsidiary company and the caused damages.

In addition it shall be underlined, that there are no provisions, concerning joint stock companies and limited liability companies in the Commerce Act, arranging responsibility of the directors for the establishment of subsidiary companies, that turn out to be ineffective in future.

Hypothetical II: Duties in the vicinity of insolvency

1. Do fiduciary duties prevent directors from entering into particularly risky transactions?

Neither the Commerce Act, nor any other special act in Bulgaria arranges a fiduciary duty that prevents the directors from entering into particularly risky transactions. Bulgarian court practice also does not draw a conclusion for the existence of such a duty by interpreting the legislation.

There are, though, some legal provisions, that indirectly prevent the directors from entering into risky transactions (e.g. art. 236 of the Commerce Act – for the “closed” joint-stock companies and art. 114 of the Securities Public Offering Act – for the “public” joint-stock companies). The term “risky” is not used in these provisions, but it actually is defined by ratios that can be calculated on the basis of the data, disclosed in the annual financial report of each specific company. For example – undertaking of an obligation which value for the current year exceeds half of the value of the company’s assets according to the last certified annual financial report (art. 236, par. 2, p. 3 of the Commerce Act) or transfer of assets, which value exceeds 1/3 of the lower value of the assets according to the last certified annual financial report (art. 114, par. 1, p. 1 (a) of the Securities Public Offering Act). For such transactions as the ones under art. 236 of the Commerce act and art. 114 of the Securities Public Offering Act the preliminary consent of the general meeting, resp. the supervisory board or the unanimous consent of the BoD is required.

In case of violation of such provisions, the results can be different, depending on the specific provision:

- the violation of art. 236 of the Commerce Act makes the member of the board, who has signed the contract legally responsible, but the transaction itself remains valid;
- the violation of art. 114 of the Securities Public Offering Act makes the transaction void and the members of the board, who have signed the contract - legally responsible;

2. At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is ‘vicinity of insolvency’ defined?)

The term “vicinity of insolvency” is used neither in the Bulgarian legal acts, nor in the specialized Bulgarian legal literature because of two reasons:

- the rules, arranging vicinity of insolvency are described in the company law, not the insolvency law; and
- Bulgarian legal literature concentrates on the studying of other two terms “over-indebtedness” (art. 742, par. 1 of the Commerce Act) („свръхзадълженост”) and cash flow insolvency (art. 608 of the Commerce Act) („неплатежоспособност”).

Regardless of the above-said, as vicinity of insolvency can be considered two points in time:

- when the shareholders’ equity (total assets minus total obligations) falls below the registered capital. This rule is applicable to the joint-stock companies and the limited liability companies (art. 138, par. 3 and art. 252, par. 1, p. 5 of the Commerce Act);
- when the loss exceeds ¼ of the company’s registered capital. This rule is applicable as an alternative to the above-mentioned rule to the limited liability companies.

3. What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.

The legal response to the vicinity of insolvency is the occurrence of a new obligation for the management – the obligation to summon the general meeting of the company and to inform its members about the new situation.

The Commerce Act does not specify the term, within which the general meeting of the limited liability company shall be summoned. Hence, it shall be summoned immediately.

The summoning of the general meeting of the joint-stock company shall take place within a term of one year and there shall be taken a decision for the application of any of the following three measures: decision for the decrease of the capital, decision for the transformation of the company or decision for the termination of the company. If, though, none of the enumerated in the previous sentence measures are taken, the company shall be terminated by court's decision under a prosecutor's claim (art. 252, par. 1, p. 5 of the Commerce Act).

If the company becomes insolvent or over-indebted, the management is obliged to ask for opening of an insolvency court procedure within a term of 15 days (art. 626 of the Commerce Act). In case this is not done within the above-mentioned term, the management shall be jointly responsible in front of the creditors for the damages, caused because of the delay for opening the insolvency procedure (art. 627 of the Commerce Act).

It can be concluded from the above-said that both – the interests of the creditors and the interests of the company's members, are purposed to be protected.

<u>Hypothetical III: Duty of care</u>

1. Is the CEO liable for annual loss suffered by the company in 2008?

The answer is positive, because the CEO has wilfully caused damages to the company by transferring the assets at an undervalue (art. 240, par. 2 of the Commerce Act).

2. Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?

According to the Bulgarian law it is the board of directors ("BoD") that appoints the executive director and determines his remuneration (and bonuses) (art. 244, par. 4 of the Commerce Act – in case of a one-tier system) and it is the supervisory board that appoints the members of the management board and determines their remuneration (and bonuses) (art. 241, par. 2 of the Commerce Act - in case of a two-tier system). The contract between the executive director and the company shall be concluded by the chairman of the BoD (art. 244, par. 7 of the Commerce Act) and the contract between the members of the management board and the company shall be concluded by the chairman of the supervisory board (art. 241, par. 6 of the Commerce Act). Hence, the general meeting of the joint-stock company does not take part neither in the conclusion of the contract with the executive director, nor in the determination of his remuneration.

Concerning the specific case, the answer is as follows:

- if the members of the BoD have acted negligently by not discovering the CEO's misconduct, then they shall be responsible for the payments, made to the CEO;
- if the members of the BoD have not been aware of the CEO's misconduct and this unawareness has not been due to the negligence of theirs, then the board has to pay to the CEO the agreed under the management contract remuneration. In this specific situation, though, the company can sue the former CEO on the grounds of an unjust enrichment.

3.1. Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions?

Under Bulgarian Commerce Act the companies are not obliged to establish committees for internal audit. Some institutions, though, as banks and insurance companies, are obliged to arrange bodies for internal control (art. 62 of the Insurance Code and art. 74 of the Credit Institutions Act).

Since the considered hypothetical discusses a bank institution, there shall be applied the provisions of Ordinance № 10 for the Internal Control in Banks of the Bulgarian National Bank. According to art. 18, par. 2, p. 2 the internal audit committee has to have an unlimited access to the assets and the information of the bank and according to art. 14, par. 1, p. 7 it has to check and estimate the defence of the assets from misuse. Hence, the members of the internal audit committee have breached their duties by not identifying the true nature of the ostensibly arms-length transactions and are accordingly liable.

3.2. Have the other directors (except the CEO) breached their duties?

Art. 237, par. 1 of the Commerce Act prescribes that the members of the board have equal rights and obligations, regardless of the internal distribution of the functions between them (management and representation of the company by some of them included). No explicit obligation for supervision by each director over the others is provided. Therefore, the rest of the members of the BoD are not obliged to supervise the transactions, which the CEO concludes with third parties. This is why, if the transactions are carried out without the knowledge, participation, decision of the rest of the members of the BoD, the latter will not be considered liable.

If the BoD has put under vote the conclusion of the ostensibly arms-length transactions, the members of the BoD who have voted "pro" conclusion of these transactions, shall be held liable; the rest of the members shall be considered free from liability (art. 240, par. 3 of the Commerce Act).

4. Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?

The answer is positive. Shareholders, possessing 10% of the capital of the joint-stock company, have right to enforce a claim for the responsibility of the members of the BoD, the management board and the supervision board for damages, caused to the company (art. 240a of the Commerce Act).

<u>**Hypothetical IV: Duty of loyalty**</u>

Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.

All members of the BoD shall be considered responsible, because they have not checked the parameters of the transaction and they have been aware of the conclusion of this transaction (art. 240b in connection with art. 240, par. 2 of the Commerce Act).

2. As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.

In this case the directors, who have votes "pro" conclusion of the transaction, can be held responsible.

3. As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.

In this case none of the directors can be considered liable, because of the approval by the general meeting (art. 240, par. 3 of the Commerce Act).

4. Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.

Director "A" shall be considered responsible, because he violates his obligation not to announce any information, of which he became aware in his capacity of a director, if this announcement can influence the company's activity and its development (art. 237, par. 5 of the Commerce Act).

5. As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.

Director “A” shall be considered responsible because of the announcement of the information, regardless of the fact that he has resigned before making the announcement (art. 237, par. 5 of the Commerce Act).

4. As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder’s weak financial position.

Director “A” shall not be considered responsible, since no damages have been caused to “Bidder” (art. 240, par. 2 of the Commerce Act).

Croatia

<u>Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary</u>

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

Provided that the directors of the parent company have not breached their duties by way of e.g. forcing the directors of the subsidiaries not to follow certain procedures prescribed by law, they would not be held liable. If correctly understood by the facts of the case, the actions of the directors of the subsidiaries were made on their own motion, since the directors of the parent company did not require or suggest skipping some of the planned tests and studies, they merely promised the bonuses. Under the circumstances, it seems that promise of the bonuses would not suffice to conclude that the directors of the parent company actually and practically requested to skip those tests and studies.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

If the directors of the parent company by their actions cause the damage to the subsidiary, the parent company would have to compensate that damage by the end of the business year. If it does not do so, the parent company is jointly and severally liable together with its directors, if they have given the instructions to the subsidiary. Standard of care is that of a prudent businessman.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalize the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalize the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

No, the general provisions on duty of care and business judgment rule apply to all transactions.

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

As soon as the directors find out that there is a loss amounting to a half of the share capital, they are obliged to convene the general meeting. This does not necessarily lead to insolvency, but if that duty is considered as a special duty in case of vicinity of insolvency, it may be considered as that particular point in time.

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

Legally, the duties of the directors do not change.

<u>Hypothetical III: Duty of care</u>

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

Only if it is considered that he has breached the business judgment rule, which depends on all circumstances of the case. It would be up to the court to establish whether the signs of crisis have be sufficient to require a prudent businessman to take or not to take some actions.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

In principle yes, since their actions would not be considered as actions in the best interest of the company.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

Members of the audit committee who are board members are subject to the same general rules as any board member. External members of the committee are logically subject to less stringent rules, since they are not board members and may not be expected the same level of involvement. However, to them applies the principle of a prudent external audit member, as a legal standard, assessed on a case by case basis.

Board members are required to be acquainted with company transactions, since that follows from the rule that, unless otherwise provided for by the articles of association, the management board makes decisions unanimously. However, even the articles of association provide that each director manages the company individually within his/her scope of duties, other directors should take appropriate actions, including e.g. informing the supervisory board, if they consider that a particular decision is not in the best interest of the company.

Duty of care in principle includes the duty to do everything reasonably possible to be informed on all management actions of other board members.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

Only if the shareholders have suffered the damage independently form the damage caused to the company and if it can be proven that the actions of the CEO have been influenced by a third person (that includes also e.g. CEO who is a shareholder and thus as shareholder 'influencing' his actions as CEO or him acting as a director of another company etc.). Any shareholder is under those circumstances entitled to a claim.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

Director A should have disclosed his interest. He is liable to the Bidder since his actions were not in the best interest of the Bidder. The acquisition is valid unless it may be proven that the sellers of the shares knew or ought to have known the circumstances of the transaction. Obviously, the director knew them.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

A is liable, since acting as director of the Bidder he knowingly acted against the best interest of the Bidder by not revealing his knowledge of the true value of the shares.

Other directors would, however, probably also be liable since they have not taken all appropriate actions to get proper information on the true value of the shares.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

Same as answer to question 2.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

A may not be managing director of the Rival (as competitor of Bidder) without the consent of the supervisory board. Otherwise he is liable for any damage caused to Bidder.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

A is then not any more subject to the duty of care and loyalty to Bidder, but arguably he may be found liable for not having acted in the best interest of Bidder at the time when he was the director.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

If the weak financial situation is established as the true reason for not pursuing the transaction, there would be no liability.

Cyprus

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

1. *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*
2. *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

   Unclear – No case-law on the subject. Parent Company and/or directors could face criminal proceedings for offences under Criminal Code Cap.154, and civil proceedings under the Civil Wrongs Law Cap.154 for torts such as Negligence (section 51).

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*
- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*
- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders, or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

Uncertain – No case-law on the subject:

1) Regarding the first question, possible infringement of the duty of care and skill. In the Judgment of the Supreme Court in Giannakis Pelekanos and others v Andreas Pelekanos

Civil Appeal No. 10953 (2006) 1A S.C.J. 390, it was stated that the defendant director had acted in such way as to exclude his fellow director from the decision-making process, promoting his own interests over the interests of the company, which constituted a breach of his duty of care and skill. To that effect reference was made to the English judgement in Re City Equitable Fire Assurance Co. [1925] Ch 407. It is noted that the Court did not conduct a detailed analysis of the said judgment and upheld the abovementioned reference of the first instance District Court. Accordingly, the Cyprus Court may follow the English Common Law and jurisprudence associated with the Companies Act 1948 on this issue. This is so also on the basis of section 29(1)(b) of the Courts of Justice Law (14/1960).

2) Regarding the second question, in the event section 169F of the Cyprus Companies Law may be applicable. Regarding the so-called 'vicinity of insolvency', the relevant provision of the Cyprus Companies Law is section 169F, which provides (section 169F(1)) that in the event that losses of past financial years, or other reasons, lead to the reduction of the share capital of a public company by 50% or to a level which, as per the opinion of the directors, puts the accomplishment of the company's goal under dispute, the directors have to call not later than 28 days from when the reduction became known to them an extraordinary general meeting at a date not exceeding 56 days from the date when the decision for calling the meeting was made, in order to assess whether the company must be dissolved or any other measure must be taken. Under section 169F(2), an omission by the directors of the company to act as above constitutes a tort and renders them responsible for damages. The said responsibility is personal, unlimited, joint and severable.

3) Regarding the third question, uncertain – section 301 of the Cyprus Companies Law may be applicable, as to fraudulent preference vis-a-vis the company's creditors.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  Uncertain – No case-law on the issue.

  In the Judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390, it was stated that the defendant director had acted in such way as to exclude his fellow director from the decision-making process, promoting his own interests over the interests of the company, which constituted a breach of his duty of care and skill. To that effect reference was made to the English judgement in *In Re City Equitable Fire Assurance Co.* [1925] Ch 407. It is noted that the Court did not conduct a detailed analysis of the said judgment and upheld the abovementioned reference of the first instance District Court.

  Accordingly, the Cyprus Court may follow the English Common Law and jurisprudence associated with the Companies Act 1948 on this issue.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  Issues:

  - *Who decides on transactions of one of the directors with the company (related party transactions)?*

    1.1 Section 191 of the Cyprus Companies Law imposes a duty on directors, who are directly or indirectly interested in a contract or proposed contract with the company, to declare the nature of their interest at the board meeting considering the transaction. If the director becomes interested in the contract after the contract is entered into, he or she must declare the interest at the first meeting of the board of directors after he/she became interested. Failure to do so constitutes a criminal offence.

    1.2 Further, there could be a related provision in the Article of Association of the company.

- *Is the duty of care used to constrain excessive executive remuneration?*

a. Uncertain – no case-law on the subject. On the basis of (a) the Judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390, which approved the citation of the first instance District Court of the English judgement in *In Re City Equitable Fire Assurance Co.* [1925] Ch 407, and (b) section 29(1)(b) of the Courts of Justice Law (14/1960), the Cyprus Court may follow the English Common Law and jurisprudence associated with the Companies Act 1948 on this issue.

b. The above matter of the CEO is regulated by section 183 of the Cyprus Companies Law, which provides that it shall not be lawful for a company to make to any director of the company any payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, without particulars with respect to the proposed payment, including the amount thereof, being disclosed to members of the company and the proposal being approved by the company.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  Uncertain – no case-law on the subject. On the basis of (a) the Judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390, which approved the citation of the first instance District Court of the English judgement in *In Re City Equitable Fire Assurance Co.* [1925] Ch 407, and (b) section 29(1)(b) of the Courts of Justice Law (14/1960), the Cyprus Court may follow the English Common Law and jurisprudence associated with the Companies Act 1948 on this issue.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

  Issues:

  - *Who can bring a claim on behalf of the company?*
  - *Does the derivative action exist? If not, how does the law ensure that minority shareholders are protected against collusive behaviour by the majority and the directors?*
  - *What is the threshold to bring a derivative action?*
  - *Do conditions exist that must be satisfied before a court will allow a derivative action to proceed (for example, will the court review whether the action is in the interest of the company or frivolous)?*

- *Who bears the costs for a derivative action?*

1) A shareholder of the company can bring a derivative action on behalf of the company (to that effect see *Theodoros Pirillis and another v. Eleftherios Kouis* Civil Appeal No. 11387 (2004) 1A S.C.J. 136).
2) The derivative action is employed in Cyprus under certain circumstances (to that effect see inter alia the Supreme Court of Cyprus Judgements in *Theodoros Pirillis and another v. Eleftherios Kouis* Civil Appeal No. 11387 (2004) 1A S.C.J. 136 and *Aimilios Thoma and others v. Iakovos Eliades* Civil Appeal 11784 (2006) 1B S.C.J. 1263).

3) In the cases where a derivative action was successfully brought, fraudulent behaviour of the wrongdoers was evident.

4) The first instance court may be faced with an argument of no case to answer by the defendant.

5) The award of costs lies in the discretion of the Court.

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  Section 191 of the Cyprus Companies Law codifies an aspect of the fiduciary duty of directors to avoid conflicts of interest.

  Section 191 imposes a duty on directors who are directly or indirectly interested in a contract or proposed contract with the company to declare the nature of their interest at the board meeting considering the transaction. If the director becomes interested in the contract after the contract is entered into, he or she must declare the interest at the first meeting of the board of directors after he/she became interested. Failure to do so constitutes a criminal offence and the director is liable to a fine of 855 EUR.

  Of relevance to section 191 is the judgment of the Supreme Court in *Giannakis Pelekanos and others v Andreas Pelekanos* Civil Appeal No. 10953 (2006) 1A S.C.J. 390, where the Supreme Court upheld the first instance judgment of the District Court to the effect that the failure of the company directors to declare the nature of their interests prior to entering into the transaction, by using the machinery and personnel of the company pursuing projects in which they had indirect interests and by purchasing property, constituted an infringement of both the articles of association of the company and of section 191.

In addition, the provision of this section is repeated in Regulation 84(1) of Part I Table A of the Cyprus Companies Law, which can be adopted in the articles of association of the company. Further Regulation 84(2) provides that a director shall not vote in respect of any contract or arrangement in which he is interested, and if he shall do so his vote shall not be counted, nor shall he be counted in the quorum present at the meeting of the board of directors, with certain exceptions. Only the general meeting of shareholders can release the director of this prohibition, either generally or in relation to a particular contract or transaction (Regulation 84(2)). Although Part I of Table A relates to public companies, Part II of Table A, which deals with private companies, clearly states, via Regulation 1, that the Regulation of Part I Table A is applicable to private companies as well, with the exception of Regulations 24 and 53 Part I.

Whether the transaction is void or voidable may be ascertained by the Cyprus courts according to common law judgments and any judgments associated with the English Companies Act 1948.

- *As in scenario 1 but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

Issue: Does the interested director have to abstain from voting when the board decides on the conflicted interest transaction? If he/she fully informs the board and abstains from voting and the board approves the transaction, is it valid?

Yes, the interested director has to abstain and fully inform the board. If the board then approves the transaction, it is valid.

- *As in scenario 1 but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

Issue: Can the shareholders authorise or ratify a related-party transaction? Can the conflicted director vote on such a resolution if he/she is also shareholder? How is minority shareholder protection ensured? For example, can the minority shareholder appeal to the courts and claim that the transaction was not in the company's interest?

The Cyprus courts will draw guidance regarding the first two issues from the common law judgments and any judgments associated with the English Companies Act 1948.

Regarding the third issue, it may be possible by bringing a derivative action if fraud is present.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that* *the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

The Cyprus courts will draw guidance from the common law judgments and any judgments associated with the English Companies Act 1948.

- *As in scenario 4 but A resigns from his position as director of Bidder before Rival makes the competing offer.*

  There is no provision under Cyprus law on the continuation of the duty of a director not to make use of corporate opportunities even after his resignation as director, or indeed for the continuation of any other director's duty after such resignation.

- *As in scenario 4 but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

  The interested director has to abstain and fully inform the board of his interest. If the board then approves the transaction, it is valid.

  Regarding the application of the corporate opportunities doctrine, the Cyprus courts will draw guidance from the common law judgments and any judgments associated with the English Companies Act 1948.

Czech Republic

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary’s directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?

According to currently valid and effective legislation in the CC, the subsidiary would be liable towards customers. Within the framework of the group, relationships between the parent company and subsidiary companies were contractually anchored. It would depend on the nature of the given contract. If it would have the character of a controlling contact, the parent company would then be entitled to give instructions to the controlling and executive bodies of the subsidiary, if it were in the interest of the entire group. Persons giving instructions on behalf of the parent company are obliged to proceed with due diligence. If they violate this obligation, they are obliged to compensate for damage that arises from it to the controlled person (subsidiary). If creditors of the controlled person also incur damage, the persons breaching due diligence are liable jointly and indivisibly for such damage, if the claim of the creditor cannot be satisfied from the assets of the controlled person. In this case however, the parent company did not violate the obligation to proceed with due diligence, and it would incur no obligations for compensation for damage.

If the contract does not have the character of a controlling contract, the parent company could not implement such measures from which the controlled person could incur financial damage, unless it pays this damage by the end of the accounting period in which such damage occurred. In this case, it is disputable whether the measures of the parent company were of such a nature. It would probably not be judged as such because it concerned motivational measures that themselves did not lead to the origin of damage.

Under which circumstances would the directors of the parent company face a liability risk in those circumstances?

In part see previous answer: if the concluded contract is a controlling contract, the directors of the parent company would be liable if their order meant a breach of due diligence. That did not occur in this instance.

If the contract concluded between a parent company and subsidiary companies does not have the character of a controlling contract, the controlling person cannot implement measures that could cause the controlled person damage. Directors of the parent company provide a guarantee that the controlling person will compensate for damage caused by its measures implemented towards the controlled person. Here to, measures of the parent company themselves did not lead to the origin of damage, liability of the directors of the parent company thus apparently would not occur.

<u>Hypothetical II: Duties in the vicinity of insolvency</u>

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalize the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalize the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

Do fiduciary duties prevent directors from entering into particularly risky transactions?

The requirement for due diligence enables a wide interpretation and does not prevent directors from making decisions relating to financial risk. In the given case however, the situation of the company was not good enough, and the external economic environment was not stable enough to allow them to bet everything on actions of one kind. Their procedure would probably be assessed as a breach of due diligence, and lead to their liability.

At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)

The vicinity of insolvency itself is not explicitly defined in the CC. For members of the boards of directors of joint-stock companies, the obligation to adopt necessary measures would arise from the general requirement for due diligence. The CC gives supervisory boards the right to call a general meeting, if the interests of the company require so, and to propose necessary measures at the general meeting. The reason for calling a general meeting is formulated in utterly general terms, as a rule it would occur this way if the supervisory board were to ascertain serious breaches of the obligations of members of the board of directors, serious deficiencies in managing the company, etc.

What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.

See the answer at question no. 1 - directors would be held liable for violation of due diligence.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

Is the CEO liable for annual loss suffered by the company in 2008?

The rules of business judgment care are a part of the new legislation in the law on business corporations. However, even according to the current wording, it should be examined whether the CEO acted with due professional care, which forms part of the interpretation of due diligence. In this case, it would be possible to accept a conclusion that it was not like this. The CEO would thus be obliged to compensate for damage he caused the company. It is not possible to say however that such damage would equate directly to an incurred loss.

In the Czech reality, such a case would most likely be dealt with as a crime, and compensation for damage would be a secondary question.

Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?

Similar agreements are usually indicated as "golden parachutes". To prevent similar cases the CC was amended in 2000 (Act no. 370/2000 Coll.): Any supply (benefits, emoluments) by a company in favour of a person who is the organ of the company, or a member of such, which this person is not entitled to under the statutory provisions or the company's internal regulations (rules) is subject to approval by the general meeting, unless the person was awarded the right to such supply (benefits) in a contract on the performance of his office. However, the company shall not provide such supply if this person's performance of his office obviously contributed to the company's unfavorable economic results, if this person is guilty of (responsible for) breaching a statutory duty in connection with the performance of his office. The directors would thus, according to Czech legislation, violate the lawful ban on providing any supply under the aforementioned circumstances.

Have the members of the company’s internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?

Committees for auditing in accordance with Act no. 93/2009 Coll. on Auditors are compelled to create only persons of public interest, thus mainly companies whose shares were accepted for trading on the European regulated market, or entities enterprising on the capital market and economically important companies (over 4,000 employees). This concerns one of the controlling bodies of the company which must, inter alia, assess the effectiveness of internal auditing and the risk management system. They should thus deal with these circumstances. But the wording of their liability is not utterly clear. If the committee is comprised of members of the supervisory board, the requirement for due diligence applies to these members. If it were comprised of other persons, this requirement would be derived from the analogy.

Other directors would breach their obligations only under the stipulation that they did not devote close enough attention to transactions, if they could and would know and recognize that the transactions are damaging in terms of the economic interests of the company.

Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?

A minority shareholder can request the supervisor board to exercise the right to compensation for damage, which the company has towards the board of directors member. If the supervisory board does not fulfill the request of the shareholder without needless delay, it may exercise this right on behalf of the company itself.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.

Director A is violating the ban on competition regulated by the CC. For violating the ban on competition, the director incurs the obligation to relinquish proceedings from the transaction in which he breached the ban on competition, or transfer the rights to it to the company. The CC however lacks explicit regulation of the obligation to notify the company that he is in a state of competition with it. But this obligation can also be deduced from the requirement of due diligence, because it includes the obligation of loyalty to the company.

As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.

Here the situation would change, if he refrained from voting and the other directors would approve the acquisition without his vote. Certain opinions in the doctrine claim that even upon the ban on competition it is not possible to enforce sanctions against someone in a competitive position if it does not concern damage to the company.

As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.

Shareholders will not decide apparently on acquisition because it is a matter for the company's business management to decide. The general meeting could approve the transaction if such operation would be a part of the articles of association of the company. Approval by the general meeting does not mean that director A did not violate the ban on competition and does not release him from liability.

Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.

Once again, violation of the ban on competition (ban on mediating or brokering company transactions for other persons) with consequences such as in scenario 1).

As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.

It is not certain whether or not in this case that violation on the ban on competition occurred, because the law does not regulate whether competition is banned even after termination of the job function. The articles of association could contain this regulation. It would depend on the assessment of all circumstances of the given case.

As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.

In relation to a transaction not implemented, it could lead to violation of the ban on competition if the director already negotiated on behalf of the Rival, but no damage or benefit occurred, so sanction consequences for the ban on competition are not applied.

Note to all cases

The solution was performed according to valid and effective legislation in the commercial code and other regulations. There are no experiences with the new legislation, there exists no case law or opinions of doctrine that have undergone fundamental discussion arising from problems appearing in practice. Relating laws, mainly process laws, exist thus far only as unpublicized drafts that undergo comments of applicable state authorities. For these reasons, answers did not take into consideration the new legislation.

Denmark

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above? Under which circumstances would the directors of the parent company face a liability risk in those circumstances?

Answer: Yes, if the actions of the directors of the parent company were seen as irresponsible and carried out on behalf of the parent company, the parent company may face liability as a shadow director.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

  No, a director may enter into risky transactions, however, if the company has insufficient funds, either generally or because the risk is particularly great, the director is obliged to exercise particular care. However, if the director bona fide and adequately informed believes the transaction to be beneficial for the company, he may enter into it.

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

A director is obliged to exercise care to ensure that the company can fulfil its obligations and commitments as they fall due. Thus, the director owes a duty to all claimants of the company and not just to shareholders. As creditors are paid before shareholders, a director has an obligation to consider the interests of creditors before shareholders if the company is close to insolvency, but it is acceptable that the director tries to save the company from insolvency and thereby look after the interests of the shareholders as long as the actions taken are not unreasonable. Consequently, if the company is in financial distress and may not be able to honour its commitments, directors must observe particular care. However, there is no definite point in time or any set threshold as to liquidity, cash or own funds that may be used as objective cut-off points as it would depend on the company and its financial situation. In case law, directors have been held liable if they have taken on additional debt (typically by buying on credit) at a point in time where there was no reasonable prospect of the company being able to service the debt; known colloquially as the 'hopelessness point.'

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

In the case described here, my view would be that the director may escape liability if he made the decision bona fide and well informed. Danish courts may be said to apply a version of the Business Judgement Rule to the extent that they are reluctant to censor decisions made by directors that later turn out to be bad business decisions unless they were clearly reckless at the time.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

<u>Questions</u>:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  In this case, the decisions appear to have been reckless to the extent that the CEO may incur liability, see reply in hypo II. I'm not sure that Krugman's warning, despite his eloquence, would be sufficient as a warning that makes the decisions look reckless to a court, but the other market indicators would probably do.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  Only if it is proven that they understood that they were overpaying. Compensation is decided by the board of directors itself, i.e. by fellow directors. There is a fiduciary duty not to allow excessive compensation, but the boundaries are wide as to the board's discretion. Note that financial companies and publicly traded companies now must have policies on remuneration requiring approval by the shareholders in general meeting, however, the application of the policy still lies with the directors.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  The liability of the audit committee depends on whether there was information available to them that would have showed the problem. Although a board is a collective organ, each director is evaluated individually. Thus, although the members of the audit committee may be liable for failing to note available alarming information, liability may not extend to the other directors, unless the information was also available to them. This may be the case, as many audit committees disclose their information to the whole board. A director cannot excuse himself by the fact that he supposed the audit committee to discover any wrongdoings.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

No, the starting point would be that the claim belongs to the company. However, if the company decides not to pursue the claim, shareholders holding 10 per cent of the capital may raise a derivative claim on behalf of the company.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  Issue: Does the law require directors to disclose direct or indirect interests in transactions with the company? Is this duty laid down in the companies act or does it derive from the fiduciary position of the director? If the director violates the disclosure obligation, is the transaction void or voidable or does the director have to pay damages?

  Yes, a director must disclose a conflict of interest and excuse himself (for the time it takes the board to decide). However, it may be permissible first to explain his view of the matter before leaving the board. A failure can make the decision void, even if the director's vote was not decisive, however, it would depend on whether the failure to make the proper disclosure may have affected the decision made by the other directors.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

  Issue: Does the interested director have to abstain from voting when the board decides on the conflicted interest transaction? If he/she fully informs the board and abstains from voting and the board approves the transaction, is it valid?

  Yes and yes, see above.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

  Ratification is probably possible.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that* *the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

There is no specific ‘corporate opportunities doctrine’, but the same result is achieved by using the ordinary standards of duty of care and loyalty, and the rules on conflict of interest, which prohibits the director from influencing the decision.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

A resignation would probably not remedy the breach of the duty of care and loyalty, unless the resignation was made before the transaction was contemplated.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder’s weak financial position.*

It is not clear, but probably no liability of the director if the board and thereby the company do not believe to have any interest that could conflict with the private interest of the director.

Finland

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

The answer does not include any considerations on product liability law.

The Companies Act does not include provisions on lifting the corporate veil (disregarding the legal entity). The issue has been discussed in the Finnish legal literature for decades. Some Supreme Court cases may be interpreted to contain wording that does not deny the possibility of lifting the corporate veil. However, there are no published court cases applying Companies Act whre the corporate veil would have been lifted. Clearly such a decision would require exceptional circumstances. Considering the circumstances of the case, especially that the directors of the subsidiaries skip test and studies and **cover up this decision**, it is most unlikely that Finnish courts would decide the parent company to be liable.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

The answer does not include any considerations on product liability law.

If the directors of the parent company knew or should have known that necessary test and studies were skipped, this might cause liability if the parent company suffers a loss because of the directors' passivity or neglect. The parent company might have a claim against its directors based on the losses suffered by the parent company due to one subsidiary's exposure to product liability claims.

According to Chapter 1, Section 8 of Companies Act, *The management of the company shall act with due care and promote the interests of the company*. (It should be noted that the law includes the board of directors under the definition of management).

According to Chapter 22, Section 1, Sub-section 1, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall be liable in damages for the loss that he or she, in violation of the duty of care referred to in chapter 1, section 8, has in office deliberately or negligently caused to the company.*

<u>Hypothetical II: Duties in the vicinity of insolvency</u>

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalize the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalize the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

Risk-taking is a normal part of business. It is the directors' duty to assess the situation with duty of care. Business Judgement Rule is recognized under Finnish Companies Act (the preparatory text of the Government Bill acknowledges the Business Judgement Rule). The risk and required care are correlated between each other: the duty of care is emphasized when the risk increases (Government Bill HE 109/2005 page 40). This means that particularly risky transactions require particular care.

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

Chapter 20, Section 23, Sub-section 1 of Companies Act stipulates the following.

If the Board of Directors of the company notices that the equity of the company is negative, it shall without delay notify the loss of the share capital for registration.

Sub-section 3 stipulates the following.

If the Board of Directors of a public company notices that the equity of the company is less than one half of the share capital, the Board of Directors shall without delay draw up financial statements and annual report in order to ascertain the financial position of the company. If according to the balance sheet the equity of the company is less than one half of the share capital, the Board of Directors shall without delay convene a General Meeting to consider measures to remedy the financial position of the company. The General Meeting shall be held within three months of the date of the financial statements.

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

The law does not include a duty to the directors or CEO to apply for bankruptcy. However, continuing the business operations may cause liability to the directors or CEO under Criminal Code. It is not very rare that criminal proceedings are initiated after bankruptcy.

Chapter 39 of the Criminal Code includes the provisions on offences by a debtor. E.g. according to Section 1, a debtor who increases his or her liabilities without basis and thus causes his or her insolvency or essentially worsens his or her state of insolvency, shall be sentenced for dishonesty by a debtor to a fine or to imprisonment for at most two years. Section 1a includes the provisions of aggravated dishonesty by a debtor when e.g. considerable or particularly substantial damage is caused to the creditors and the dishonesty by a debtor is aggravated also when assessed as a whole, the offender shall be sentenced for *aggravated dishonesty by a debtor* to imprisonment for at least four months and at most four years.

Favouring a creditor (Section 6) is also a crime.

<u>Hypothetical III: Duty of care</u>

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

<u>Questions</u>:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

The CEO is liable under Companies Act at least for the damage caused by the transaction taken to transfer assets at an undervalue to a company owned by the CEO him/herself. According to Chapter 6, Section 19 of Companies Act, section 4 on disqualification applies also to the Managing Director. According to Chapter 6, Section 4 of the Companies *Act A Member [of the Board of Directors] shall likewise be disqualified from the consideration of a matter pertaining to a contract between the company and a third party, if the Member is to derive an essential benefit in the matter and that benefit may be contrary to the interests of the company. The provisions in this section on a contract apply correspondingly to other transactions and court proceedings.*

For damages unrelated to the damages caused by the above-mentioned self-interest transactions, the answer is unclear. For losses caused by transactions taken in 2005, 2006 and early 2007 the CEO is not liable as the business was common market practice and had generated high profits for the company. Towards the end of 2007 and in 2008 signs of losses became clearer and it is possible that he or she is liable for neglecting the fiduciary duty. According to Companies Act, Chapter 1, Section 8, *The management of the company shall act with due care and promote the interests of the company*.

According to Chapter 22, Section 1, Sub-section 1, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall be liable in damages for the loss that he or she, in violation of the duty of care referred to in chapter 1, section 8, has in office deliberately or negligently caused to the company.*

According to Supreme Court case KKO 1997:110 risk-taking is a part of credit functions of commercial banking. According to the Supreme Court, duty of care requires, however, that credit decisions are prepared carefully and that they can be justified by commercial grounds. When assessing the duty of care, the decisive point of time is the state of affairs at the time when the decisions were made. Already when the first credit decision was taken 22 November 1990, the appellants had to be aware even based on the information given in the media of the weakening economic trends and the decreasing housing prices prevailing at that time. Nothing referred to an essential and rapid amelioration of the situation.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

The answer is written under the presumption that there was no previous agreement on the severance benefits.

The directors are liable. The described resignation agreement would be **highly unusual** in Finland for any company. In fact I don’t think such a package has ever been given to any CEO even in a highly successful company. Under the circumstances, when the resignation takes places in a situation of a loss of eight billion EUR, following the CEO’s investment decisions, the board has not acted with due care considering the exceptionally expensive resignation agreement.

According to Chapter 1, Section 8, *The management of the company shall act with due care and promote the interests of the company*. (It should be noted that the law includes the board of directors under the definition of management).

According to Chapter 22, Section 1, Sub-section 1, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall be liable in damages for the loss that he or she, in violation of the duty of care referred to in chapter 1, section 8, has in office deliberately or negligently caused to the company.*

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

Under Companies Act, the answer is unclear. The members of the audit committee are liable, if the real nature of the transactions taken by the CEO was evident in the material or other information received by the audit committee. Even if the issue was not evident but there was anyway reason to doubt the true nature of those transactions. the committee members may be liable for neglecting the duty of care of Companies Act Chapter 1, Section 8. The same applies to the other directors. They are liable if they had reason to doubt the true nature of the transactions from the materials and other information that they had. The other directors may have had less possibility to notice the suspicious transactions and it is possible that only the audit committee members are liable. The law is not different for members and non-members but the circumstances in question determine who is liable.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

Yes, at least if the plaintiff hold at least 10 % of all the shares. An owner of just one share has the same right if non-enforcement of the claim would be contrary to the principle of equal treatment but this is not evident in the case description.

The Companies Act includes the following Chapter 22, Section 7:

Right of the shareholders to bring an action on the behalf of the company

(1) One or several shareholders shall have the right to bring an action in their own name for the collection of damages to the company under sections 1—3 or under section 44 of the Auditing Act, if it is probable at the time of filing of the action that the company will not make a claim for damages and:

(1) the plaintiffs hold at least one tenth (1/10) of all shares at that moment; or

(2) it is proven that the non-enforcement of the claim for damages would be contrary to the principle of equal treatment, as referred to in chapter 1, section 7.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

Director A is liable under Companies Act.

According to legal literature, competing action is forbidden due to duty of loyalty. Although the Companies Act contains no explicit provision on the duty of loyalty, legal literature agrees that it is part of duty or care (Chapter 1, Section 8). This is also stated in the Government Bill for the Act (HE 109/2005 page 79).

Furthermore, according to Chapter 6, Section 4 of the Limited Liability Companies Act, *A Member [of the Board of Directors] shall likewise be disqualified from the consideration of a matter pertaining to a contract between the company and a third party, if the Member is to derive an essential benefit in the matter and that benefit may be contrary to the interests of the company. The provisions in this section on a contract apply correspondingly to other transactions and court proceedings.*

According to Chapter 1, Section 8, *The management of the company shall act with due care and promote the interests of the company*. (It should be noted that the law includes the board of directors under the definition of management).

According to Chapter 22, Section 1, Sub-section 1, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall be liable in damages for the loss that he or she, in violation of the duty of care referred to in chapter 1, section 8, has in office deliberately or negligently caused to the company.*

According to Chapter 22, Section 1, Sub-section 2, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall likewise be liable in damages for the loss that he or she, in violation of other provisions of this Act or the Articles of Association, has in office deliberately or negligently caused to the company, a shareholder or a third party.*

According to the Supreme Court case KKO 1997:110, even a deputy director may be liable for damages even when the deputy director did not participate in the decision-making, if he or she neglected the fiduciary duty e.g. by not disclosing to the board the essential factors related to the decision that he or she was aware of.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

Director A is liable under Companies Act (Chapter 1, Section 8 as described in point 1). Also the above-mentioned Supreme Court case KKO 1997:110 shows that non-disclosure of essential factors may cause liability even when the director does not participate in the decision-making.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

Director A is liable under Companies Act (Chapter 1, Section 8 as described in point 1). Also the above-mentioned Supreme Court case KKO 1997:110 shows that non-disclosure of essential factors may cause liability even when the director does not participate in the decision-making. The ratification of the shareholders does not remove Director A's duty to disclose his or her knowledge of the discrepancy between the purchase price and the value of the assets.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

Director A is liable under Companies Act.

According to legal literature, competing action is forbidden due to duty of loyalty. Although the Companies Act contains no explicit provision on the duty of loyalty, legal literature agrees that it is part of duty or care (Chapter 1, Section 8). This is also stated in the Government Bill for the Act (HE 109/2005 page 79).

According to Chapter 6, Section 4 of the Companies *Act A Member [of the Board of Directors] shall likewise be disqualified from the consideration of a matter pertaining to a contract between the company and a third party, if the Member is to derive an essential benefit in the matter and that benefit may be contrary to the interests of the company. The provisions in this section on a contract apply correspondingly to other transactions and court proceedings.*

According to Chapter 1, Section 8 *The management of the company shall act with due care and promote the interests of the company*. (It should be noted that the law includes the board of directors under the definition of management).

According to Chapter 22, Section 1, Sub-section 1, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall be liable in damages for the loss that he or she, in violation of the duty of care referred to in chapter 1, section 8, has in office deliberately or negligently caused to the company.*

According to Chapter 22, Section 1, Sub-section 2, *A Member of the Board of Directors, a Member of the Supervisory Board and the Managing Director shall likewise be liable in damages for the loss that he or she, in violation of other provisions of this Act or the Articles of Association, has in office deliberately or negligently caused to the company, a shareholder or a third party.*

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

Under Companies Act, the answer is unclear. After the resignation Director A has no fiduciary duty towards the Bidder. It is unclear, however, if non-disclosure of the facts before the resignation could be deemed to be such a neglect that it has causality with any damage suffered by the Bidder. Under the circumstances, especially if the resigning director has mentioned the conflict of interest as the cause of resignation, the remaining board members should take all reasonable efforts to base their decision on all relevant facts.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

Under Companies Act, the answer is unclear. If the Bidder's financial position is weak, the transaction might be too risky as it is not certain if the Bidder could sell the assets to the Rival with a profit. Thus it is not clear if the Bidder has been caused damage by Director A.

France

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

  French case law is very restrictive to admit the possibility to hold the parent liable for instructions given to the subsidiary, such as in the current case.

  The employees working for the subsidiaries are formally still employed with the parent company but are posted with the subsidiaries under an agreement entered into by the parent company, and the two subsidiaries is something common in groups. It would not lead the courts, as such, to consider that the subsidiary was not an independent entity.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

  The parent company would have to be considered a shadow director or it would have to create a misleading appearance towards thirds parties that the parent was actually contracting (selling the drugs) with clients. Case law is becoming currently more restrictive as the latest decisions since 2004 require a misleading appearance and not just involvement in the business of the subsidiary.

<u>Hypothetical II: Duties in the vicinity of insolvency</u>

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

Under French law, directors and managers are not prohibited from entering into risky transactions. However, in the case at hand, since the company will have to file for bankruptcy because of the transaction, it is almost certain that it will be held liable for breach of its duty of care.

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

Once the company has filed for bankruptcy, any management mistake that was committed before the bankruptcy may lead to liability.

- *What is the legal response to below situation?*

The directors would almost certainly be held liable for management mistakes.

<u>Hypothetical III: Duty of care</u>

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  The BJR, as known in the US, does not apply in France, but French courts do not tend to second-guess business decisions as long as the company does not become insolvent. If it does, they easily find a management mistake. In the current case, the company has not become insolvent. This situation is similar to a few situations of French banks. No suit has been filed and I doubt that a judge would find a management mistake. Suits are more likely to be filed (but not necessary to be successful) on the ground that the company, when listed, did not disclose with accuracy the relevant facts.

  It cannot be said generally when warning signs ('red flags') become so obvious that initially permissible risk-taking constitutes a violation of the duty of care. This is decided by courts on a case-by-case basis. They will usually hold that the situation must have been so desperate that there would have been no hope to save the company.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  The decision belongs to the board of directors (or supervisory board), but if the transaction is signed before and without authorisation, it is simply voidable in case of prejudice to the company.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  Theoretically, members of the audit committee are not subject to specific liability rules or a separate standard of care in light of their position and/or expertise, especially in suits by shareholders. However, if the board of directors is held liable for having approved the transaction, members of the audit committee will face a secondary action by other members of the board in order to share a larger portion of the damages by arguing that they are more liable.

  Directors are generally not required to monitor their colleagues. If a director lies to them, they will probably not be held liable for not having identified the problem, unless it was obvious.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

  - Who can bring a claim on behalf of the company?

    Any shareholder.

  - What is the threshold to bring a derivative action?

    One share.

  - Do conditions exist that must be satisfied before a court will allow a derivative action to proceed (for example, will the court review whether the action is in the interest of the company or frivolous)?

    No.

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  The law requires directors to disclose their interest. This duty is laid down in the Code de Commerce. The transaction is void because the director took part in the vote, regardless of the fact that his vote was not essential, and even if the operation would have been beneficial to the company. However, the nullity is not opposable to good faith third parties.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

  The conflicted director must abstain from voting. As long as he abstains and the board approves the transaction, it is valid.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

  Shareholders cannot authorise the transaction. They can only approve it, with no legal effect. Under French law, the rule is that each organ of the company receives its powers from the Companies Act and modifications are limited.

  A minority shareholder can appeal to the court and claim that the transaction was not in the company's interest even if the transaction was approved by the majority of the shareholders.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

  The body of case law on the corporate opportunities doctrine is not very developed. Directors (but not managers of Limited - SARL) are allowed to run competing businesses. However, this case law is evolving. It cannot be ruled out that a French court would hold that there was a breach of the duty of loyalty, since the exact extent of this duty is still not fully clear.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

  There could be a case for liability, but again this is not certain.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

  There is no prejudice, so that there would be no liability.

Germany

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary[3]

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary’s directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

1. *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above? Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

   Under German law the liability of a parent company could in these circumstances arise out of the principle of liability for an intervention destroying the economical existence of the company (*existenzvernichtender Eingriff*), general stock corporation law, as well as group law regulations.

[3] Answers on German law kindly provided by Niklas Bielefeld.

a) Intervention destroying the economic existence of the company (*existenzvernichtender Eingriff*)

The limited liability of shareholders and the separation of liabilities and assets between shareholders and company – as laid down in s. 1(1), sent. 2 of the German Stock Corporation Act (*Aktiengesetz*, AktG) for the German stock corporation (*Aktiengesellschaft*, AG) and in s. 13(2) of the German Limited Liability Company Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, GmbHG) for limited liability companies (*Gesellschaft mit beschränkter Haftung*, GmbH), respectively – have always been emphasised and enforced by German courts as two of the core principles of company law. The German Federal Court of Justice (*Bundesgerichtshof*, BGH) has over the years established a rule that the shareholders in a limited liability company may be subject to personal liability towards the company in case of a conscious intervention or interference destroying the economic existence of the company. This case group is not quite clear-cut, however, from a dogmatic point of view and has undergone several changes and alterations over the years. According to recent decisions by the BGH the personal liability of the shareholders for this particular form of misuse and abuse of the corporate form is derived from s. 826 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB), a rule of tort law. It applies only in very narrow circumstances, where the shareholders consciously and abusively diminish the assets of the company, causing the company to become insolvent in the process. The actions of the shareholders leading to the insolvency must be of an unethical and immoral nature. In an authoritative decision from 2008 the BGH stated:[4]

> "The liability for intervention destroying the economic existence of the company (remark: *as a case group of s. 826 BGB*) shall have the effect of an enforced prohibition of the withdrawal of company assets which endorses – but also goes noticeably beyond – the general statutory rules on capital maintenance by compensating for the unethical self-serving behaviour of shareholders to the detriment of the creditors of the company and thereby causing or deepening the company's insolvency through the establishment of a rigid liability for damages to the impaired assets of the company."

According to the BGH, the actions of the shareholders have to aim at giving preference to their financial interests over the legally protected interests of the creditors through a conscious impairment of the assets of the company. Since the courts have always been reluctant to interpret this case group broadly, the personal liability of shareholders is limited to this type of behaviour.

While not being undisputed, it is argued by most legal authors that this concept of liability, which was developed for private limited companies (GmbH's), shall also apply to public companies (AG's).[5]

In the above case, German courts would almost with certainty conclude that the parent company was not liable according to s. 826 BGB for causing the insolvency of one of its subsidiaries, because the relevant actions, i.e. the setting-up of the bonus scheme – although probably unethical and reckless towards the general public – were not aimed at impairing the subsidiary's assets in favour of the parent company's self-interest and to the detriment of the creditors' interests.

[4] BGH, Judgement of 28 April 2008 - II ZR 264/06 ("Gamma", NJW 2008, 2437, 2438); see also BGH, Judgement of 9 February 2009 - II ZR 292/07 ("Sanitary", NJW 2009, 2127).
[5] Hüffer, Aktiengesetz, 10th edition, 2012, § 117, sec. 14; Spindler, in Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 117, sec. 87-88.

b) Liability according to s. 117 AktG

If the two subsidiary companies developing the drugs in the above case were AG's instead of GmbH's, the liability of the parent company could also result from s. 117 AktG, which stipulates in subsection 1:

> "Any person who, by exerting his influence over the company, intentionally induces a member of the management board or the supervisory board, a registered authorised officer (*Prokurist*) or an authorised signatory to act to the disadvantage of the company or its shareholders shall be liable to the company for any resulting damage. Such person shall also be liable to the shareholders for any resulting damage insofar as they have suffered damage in addition to any loss incurred as a result of the damage to the company."

This regulation not only provides for a liability towards the company, but also towards its shareholders. The required influence over the company's management or officers will in most cases result from a position as shareholder of the AG. Thus, the parent company could in principle be subject to such liability. In addition, the influence must be aimed at inducing an action by the management that is in contravention of the company's interests (see s. 76 AktG) and its specific social responsibility resulting from art. 14(2) of the German Federal Constitution (*Grundgesetz*, GG). It is generally acknowledged that this criterion has to be evaluated in the light of the general duty of care of the directors as laid down in s. 93 AktG.[6] Whether an action can be regarded as a violation of the director's duty has to be determined by the rules set out in s. 93 AktG. Section 93(1) sent. 1 AktG states that in conducting the company's business, the members of the management board shall employ the care of a diligent and conscientious manager. Sent. 2 clarifies that it shall not be deemed a violation of the aforementioned duty if, at the time of the entrepreneurial decision, the members of the board had good reason to assume that they were acting on the basis of adequate information and for the benefit of the company. This provision effectively establishes a *business judgment rule* in German corporate law. Although the directors are hereby generally granted a rather broad range of discretion for decision-making, the assumption of unforeseeable risks would have to be regarded as a violation of the duties of the directors.

Putting drugs on the market which have not been sufficiently tested constitutes an unforeseeable risk. The directors of both parent and subsidiary company knew that the testing schedule initially was 12 months and consciously wanted to short-cut the process by setting up the bonus scheme to reach the aim of regulatory approval within six months, hereby accepting enormous product liability risks for the subsidiary company. It is a matter of value judgement whether the considerable advantages of a much faster testing process – which eventually materialised in substantial profits with one of the drugs – make up for the danger of enormous liability risks. This seems rather questionable, though, in light of other risks for the welfare of the involved companies, such as for example the considerable reputational damage caused by "scandals" in the pharmaceutical industry. Generally, the directors may not take actions which pose a potentially

[6] Spindler in Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 117, sec. 37; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 117, sec. 24.

existential risk to the company, even if from an *ex ante* perspective the decision has a positive net present value.[7] In addition, it conflicts with the social responsibilities of the company to put potentially dangerous drugs on the market without proper testing in order to be the first supplier in the relevant market. Furthermore, giving false information to the authorities during the approval process may also be unlawful under the relevant statutory rules. In any case, the encouragement of such illegal behaviour by the subsidiary companies' directors falls outside of the directors' discretion granted by the business judgement rule.

Therefore, it can be reasonably concluded that the parent company and its directors would be liable under s. 117 AktG for unlawfully using their influence over the subsidiary company.

c) Group Law – liability in the case of an domination agreement (*Beherrschungsvertrag*)

As regards German group law, the liability of the parent company and its directors towards the subsidiary company could also arise out of the application of s. 309(2) AktG if a domination agreement existed between the two companies. According to subsection 1 of this provision, the legal representatives of the controlling parent company shall, in issuing instructions to the controlled company, employ the care of a diligent and conscientious manager. If such legal representatives violate their duties, they are jointly and severally liable to the company for any resulting damage pursuant to subsection 2. Although the wording of the provision only concerns the liability of the directors of the controlling company, it is undisputed that the controlling company itself is also liable for the damage. The liability of the controlling company further requires an "instruction" by the management of the controlling company. An instruction in this sense is every measure by means of which the management of the controlling company tries to influence the conduct of the controlled company. Thus, no express order or directive by the management of the controlling company is necessary.

In the above case, the awarding of the bonuses to the directors of the subsidiaries was only put in place by the management of the controlling company in order to induce them to speed up the development and testing of the drugs. It is highly likely that German courts would deem this to be an instruction in the sense of s. 309 AktG. Again, whether an action constitutes a violation of the director's duties has to be determined in light of the definition of directors' duties under s. 93 AktG. As elaborated above, the instruction by the management of the parent company would very likely have to be qualified as a violation of the directors' duties for various reasons.

For the sake of completeness, it shall be noted that the burden of proof regarding the violation of the duties of the directors is borne by the directors according to s. 93(2) sent. 2 and s. 309(2) sent. 2 AktG. Furthermore, each shareholder of the subsidiary company as well as the creditors of the subsidiary are entitled to bring the claim either against the parent company or against its directors according to s. 309(4) AktG. For the creditors this is only the case if their claims cannot be satisfied by the subsidiary company itself.

Irrespective of a possible violation of duties, the parent company would be liable for any annual loss that the subsidiary company may suffer pursuant to s. 302 AktG.

[7] Federal Court of Justice, Judgement of 4 July 1977 - II ZR 150/75 (Neue Juristische Wochenschrift 1977, 2311); High Court of Düsseldorf, Judgement of 9 December 2009 - I-6 W 45/09 (beck-online, BeckRS 2010, 00532); High Court of the State of Thuringia, Judgement of 8 August 2000 - 8 U 1387/98 (Neue Zeitschrift für Gesellschaftsrecht 2001, 86).

d) Group law – liability in a factual group (*faktischer Konzern*)

If no control or domination agreement is in force between the parent and the subsidiary company the liability of the parent company and its directors would result from s. 317 AktG, the requirements of which are rather similar to those of s. 309 AktG. The parent company must have caused the subsidiary company to take a disadvantageous measure without compensating the subsidiary for the damage incurring therefrom.

It shall be added for the sake of completeness that the liability of the parent company and the directors could, of course, also result from regulations of German tort and product liability law.

e) Substantive consolidation

The above constellation also gives reason to mention the equitable concept of substantive consolidation. However, group insolvency law in general is hardly regulated and comparatively underdeveloped in Germany. While the concept has been discussed recently in the legal literature (with a rejecting tenor),[8] it has to be concluded that it is still unknown to German law.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalize the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalize the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in lime with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

[8] Alexander Verhoeven, Zeitschrift für das ganze Insolvenzrecht (ZInsO), 2012, 1689-1697; Karsten Schmidt, Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis (ZIP), 2012, 1053-1058; Karsten Schmidt; Konkurs-, Treuhand- und Schiedsgerichtswesen (KTS), 2011, 161-184.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

1. *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

The taking of certain risks is, of course, inherent in any kind of business activity. However, in general directors may enter into particularly risky transactions only under certain circumstances. According to s. 93(1) sent. 1 and 2 AktG, the directors have to evaluate all risks and chances that are related to the specific transaction, make their decision on an appropriately informed basis, and act solely for the purpose of the welfare of the company. There is no outright prohibition of speculative finance transactions or other transactions carrying unforeseeable risks, as the ones described above, but such transactions may generally only be entered into if they are part of the ordinary business operations of the company as laid down in the articles of association, or if they are ancillary to transactions that fall within the company's regular business activities. This is the case for banks and other financial institutions, but not for other kinds of companies.[9]

Furthermore, the directors may not enter into particularly risky transactions if they pose a potentially existential risk to the company, i.e. if the company will very likely become insolvent if the transaction fails.[10] This principle applies even if from an *ex ante* perspective there is a predominant likelihood of the realisation of a profit.[11] The higher the threat of insolvency, the more stringent is the duty of the directors to abstain from such transactions. Although some authors have proposed that speculative derivatives transactions and the like should only be permissible up to an amount in reasonable proportion to the company's equity capital, no specific ratios have been suggested to specify this criterion yet.[12]

As regards a possible personal liability of the directors according to s. 93 AktG in the above situation, the equity ratio would have to be taken into consideration. Although there is no specific prohibition of under-capitalisation, the directors are obliged to ensure that the company has an appropriate equity cushion that permits it to engage in its relevant area of business. The equity ratios of competitors and comparable companies are a point of orientation. In addition, the fact that the company encounters increasingly financing problems and a rise of negotiated prices resulting from its very low equity ratio should have been "red flags" for the directors. It should be noted in this context that a non-authoritative corporation tax directive defines an equity ratio of 30

[9] Federal Court of Justice, Judgement of 5 October 1992 – II ZR 172/91 (Neue Juristische Wochenschrift 1993, 57, 63).
[10] Federal Court of Justice, Judgement of 4 July 1977 - II ZR 150/75 (Neue Juristische Wochenschrift 1977, 2311); High Court of Düsseldorf, Judgement of 9 December 2009 - I-6 W 45/09 (beck-online, BeckRS 2010, 00532); High Court of the State of Thuringia, Judgement of 8 August 2000 - 8 U 1387/98 (Neue Zeitschrift für Gesellschaftsrecht 2001, 86).
[11] Federal Court of Justice, Judgement of 4 July 1977 - II ZR 150/75 (Neue Juristische Wochenschrift 1977, 2311); High Court of Düsseldorf, Judgement of 9 December 2009 - I-6 W 45/09 (beck-online, BeckRS 2010, 00532); High Court of the State of Thuringia, Judgement of 8 August 2000 - 8 U 1387/98 (Neue Zeitschrift für Gesellschaftsrecht 2001, 86).
[12] Hölters, Aktiengesetz, 1st edition, 2011, § 93, sec. 159; Säcker, Gesellschaftsrechtliche Grenzen spekulativer Finanztermingeschäfte - Überlegungen aus Anlass der Garantieerklärung der Bundesregierung für die Hypo Real Estate-Group, in Neue Juristische Wochenschrift 2008, 3313, 3314.

per cent as appropriate.[13] Nevertheless, in the case under consideration insolvency was not immediately impending since there was still a certain, albeit low level of equity cushion.

2. *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

Apart from s. 92(2) sent. 3 AktG, German company and insolvency law do not provide for specific statutory duties of the directors prior to the existence of statutorily defined so-called reasons or events of insolvency (*Insolvenzgründe*).

There are three different reasons for insolvency, which trigger the duty of the directors to file for insolvency proceedings in the above case: cash-flow insolvency (illiquidity), impending cash-flow insolvency, and over-indebtedness. Section 17(2) of the German Insolvency Code (*Insolvenzordnung*, InsO) defines illiquidity as the inability of the company to pay its debts when they fall due. Impending cash-flow insolvency in the sense of s. 18(2) InsO occurs when the company will presumably become unable to pay its existing debts when they fall due in the near future (usually a three-months perspective is applied). The company is insolvent because of over-indebtedness according to s. 19(2), sent. 1 InsO when the value of its assets is insufficient to cover its liabilities unless, considering all specific circumstances, the continuation of the enterprise is more likely than its termination.

There is no specific point in time that defines the "vicinity of insolvency" and that would change the duties of the directors with regard to the conduct of the business other than the occurrence of these reasons of insolvency. Rather, the discretion of the directors granted by s. 93 AktG becomes narrower when the company faces a crisis and certain payments or risk-taking could potentially entail insolvency. But this is a question for each single action or payment and cannot be assessed by way of a general "yardstick" method. This approach is exemplified by s. 92(2), sent. 3 AktG. Section 92(2) AktG states:

> "After the non-solvency of the company has occurred or its over-indebtedness has emerged, the management board may not make any payments. The foregoing shall not apply to payments made after this time that are nonetheless compatible with the care of a diligent and conscientious manager. The same obligation shall apply to the managing board for payments to shareholders as far as such payments were bound to lead to the company's insolvency, unless this was not foreseeable even when employing the care set out s. 93(1), sent. 1."

The prohibition of payments by the directors in s. 92(2), sent. 1 AktG only applies *after* one of the following two reasons for insolvency, illiquidity or over-indebtedness, have occurred. The prohibition is made more flexible by the exception that such payments are permissible if they are "compatible with the care of a diligent and conscientious manager", a reference to the BJR of s. 93(1) AktG. It is made clear by sent. 3 that *prior* to the occurrence of one of these reasons for insolvency only payments to shareholders are prohibited. Further, such payments are only prohibited if it was foreseeable that they would lead to the insolvency of the company. The fact that foreseeability is judged from the *ex ante* perspective of a diligent and conscientious director

shows the importance that the idealised discretion of the directors laid down in s. 93 AktG plays under German law. The rigidity of German law in this respect is further underlined by the fact that

[13] Körperschaftsteuer-Richtlinien 2004 mit Hinweisen 2008 (KStR 2004), R 33 section 2 sent. 3.

the prohibition of payments pursuant to s. 92(2), sent. 1 does not apply in the case of impending insolvency in the sense of s. 18(2) InsO. Thus, the danger of insolvency alone does not trigger any specific duties.

3. *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

As the BGH has emphasised on many occasions, the directors are obliged to monitor constantly the company's financial and solvency position as well as the ratio of assets and liabilities.[14] If the directors have no reason to regard the company as illiquid or over-indebted after consultation of all necessary resources and thereby applying the care of a diligent and contentious director, there is no reason under German law to consider the interests of creditors. The directors only have to act in the interest of the company and not its creditors.[15]

As already mentioned above, this approach only changes with the occurrence of one of the reasons of insolvency. The duties of the directors change insofar as they are from this point on required by s. 92 AktG and s. 15a InsO to protect the company's assets for an orderly lawful distribution among its creditors and to file for the opening of insolvency proceedings. Hereby, unlawful advantages to shareholders or certain creditors shall be prevented.[16]

The duty to file for the opening of insolvency proceedings is enforced by criminal law (s. 15a(4) InsO), which penalises the belated filing, as well as by s. 283 of the German Criminal Code (*Strafgesetzbuch*, StGB) if the directors consciously or recklessly caused the company to become insolvent.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008,

[14] Recently: BGH, Judgement of 27 March 2012 − II ZR 171/10, Neue Zeitschrift für Gesellschaftsrecht (NZG), 2012, 672.
[15] BGH, Judgement of 10 July 2012 − VI ZR 341/1, Neue Juristische Wochenschrift (NJW), 2012, 3439, 3441.
[16] Hüffer, Aktiengesetz, 10th edition, 2012, § 92 sec. 14; Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 92, sec. 57.

accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  Since the introduction of s. 93(1) sent. 2 AktG directors are to a certain degree protected from personal liability by a business judgement rule which allows them to act and decide under conditions of uncertainty if their actions and decisions are taken on an appropriately informed basis and for the purpose of the welfare of the company.

  Thus, directors have to collect comprehensive information on the envisaged transaction. Where necessary, they are required to consult experts. They are then expected to decide whether to proceed with the transaction on the basis of a universal valuation of all related risks and benefits for the company. [17] Thus, as elaborated above, taking risky measures is generally permissible if and to the extent that such risks are balanced by the expected advantages for the company.

  It will always be considered a violation of the duty of care if the envisaged action is outright unjustifiable. This is the case if the action would be considered wrong from the perspective of an uninterested third person from outside of the company.[18] While it is difficult to describe what constitutes a violation of the duty of care on an abstract basis, it is highly likely that courts will consider the duty of care to be violated if the likelihood of a loss to the company is higher than the likelihood of any profits, irrespective of the potential size of such profits.[19]

  When applying these criteria to the above case, the CEO would presumably be held liable for at least parts of the losses of the company in 2008. The general reluctance of German courts to

[17] Hölters, Aktiengesetz, 1st edition, 2011, § 93, sec. 154; Hüffer, Aktiengesetz, 10th edition 2012, § 93, sec. 4; Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 93, sec. 51; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, sec. 80.

[18] Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 93, sec. 51.

[19] Federal Court of Justice, Judgement of 4 July 1977 - II ZR 150/75 (Neue Juristische Wochenschrift 1977, 2311); High Court of Düsseldorf, Judgement of 9 December 2009 - I-6 W 45/09 (beck-online, BeckRS 2010, 00532); High Court of the State of Thuringia, Judgement of 8 August 2000 - 8 U 1387/98 (Neue Zeitschrift für Gesellschaftsrecht 2001, 86); Hölters, Aktiengesetz, 1st edition, 2011, § 93, sec. 154; Hüffer, Aktiengesetz, 10th edition 2012, § 93, sec. 4; Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 93, sec. 51; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, sec. 80.

interfere with pure business decisions notwithstanding, courts have in recent years become more prepared to evaluate such decisions in the light of the directors' discretion and the boundaries of the business judgement rule. Although it might initially have been a sound decision for a large and experienced bank to invest in CDOs – given the healthy profits that these investments generated initially – it soon became apparent that such transactions were likely to cause tremendous losses at least on a short to mid-term perspective. Against the background not only of the particular structure of such products ("sub-prime"), but also of the warning that – among other signs of potential for losses – defaults and foreclosures increased in the USA and income from the mortgages fell rapidly from 2005 on as well as the statements of economist Krugman, the first bankruptcy of a large US subprime lender, and the huge write downs of other investors in 2007, it was reasonably to conclude that the investments in CDOs carried a very high risk of losses for the company. In addition, one must also take into consideration the behaviour of "peer" banks or enterprises that were similarly exposed to the risks carried by CDOs and compare their reactions to the warning signs. For example, if they acted differently than the CEO in our case and divested their holdings, this would be a strong sign that further investments in the securities until 2008 constituted a violation of the duty of care. All in all, it therefore seems justifiable to hold the CEO liable under the German business judgment rule for all or the largest part of the losses incurred from early 2007 to 2008.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

German stock corporation law provides for a two-tier system where a mandatory supervisory board (*Aufsichtsrat*, s. 94 seq. AktG) controls the actions and decisions of the board of directors (*Vorstand*, s. 76 seq. AktG), see s. 111(1) AktG. The general principle of s. 78(1) AktG is that the board of directors is the legal representative of the company. In deviation from this principle, the supervisory board decides on and represents the company in all transactions with members of the management board (s. 112 AktG). The supervisory board is also competent to determine the remuneration of the members of the board of directors according to the rules set forth in s. 87 AktG. This is now regarded as one of the foremost duties of the supervisory board by the German legislator. Section 87(1) sent. 1 AktG provides:

> "In determining the remuneration of the overall earnings (salary, profit participation, allowances, insurance rewards, premiums, incentive-oriented remuneration promises such as stock option rights and additional remunerations of any kind) of each single member of the board of directors, the supervisory board is obliged to ensure that these shall be of an appropriate proportion with regard to the duties and services of the member of the board of directors as well as the situation of the company and that they shall not exceed the usual remuneration without any particular reason."

The liability of the members of the supervisory board for damage to the company due to excessive remuneration of the members of the board of directors has been made an express statutory rule in s. 116 sent. 3 AktG with the coming into force of the Board of Directors Remuneration Act (*Vorstandsvergütungsgesetz*).

The liability of the members of the supervisory board who decide on such transaction in a German stock corporation depends on one crucial question: of which nature is the payment to the CEO upon his leaving the company?

The BGH held in a famous and very controversial decision regarding the question of criminal liability of the supervisory board members for granting excessive payments to members of the board of directors in 2005 ("Mannesmann")[20] that the payment to a leaving CEO violated the fiduciary duties of the members of the supervisory board if: (1) it is not provided for in the service contract of the relevant director; (2) it constitutes an award in order to increase retroactively the remuneration of the director; and (3) it does not bring about any (future) benefits for the company. The BGH regards so-called "compensation-less" appreciation awards ("*kompensationslose Anerkennungsprämie*") as a violation of the duty of care under German law.

Large parts of the company law literature assess the case differently insofar as they are prepared to regard even exorbitant payments to directors who leave the company as possibly legitimate if they constitute an award or reward for extraordinary services that the directors has performed for the company. Such payments might also have a beneficial effect on the company as they may create a strong incentive for potential future directors to work for the company; thus, such payments would not be without a certain element of compensation.

Even if this more generous view is applied, the payment and other benefits to the CEO in the above case would likely constitute a breach of the duty of care of the members of the supervisory board, unless the director had performed particularly outstanding services for the benefit of the company during his time as CEO. But the tremendous losses suffered by the company, which were a consequence of his decision to invest in CDOs, would make it unlikely that such a view would be justified in court proceedings under German law.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

In a German stock company the supervisory board is competent to monitor such transactions according to s. 111 AktG. Although members of German supervisory boards often have specific expertise in various areas, this is not expressly required by statutory law, so that no particular rules regarding a higher level of care exist.[21] Hence, the situation would not be entirely comparable to the monitoring of such transactions for example by specifically qualified members of a British internal auditing committee. It has repeatedly been decided by the BGH, however, that board members who have specific knowledge or skill in a particular area such as accounting are required under German law to live up to a higher standard of care in their area of expertise.[22]

The main duty of the supervisory board is set out in s. 111(1) AktG and consists in controlling the management of the company. This encompasses the monitoring of the legality, soundness, purposefulness, functionality and usefulness of the directors' actions.[23] The supervisory board is entitled to a broad range of information and control rights, such as regular reports by the board of directors on a variety of important facts concerning the business of the company.[24] If the respective transactions in the above case were of particular importance for the profitability or

[20] BGH, Judgement of 21st December 2005 - 3 StR 470/04, Neue Juristische Wochenschrift (NJW) 2005, 522.
[21] The personal requirements for members of the supervisory board are set out in s. 100 AktG.
[22] Recently: BGH, Judgement of 2 September 2011 - II ZR 234/09, Wertpapier-Mitteilungen (WM) 2011, 2092.
[23] Hüffer, Aktiengesetz, 10th edition, 2012, § 111 sec. 6.
[24] See s. 90 AktG.

solvency of the company, the board of directors would be required under s. 90(1), no. 4 in connection with subsection 2, no. 4 AktG to inform the supervisory board of such transactions early enough to give the supervisory the opportunity to comment on the transactions prior to their execution.

It might be justified to argue that depending on the structure of the bank's business in the above case and the regularity with which the bank traded with such companies, the supervisory board should have duly noticed irregularities – the constant selling of assets at an undervalue to companies in the Cayman Islands – when exercising their duty of care and control rights in a proper way. Upon noticing these irregularities, the supervisory board would have been required to investigate further the nature of the transactions, specifically if such transactions occurred frequently or were of a certain value. The non-performance of such investigations would very likely lead to liability of the members of the supervisory board towards the company according to s. 116 sent. 1 AktG.

To a limited degree, German law recognises a duty of the members of the board of directors to control their colleagues' actions that is structurally different from the control duties of the supervisory board. This specific monitoring duty is characterised and shaped both by the principles of collegiate bodies and the functional separation of the individual portfolios of each member.[25] Accordingly, under normal circumstances German law limits such duty to the regular participation in meetings of the board and the general monitoring of the board's actions.[26] The relationship among the individual board members should be characterised by mutual trust. The duty to investigate further or inform the supervisory board is only triggered if specific circumstances give rise to suspicions that another member of the board is acting wrongfully.[27] This rather generous system may, of course, change substantially in a crisis of the company and in other specific situations.[28]

In the above case liability of the other members of the board of directors is therefore not unlikely but would – as the liability of the supervisory board members – depend largely on the other circumstances of the case, such as the regularity with which business with other offshore jurisdiction was done by the company and the frequency as well as the specific terms of the transactions.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

According to s. 147 seq. AktG, claims against the members of both the board of directors and the supervisory board must be brought if a simple majority in the general meeting so decides. Additionally, a minority of shareholders whose aggregate shareholding equals at least 1 per cent of the company's capital or a minimum aggregate amount of 100,000 EUR are entitled to apply at

[25] Hüffer, Aktiengesetz, 10th edition, 2012, § 77 sec. 15, Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 77, sec. 59; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 77, sec. 49; Wiesner/Kraft, Münchener Handbuch des Gesellschaftsrechts, 3rd edition, 2007, § 26 Rn 5.
[26] Hüffer, Aktiengesetz, 10th edition, 2012, § 77 sec. 15, Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 77, sec. 59; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 77, sec. 49; Wiesner/Kraft, Münchener Handbuch des Gesellschaftsrechts, 3rd edition, 2007, § 26 Rn 5.
[27] Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, 137, 142.
[28] Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 77, sec. 59; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, 135, 142.

the competent court for admission to enforce the company's liability claim *in their own name* according to s. 148 AktG.

According to s. 148(3) sent. 1 AktG, the company is at any time entitled to take over the proceedings and pursue the claim. A judgement according to s. 148(5) sent. 1 AktG has binding effect for and against the company and all shareholders of the company regardless of them being parties to the proceedings.

It should also be noted that according to s. 93(5) sent. 1 and 2 in connection with s. 116 sent. 1 AktG creditors of the company are entitled to enforce the company's claims under certain circumstances.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  Currently, there are no statutory rules which require directors to disclose potential conflicts of interest. But it is widely acknowledged in the legal literature that a general duty of loyalty exists, which requires directors not only to avoid any kind of conflict of interest but also to disclose such information to the board of directors as well as to the supervisory board.[29] Accordingly, no. 4.3.4 of the German Corporate Governance Code[30] – a non-binding set of recommendations of an independent government committee of experts that is increasingly perceived as a major point of orientation in questions of corporate governance – requires the directors to do so.

  However, the transaction would neither be void under German general civil law nor would its validity be dependent on the consent of the company, i.e. the consent of the supervisory board. The fact alone that A is also the majority shareholder of Target does not trigger a shift in competences for the conclusion of the transaction.[31] The transaction would not constitute a form of self-dealing within the meaning of s. 181 alt. 1 BGB either. Thus, it would be legally valid.

  The CEO would likely be liable for damages according to s. 93(2) AktG for violation of the duty of loyalty under stock corporation law. The fact that his vote was not decisive for the positive

[29] Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, 124.
[30] See http://www.corporate-governance-code.de/eng/kodex/index.html.
[31] High Court of Justice of Saarbruecken, Judgement of 30 November 2000 - 8 U 71/00-15, Neue Zeitschrift für Gesellscahftsrecht (NZG) 2001, 414.

vote is generally not accepted as justifying an exclusion from liability. This is especially true in a case where the member of the board withheld essential information from his colleagues.

In addition, the CEO would possibly be liable under tort law for fraud according to s. 823(2) BGB in connection with s. 263 StGB.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

The director may be liable for the damages if he did not reveal the disadvantageous conditions of the transaction in violation of his duty of loyalty. In situations like this most legal authors apply an arms' length approach in order to assess whether the transaction is detrimental to the company.[32] Where the transaction does not stand such a test, all directors will be held liable.

Statutory law does not provide for rules on the exclusion of board member from the decision-making through resolutions of the board. Nevertheless, it is universally acknowledged that s. 34 BGB, which regulates the exclusion of interested members of the board of directors of an association from the respective decision-making process, shall be applicable *mutatis mutandis* to the board of directors of an AG.[33] Director A would therefore be excluded from voting.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

According to s. 93(4) sent. 1 AktG, the liability of the members of the board is not triggered if their actions are based on a prior lawful resolution of the shareholders. However, liability is not excluded if the board member withheld essential information from the shareholders.[34] According to s. 93(4) sent. 3 AktG the ratification of the transaction with the effect of relieving the board members of liability is only permissible in the form of a waiver of the claim three years after the claim has come into existence. Such waiver also requires the full knowledge of all relevant facts by the shareholders, i.e. the violation of a duty by the director and the nature as well as the volume of the damages.[35] If the shareholders in the given case did not have the necessary information to evaluate the transaction correctly and were instead of the opinion that the transaction was in the best interest of the company, ratification would not exempt the CEO from liability. In addition, s. 93(4) sent. 2 AktG grants a minority of shareholders holding at least 10 per cent of the share capital the right to object to the resolution and hereby prevent the waiver from becoming valid.

Furthermore, the CEO would be excluded from voting in the general meeting resolving on such waiver according to s. 136(1) sent. 1 alt. 1 AktG as the resolution would concern his own liability towards the company.

[32] Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, 135.
[33] Hüffer, Aktiengesetz, 10th edition, 2012, § 77 sec. 8; see also Bunz, Die Business Judgment Rule bei Interessenkonflikten im Kollegialorgan, Neue Zeitschrift für Gesellschaftsrecht (NZG) 2011, 1294.
[34] Hüffer, Aktiengesetz, 10th edition, 2012, § 93 sec. 26.
[35] Hüffer, Aktiengesetz, 10th edition, 2012, § 93 sec. 26 seq.

Section 142(2) sent. 1 AktG also provides for the possibility of minority of shareholders holding at least 1 per cent of the registered share capital or 100,000 EUR to have certain transactions reviewed by an independent expert ("*Sonderprüfung*"). This requires an application to the competent court and the demonstration that reasonable suspicions exist that a violation of directors' duties, the law, or the articles of association took place in connection with the relevant transaction. These safeguards guarantee a minimum of minority shareholder protection from collusion by the board of directors and majority shareholders.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

The so-called business opportunity doctrine ("*Geschäftschancen-Theorie*"), developed by the BGH, is modelled after the US corporate opportunities doctrine but is in many ways more rigid in its application. Accordingly, no. 4.3.3 of the German Corporate Governance Code states that no director may take advantage of business opportunities which belong to the corporate business. When being confronted with such a corporate opportunity, the director shall not act in his own interest or in the interest of third parties, but only in the interest of the company. Unfortunately, the question when an opportunity belongs to the company's business has not yet been answered satisfactorily.

Some criteria have nonetheless been established by the courts. An opportunity is a corporate opportunity if the company has already taken certain steps to make use of the opportunity or if it has expressed its interest in doing so, for example through a relevant decision of the board of directors or other managers of the company.[36] In such cases the director is required to accept the company's prior right to take advantage of the opportunity.[37] The corporate opportunities doctrine is dogmatically rooted in the duty of loyalty of directors. It resembles structurally the duty not to compete with the company, which is regulated in s. 88 AktG. The relation between these two duties is largely unclear. According to most authors, the duty not to compete helps to shape the corporate opportunities doctrine. However, it is in some respects broader, for example because a violation does not require a loss or damage to the company. In other respects it is narrower than the corporate opportunities doctrine. This is for example true for the acquisition of property by the director for private purposes or with regard to the duration of the duty, since the duty not to compete usually ends with the termination of the position as a director.[38] Although the two duties are apparently perceived to be congruent to some extent, these differences show that they are not perfect substitutes. Rather, under German corporate law they complement each other.

In light of these criteria director A would be prevented by his duty of loyalty to purchase the relevant assets since Bidder had already placed a bid for them, thereby manifesting its

[36] BGH, Judgement of 8 May 1989 - II ZR 229/88, Neue Juristische Wochenschrift (NJW) 1989, 2687, 2688.
[37] BGH, Judgement of 8 May 1967 - II ZR 126/65, beck-online, BeckRS 1967, 31368054; BGH, Judgement of 23 October 1985 - VIII ZR 210/84, Neue Juristische Wochenschrift (NJW) 1985, 586; Fleischer, Handbuch des Vorstandsrechts, 1st edition, 2006, § 9, sec. 23-25; Spindler, Münchener Kommentar zum Aktiengesetz, 3rd edition, 2008, § 88, sec. 56 seq.; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, sec. 140.
[38] Examples and distinction taken from Fleischer, Handbuch des Vorstandsrechts, 1st edition, 2006, § 9, sec. 24.

interest in taking advantage of the opportunity. As a result, the acquisition would have to be regarded as a corporate opportunity. Hence, A acted in violation of his duty of loyalty when acquiring the assets.

As regards restrictions to the general prohibition as known in US law (for example financial incapacity of the company), German courts have been very reluctant to accept them in practice. This is especially true for the question of insufficient liquidity of the company, which could easily be used as pretence by the directors.[39] Here the BGH stated clearly that the directors would be required to consider raising new capital for the company rather than pursuing the business opportunity for their own account.[40] The court also follows a strict approach with regard to privately gained knowledge of the business opportunity. In such a case, the duty of loyalty would still prevent the directors from taking advantage of the opportunity.[41] As discussed above, consent or waiver by the company is only valid if the competent corporate body is fully informed of the details, chances and risks of the envisaged transaction.[42]

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

Under German law, the duty to abstain from taking advantage of corporate opportunities does not end with the termination of the position as director.[43] In this respect, the corporate opportunities doctrine differs markedly from the duty not to compete. According to the BGH, the dogmatic reasons for this are the general civil law principles of post-contractual loyalty and consideration.[44] Although the legal literature generally acknowledges the advantages of the continuity of the duties, it also mentions its unsatisfying dogmatic derivation. In addition, there should be a specific time period after which the duties end in order to ensure coherence with the duty not to compete, which usually ends with the termination of the position as director.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

The BGH is of the opinion that such a decision is only valid if the other members of the board are fully informed of the details, terms and arrangements as well as the chances and risks of the envisaged transaction.[45] If these conditions were met and the board did consider and decide on possible methods of raising capital for such a transaction in order to exploit the opportunity on behalf of the company, director A would probably not act in violation of his duty of loyalty. But here again, the general rule of German association law of s. 34 BGB applies, so that A – as an interested member of the board – would be excluded from voting on the board resolution.

[39] BGH, Judgement of 23 October 1985 - VIII ZR 210/84, Neue Juristische Wochenschrift (NJW) 1985, 586; Spindler/Stilz, Aktiengesetz, 2nd edition, 2010, § 93, sec. 145.
[40] BGH, Judgement of 23 October 1985 - VIII ZR 210/84, Neue Juristische Wochenschrift (NJW) 1985, 586.
[41] BGH, Judgement of 23 October 1985 - VIII ZR 210/84, Neue Juristische Wochenschrift (NJW) 1985, 586; High Court of Justice of Frankfurt, Judgement of 13 May 1997 - 11 U (Kart) 68/96, GmbH-Rundschau (GmbhR) 1998, 376.
[42] BGH, Judgement of 8 May 1989 - II ZR 229/88, Neue Juristische Wochenschrift (NJW) 1989, 2687, 2688.
[43] *BGH,* Judgement of *11 October 1976 - II ZR 104/75*, Neue Juristische Wochenschrift (NJW) 1977, 247.
[44] *BGH,* Judgement of *11 October 1976 - II ZR 104/75*, Neue Juristische Wochenschrift (NJW) 1977, 247.
[45] BGH, Judgement of 8 May 1989 - II ZR 229/88, Neue Juristische Wochenschrift (NJW) 1989, 2687, 2688.

Hungary

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

As a general rule, the parent company shall not be liable for the debts of the subsidiary. If, however, the subsidiary became insolvent and went under liquidation, the parent company shall be liable for the debts which were not covered by the assets of the subsidiary if the parent company and the subsidiary worked as a registered group of companies; if the bankruptcy was the result of permanently detrimental business policy implemented by the parent company; if absence of coverage was the result of abuse of limited liability; or if, as a shadow director, the parent company failed to act in compliance with the priority of creditors' interests on the verge of insolvency. The same answer is to be given under the regime of the Bill of the New Hungarian Civil Code. The fact, that employees working for the subsidiaries are formally still employed with the parent company does not establish liability *per se*.

As none of these specific preconditions seem to be met in the described case, the parent company shall not be liable for the debts of the subsidiary.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

Influence of the decision of the subsidiary as such does not establish liability of the directors of the parent company, even if such an influence may result in wrongful conduct of the subsidiary's directors. Although the directors of the parent company may be held as shadow directors, the liability of shadow directors is triggered only if the company (here the subsidiary) came to the verge of insolvency and the directors failed to act in compliance with the priority of interests of the subsidiary's creditors.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

Fiduciary duties do not prevent directors from entering into risky transactions but such transactions may be in incompliance with the business judgement standards if they are unreasonable. The directors prepared the transaction with the reasonable care (market analysis) but left the company unprotected against a risk which was of a low probability but threatened with bankruptcy. This risk might have been avoided e.g. by buying options, derivatives or other positions insuring the company against such risks. The decision involving such a risk would presumably be held as falling behind the normal business risks. Thus, directors are to be held failing to act in compliance with the required duty of care and their liability may be established vis-á-vis the company. If the company went under liquidation and its assets did not provide coverage for its debts, the liability may be established vis-á-vis the creditors.

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

It is the time when the company came to the verge of insolvency (a situation "threatening insolvency") which is to be assessed on the basis of a liquidity forecast rather than a balance sheet test. Factors, like the status of the company's markets, business trends affecting the financial status of the company, as well as potential changes thereto and how various economic problems can be handled by the directors, if at all, and in what timeframe, etc. are to be taken into consideration. It is also has to be assessed if there is a risk of breach of loan agreements, the potential of financial support of shareholders in the form of a capital increase or by other means, and whether there are any other alternative financial resources available for the Company or not.

Thus, in the case at hand, when a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm – having regard to the other described circumstances of the case like trends of falling of equity ratio as well -, the threatening insolvency (verge of insolvency) might be established even if the likelihood of this happening was very low.

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

In the case of coming to the verge of insolvency the general obligation of directors to focus on the interests of the company shifts to an obligation to prioritise the interests of creditors. Failing this may establish "wrongful trading." Non-compliance with this priority requirement may result in personal liability of the directors vis-á-vis the creditors of the comapny. Directors will only incur liability if the company was declared insolvent by court and the wrongful trading resulted in a loss of the creditors (i.e. decrease of the company's assets available for distribution to the creditors in a liquidation procedure). Directors may be exonerated by proving that they acted in line with the required duty of care that was to be expected of a person in their position

<u>Hypothetical III: Duty of care</u>

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

<u>Questions</u>:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

It is difficult to assess that, in the chain of events described here, which element should have lead to withdrawing from the business according to the required duty of care. One can assume - which probably would be the conclusion of a Hungarian court - that the CEO breached its fiduciary duties by continuing the investments in CDOs which, taking into account the volume of the company's investment as well, became an extremely risky market by the end of 2007. If that is the case, the CEO can be liable for loss suffered by the company in 2008 except a discharge was provided to him by the shareholders of the company.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

The answer to this question depends mainly on the general practice and customs in business. Directors did not necessarily breached their fiduciary duties by approving the agreement, if such agreements provided the customary services to the resigning CEO. There is, however, no clear starting point in Hungarian court practice or legislation to assess this aspect of the case.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

Omission of duty to control may be a basis for liability according to the general rules and doctrines of liability. Allocating risks to supervisory bodies in this context is also would fit to the frameworks of Hungarian company law, although there is not any court practice or legislation which could indicate clearly how such a case would be decided under Hungarian law.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

It is the general meeting that has to decide if the company enforces a claim against the executive officer. If the general meeting of the company has refused the request to enforce a claim against the members, executive officers, supervisory board members or against the auditor of the business association, or, if the business association's supreme body failed to adopt a decision regarding a proposal that has been properly presented, a group of members (shareholders) controlling at least *five per cent of the votes* may enforce the claim themselves on behalf of the company within a period of thirty days after the general meeting.[46] The rights of the minority shareholders are original rather than derivative ones, so they may enforce such rights even if the discharge was provided by the majority of votes to the director.

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is*

[46] § 50 subpar 5 of Company Act

beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.

Director A has certainly failed to comply with the statutory duties imposed on him as concerning the duty of loyalty. The decision caused a loss to Bidder. Members of the board are to be held joint and severally liable for damages resulting from their wrongful decision. Directors may be exonerated from liability by proving that in the course of passing the decision they acted according to the required standard of conduct. Other members of the board – who neither were nor ought to have been aware of the fact that Bidder will pay a price high above the value of Target – may be exempted from liability but Director A certainly not. The fact that his vote was not decisive is irrelevant.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

That does not change the position of Director A. His act was wrongful not only because he failed to reveal his interest in Target but also because, as a member of the board, he supported a decision causing damage to the company. As that is still the case, he still will be held liable.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

The ratification of the decision does not relieve the directors of liability. Ratification of such a decision of the board of directors does not change the fact that directors (esp. Director A) failed to act according to the priority of the interests of the company and caused compensable loss to the company by infringing their/his duty of loyalty. A discharge may be given to directors confirming that they acted in compliance with the interests of the company which may bar the company from enforcing claims against the directors but such a discharge does not prevent minority shareholders from enforcing claims in the name of the company and is also ineffective if certain facts (e.g. that the price was much higher than the value of Target) were not clear for the shareholders at the time of deciding for it.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

In such a case director A seems to deprive the company of a business opportunity otherwise open for the company and exploit the profit making possibility for his own interests. This constitutes an abuse of his managing powers and violation of his fiduciary duties which may establish his liability for damages. The company also might have a claim for transferring the profit made by company Rival on the transaction on the basis of unjust enrichment.[47]

[47] § 361 of Civil Code. So far this has never been tested in Hungarian court practice.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

Resignation does not relieve director A from liability. Once he launched the chain of events resulting in damage (causal link), he is a tortfeasor to be liable for the loss caused by him. There is neither statutory norm nor court practice giving any indication for other conclusion.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

There is no basis for liability of director A. In such a case a causal link between the loss of profit suffered by the company and violation of duty of loyalty (incompliance with the required standard of conduct) is not to be established. Thus, the liability of director A is not to be established. Neither a claim for restoration of unjust enrichment would be accepted because the profit earned by Rival could not be earned by Bidder even in absence of the transaction made by Rival. Thus, Rival earned the profit not to the detriment of Bidder.

Ireland

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

1. *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

   There is a risk of liability if the separate legal personality of the companies was disregarded and the directors of the parent company were regarded as having acted without due care, skill and diligence. However, this is unlikely given the persuasive force of the decision of the House of Lords in Appeal in *Adams v Cape Industries Plc* [1990] Ch 433, which allows a corporate structure to be set up so as to shelter companies within a group from a potential future liability as opposed to an existing liability. This decision was cited with approval by the Irish High Court in *Fyffes Plc v DCC Plc.*[48]

2. *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

   There is a risk of liability only if the separate legal personality of the companies was disregarded and the directors of the parent company were regarded as having acted without due care, skill and diligence.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in lise with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness.

[48] [2005] IEHC 477.

Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

Response:

The duty to act with due care, skill and diligence means that risky transactions which are undergone without appropriate risk assessment may breach the duty although a business judgment rule operates in the directors' favour. When the company becomes insolvent, the duty to act in the best interests of the company moves to a duty to act in the interests of the company's creditors. A duty to consider the interests of creditors will displace the duty to act in the interests of the company and arise under Irish law not just where formal insolvency procedures have been activated, but also where there is an entitlement to initiate them. This was established in *Re Frederick Inns Ltd.*[49]

There is no clear definition of the vicinity of insolvency. However, the case law suggests that a formal declaration of insolvency or initiation of insolvency processes need not have occurred in order for directors to be under a duty to consider creditors' interests. The Irish courts are pragmatic and recognise that the directors should not be under a duty to cease trading immediately provided that there is a chance that the company could trade its way out of its difficulties.

In *Re USIT World plc*[50] the liquidator expressed concern that the company had traded while it was insolvent on a balance sheet basis. Peart J. recognised that a reasonable and limited effort at trading out of the company's difficulties is not irresponsible. He made the following pertinent comments on the issue:

> "Many companies will experience for many reasons unrelated to the general health of the company, a downturn in profitability over a quarter, two quarters or even three quarters. That in my view does not mean that even where a risk of insolvency downstream is warranted or anticipated, some reasonable effort at rescuing the situation may not be permitted to be undertaken. To attempt to trade out of a difficulty is not an irresponsible act. Care of course must be taken to ensure that effective and realistic steps are taken and that creditors' interests are kept to the fore, rather than that a careless or reckless gamble is taken without proper advice and planning to an achievable end. Some sort of short term emergency fire-fighting must be permitted to take place without those efforts, provided they are reasonable and responsible, from being made. Many companies have survived and prospered after temporary setbacks."[51]

In this case it was acknowledged that the fallout of September 11, 2001 had a very large part to play in the company's difficulties since it led to financing being pulled. Furthermore, the directors had taken legal and accountancy advice in relation to its continued trading after September 11.

In the context of an ongoing slump, such generosity of approach is less likely and the period of time for continuing to trade is likely to be expected to be short.[52]

[49] [1994] 1 I.L.R.M. 387.
[50] [2005] IEHC 285, unreported, Peart J., August 10, 2005.
[51] *ibid.* at 70-71.
[52] See further D. Ahern, "Directors' Duties in an Economic Downturn: Lessons from the Restriction Regime" (2009) 31 *Dublin University Law Journal* 183.

It is likely that a sympathetic approach would be taken considering the exceptional nature of the fall in oil prices. In *Business Communications Ltd v Baxter*[53] Murphy J. stated that "[o]f course one must be careful not to be wise after the event. There must be no 'witch hunt' because a business failed as businesses will."

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

[53] High Court, unreported, Murphy J., July 21, 1995.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

 At common law the director is protected if he exercises the skill, care and diligence that a person in his position would be expected to have: *Re City Equitable Fire Insurance Co Ltd*.[54]

 Although the better view is that *Re City Equitable* cemented a hybrid, part-subjective, part-objective standard, there are indications that the Irish judiciary has been relatively slow to fully embrace this standard. Dicta of Kenny J. in *PMPA Insurance Co Ltd v New Ireland Assurance Co Ltd*[55] saw the business judgment rule being applied in its most traditional form. Having outlined that the management of the company is delegated by the shareholders to the directors, Kenny J. went on to state that a decision of the board of directors would not be interfered with unless it was in breach of the articles of association or could be classed as dishonest or grossly incompetent.

 The most radical shift in judicial thinking in relation to care, skill and diligence came about in the aftermath of the Barings Bank scandal. The *Barings* litigation[56] involved crossing the Rubicon in terms of how the duty to exercise care, skill and diligence was perceived. In the most significant judgment since *Re City Equitable*,[57] Jonathan Parker J. showed that the tide had turned for inert directors and that objective standards had to be weighed in the balance.

 The shift from a purely subjective assessment of care, skill and diligence under equitable and common law duties to a more complex assessment which accommodates objective standards has occurred tangentially within the context of the statutory restriction and disqualification systems which are primarily designed to safeguard the public interest, with a particular emphasis on the interests of creditors.[58]

 The courts have always been reluctant to second guess the business decisions of directors. However, in recent times, rather than being unduly deferential there has been a judicial willingness to examine the quality or grossness of the error of judgment. It would seem that today's courts are less afraid to evaluate directorial conduct. This can be seen as a response to changing societal expectations. A distinction is drawn between calculated risks and rash and reckless risks: *Re USIT World Plc*.[59]

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

 The directors are usually given the power to rule on these matters in the company's articles of association. On the question of whether approval of such an arrangement would breach the duty to act in the best interests of the company, this is difficult to assess as a matter of fact. A recent

[54] [1925] Ch. 407. Romer J.'s judgment builds on principles developed in the earlier cases of *Overend Gurney & Co v Gibb* (1872) L.R. 5 H.L. 480; *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch. 392; *Dovey v Cory* [1901] A.C. 477 and *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch. 425.
[55] High Court, unreported, Kenny J, *The Irish Times*, October 23, 1975.
[56] *Re Barings Plc (No. 5), Secretary of State for Trade and Industry v Baker* [1999] 1 B.C.L.C. 433.
[57] *Re City Equitable Fire Insurance Co Ltd* [1925] Ch. 407.
[58] See s.150 of the Companies Act 1990 (restriction) and s.160 of the Companies Act 1990 (disqualification).
[59] [2005] IEHC 285, unreported, Peart J., August 10, 2005.

case on similar facts was settled before the Irish High Court gave judgment. If the directors subjectively believed that they were acting in the best interests of the company then they will be protected.[60] To date the courts do not objectively review such decisions. The duty of care is not used to constrain executive remuneration. However, statutory provisions provide greater assistance. Sections 186-189 of the Companies Act 1963 require approval of qualifying cash and non-cash payments made in connection with loss of office by a director to be approved by the shareholder body. Failure to follow the approval procedure will render the payment unlawful.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

It is possible that the directors in question would be considered to have acted in breach of their duty to act with due care, skill and diligence by not appropriately identifying the nature of the transactions. Potentially the company could recover the loss suffered by way of damages/equitable compensation if a breach is found. The lack of modern Irish case law hinders a more certain answer. However, case law in the area of disqualification in relation to banks in Ireland indicates that directors are under a duty to inform themselves appropriately in relation to the company's affairs. A duty of monitoring is expected in relation to other directors but it is difficult to identify the circumstances in which it will be appropriate to say that the other directors were in dereliction of their duty in failing to spot a complex transaction as being connected with one of the directors. If they have relevant financial expertise, they would be expected to exercise it. And if they do not have it, they would be expected to take steps to educate themselves.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

A minority shareholder can generally only bring a derivative action on behalf of the company where the company has decided not to sue in respect of a wrong and there is wrongdoer control of the company which has influenced the decision not to sue. If a court exercises its discretion to grant leave to bring a derivative action, the company will indemnify him against costs on the basis that the action was in the interests of the company.[61] Leave will only be granted if the claim is regarded as being in the company's interests, not vexatious, another appropriate remedy is not considered more suitable (e.g., an oppression petition), there is support from other shareholders and there has not been undue delay.

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

[60] *Banfi Ltd v Moran* [2006] IEHC 257.
[61] *Fanning v Murtagh* [2008] IEHC 277.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

Part IV of the Companies Act 1990, s.53 requires directors to notify the company in writing of any interest in shares or debentures in the company or any related company and of their entry into any contract to sell or assign their interest. The company is obliged to keep a register of interests recording interests of directors. Where a director fails to make an appropriate notification within the required time period, he or she is guilty of an offence.[62] This is punishable on summary conviction by a fine of up to IR£1,500[63] and/or up to 12 months imprisonment and on conviction on indictment, to a fine of up to IR£10,000[64] and/or imprisonment not exceeding five years.[65] In terms of the civil law, if a director does not make the appropriate notification within the required time period, any relevant interest and rights will not be legally enforceable by him or her in respect of the shares or debentures.[66] This means, for example, that the right to vote or sell shares cannot be exercised by the affected director.

Section 194(1) of the Companies Act 1963[67] provides:

> "It shall be the duty of a director of a company who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the company to declare the nature of his interest at a meeting of the directors of the company."

The mandatory statutory disclosure of directorial interests pursuant to s.194 requires directors (including shadow directors) to disclose conflicts of interest in relation to direct or indirect interests in a proposed contract with the company by declaring the nature of such interest at a directors' meeting. Such declarations are entered in a register of directors' interests which can be inspected by a director, secretary or member of the company and the company's auditor. Where a proposed contract with a company arises, s.194(2) specifies that the declaration of interest be made by a director at the meeting where the question of entering into the contract is first considered, or if the director is not present at that meeting, at the next board meeting held after he or she has become interested in the contract.

There is persuasive authority to suggest that for the purposes of compliance with s.194 it may be irrelevant whether the contract is approved by the board or not so long as the requisite disclosure has been made.[68] There are, however, some consequences for failing to make the required disclosure. If a director fails to comply with s.194, he or she is guilty of an offence and is liable to a fine not exceeding IR£1,500.[69] Although no civil consequences of non-compliance are specified in s.194, there is persuasive authority which suggests that

[62] Companies Act 1990, s.53(7).
[63] €1,904.61.
[64] €12,697.38.
[65] This is the effect of Companies Act 1990, s.240 (as amended by the Company Law Enforcement Act 2001, s.104(a).
[66] Companies Act 1990, s.58(3).
[67] As amended by the Companies Act 1990, s.47(3).
[68] *Neptune (Vehicle Washing Equipment) Ltd v Fitzgerald* [1996] Ch. 274.
[69] €1904.61: Companies Act 1963, s.194(6). The penalty was increased from IR£100 to IR£500 by Schedule 1 of the Companies (Amendment) Act 1983 and to IR£1,500 by s.240(7) of the Company Law Enforcement Act 2001.

nonetheless under general law principles any contract affected by a breach will be voidable. In *Craven Textile Engineers Ltd v Batley Football Club Ltd*[70] the Court of Appeal considered the position of a director of Batley Football Club who was also a director and the controlling shareholder in Craven Textile Engineers Ltd. Craven Textile Engineers carried out improvement works on the club's football grounds including the provision of carpeting and turnstile dividers and doors without the director having disclosed his interest to the club's board of directors under the equivalent s.317 of the Companies Act 1985. The Court of Appeal held that while s.317 did not set out any civil consequences for breach, under ordinary principles of general law, the breach rendered such a contract voidable.[71]

In addition, s.29 of the Companies Act 1990 which is concerned with substantial property transactions involving directors and connected persons requires shareholder approval by means of an ordinary resolution for the acquisition of substantial non-cash assets from a director or a connected person. In this context, a body corporate controlled by a director would qualify as a connected person. The threshold value of €63,486.90 or 10 per cent of the acquiring company's relevant assets would be met in this case. In cases of non-compliance, the transaction would be voidable at the company's instance. Personal liability could also be imposed on the director in the form of a liability to account for any gains made or to indemnify the company for the losses incurred though purchase of the assets at an overvalue.

Separately, a duty of disclosure arises in relation to the fiduciary duty on directors to avoid conflicts of interest.[72] In this regard, directors would be expected to disclose to the company their interest in a transaction in which the company is involved. The relevant transaction would be treated as being voidable at the company's election where appropriate disclosure had not been made.[73]

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

In this scenario, the requirement to make disclosure of the material interest to the board would be complied with (s.194 of the Companies Act 1963). This would still leave a difficulty in relation to the equitable duty to avoid conflicts of interest. The courts in Ireland have not made a ruling on whether the duty to avoid conflicts of interest can be satisfied by disclosure at board level rather than at shareholder level. It is possible that shareholder approval may be required. Legislative proposals are in place which would require an ordinary resolution of the shareholder body in relation to both internal and external conflicts of interest.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

Shareholders can ratify a related party transaction by means of a simple majority provided that they have been provided with all relevant information before making a decision to ratify. Ratification will cure the breach of the equitable duty to avoid conflicts of interest. If ratification takes place with the assistance of the vote of a wrongdoing director-shareholder, this may

[70] [2001] B.C.C. 679.
[71] *Hely-Hutchinson v Brayhead Ltd* [1968] 1 Q.B. 549, 594, per Lord Pearson and *Guinness Plc v Saunders* [1990] 2 A.C. 663 were cited in support of this proposition.
[72] *Fyffes Plc v DCC Plc* [2005] IEHC 477.
[73] *Hopkins v Shannon Transport Systems Ltd* (1972) [1963-1999] Ir. Co. Law Rep. 238.

qualify as a wrong which would permit a derivative action by a shareholder on behalf of the company where the directors are unwilling to initiate legal proceedings in the company's name.[74]

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

How competing activity is likely to be treated in Ireland remains to be seen as there have been few judgments on the matter. In *Spring Grove Services (Ireland) Ltd v O'Callaghan*[75] Herbert J. stated:

> "A Director of a Company owes strict obligations of good faith, fair dealing and honesty to the Company of which he is a Director. Aspects of these obligations, commonly referred to as 'Fiduciary duties', include a duty not to compete with the company ...."[76]

There has not been case law on this in Ireland but the strict approach of the English courts in cases such as *Regal (Hastings) Ltd v Gulliver*[77] and *Re Allied Business and Financial Consultants Ltd; O'Donnell v Shanahan*[78] would be likely to be applied such that all opportunities encountered as a director should be put to the company for its decision on whether they would be of value.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

The English case law suggests that it is the no profit rule rather than the no conflict rule which applies to former directors.[79] The rationale for this is that under the general policy against restraint of trade it would be improper to regard a former director as subject to the same duties of loyalty as an existing director.[80] Thus the courts have viewed the non-application of the no conflict rule on termination of directorship as directly linked to the loss of directorial powers.[81]

[74] *Prudential Assurance Co Ltd v Newman Industries Ltd (No.2)* [1982] Ch. 204 at 219.
[75] High Court, unreported, Herbert J., July 31, 2000.
[76] *ibid*. at para.[26].
[77] [1942] 1 All R.R. 378.
[78] [2009] EWCA Civ 751, [2009] 2 B.C.L.C. 666. See further D. Ahern, "Guiding Principles for Directorial Conflicts of Interest: *Re Allied Business and Financial Consultants Ltd; O'Donnell* v *Shanahan*" (2011) 127 *Modern Law Review* 596.
[79] See Warren J. in *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch), para.[251] and cases cited therein; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC Civ 1638 (Ch), para.[1309], per Lewison J. and *Kingsley IT Consulting Ltd v McIntosh* [2006] EWHC 1288 (Ch), [2006] B.C.C. 875, para.[51], per Terence Mowschenson Q.C.
[80] On this see P. Koh, "Principle 6 of the Proposed Statement of Directors' Duties" (2003) 66 M.L.R. 894, 900-901.
[81] This perspective views the purpose of the no conflict rule as being to prevent the fiduciary "being swayed by personal considerations of his personal interests or competing fiduciary interests in the exercise of the powers exercisable by him in a fiduciary capacity": *Wilkinson v West Coast Capital* [2005] EWHC 3009 (Ch), [251] *per* Warren J. See also *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch), para.[1308], per Lewison J.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

If the company has chosen not to pursue the opportunity, the director is free to go ahead provided appropriate disclosure has been made. Irish case law suggests that the conflicted director should not participate in the decision of the board.[82]

[82] *Hopkins v Shannon Transport Systems Ltd* (1972) [1963-1999] Ir. Co. Law Rep. 238.

Italy

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary’s directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

  On the basis of the facts described above, the pharmaceutical company (which controls the subsidiary under the terms set out by Art. 2359 (1) Civil Code) faces civil liability pursuant to Art. 2497 (1) Civil Code. According to this provision, when the controlling company (*la societa’ che esercita attivita’ di direzione e coordinamento di societa’*) operates in its own entrepreneurial interest in breach of the principles of corporate governance and good management, the same company is directly liable towards the members of the controlled companies (*le societa’ soggette alle attivita’ di direzione e coordinamento*) for the damages caused to the value of their shareholding as well as towards their creditors for the diminished value of the company's patrimony.

All the above, of course, would not occur if the members of the controlled company or the creditors were able to satisfy their claims directly against the controlled company (Art. 2497 (3) Civil Code).

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

  They will be liable for damages pursuant to Art. 2497 (2) Civil Code, as they have largely contributed to taking the decisions that brought the insolvency of the subsidiary company (from the circumstances described in the hypothetical, there is no need to make recourse to the notion of *de facto*/shadow directors in this specific case).

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

  It depends on the circumstances. With respect to the facts described in the hypothetical, it seems that this is not the case. Directors' duties are *obbligazioni di mezzi* (broadly, obligations which should be fulfilled with competent effort) and not *obbligazioni di risultato* (broadly, obligations which require the obligor to achieve a specific result). With the exception of gross negligence (eg. Cass.8 May 1991 n. 5123 in Foro it, 1992, I, 817), Italian courts will not be concerned with the opportunity/risk of a managerial decision taken in compliance with Art. 2392 Civil Code (duty of care).

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

  There is no definition of 'vicinity of insolvency' under Italian law and it is unlikely that a director can be considered to have a duty to protect the interests of creditors before (some or all of) the requirements for an insolvency declaration are present. It is only when the company is not able to regularly fulfil its financial obligations (Art. 5 Insolvency Act), the amount of the existing unpaid debts is greater than 30,000.00 Euros, and certain specific accounting/monetary thresholds are met (Art. 1 (2) Insolvency Act), that it is possible to apply to the court by petition for starting insolvency proceedings.

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders, or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

  From the facts described in the hypothetical the conditions for applying to the court to start insolvency proceedings do not seem to be in place. The directors' decision was difficult/risky, but an appropriate one on the basis of the market conditions at the time when it was made. Following the unsuccessful implementation of the business strategy, it is likely that an application to the court by petition for starting insolvency proceedings will be made by the creditors, the public prosecutor (Art. 6 Insolvency Act) or by the company (Art. 217 no. 4 Insolvency Act).

<u>Hypothetical III: Duty of care</u>

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  Yes, the CEO is likely to be held liable for the losses suffered by the company in 2008. He breached the duty of care set out in Article 2392 (1) Civil Code that requires a director of a company to exercise his duties with the knowledge, skill and experience that may reasonably be expected of an average director carrying out a similar role (*la diligenza richiesta dalla natura dell'incarico*), and by the specific care and competence that the director has (*le specifiche competenze*). In this case, even if little is known about the CEO's specific competence, there is plenty of evidence that suggests that he has undertaken an excessive level of risk not complying with the level of care to be expected by a reasonable director in a similar position (the average director) (e.g. the authoritative predictions made by Krugman, the first insolvency cases and the general market trends on structured finance commitments). This is so even if it is accepted that the standard of review for business decisions in Italy follows a pattern similar to the 'business judgement rule' adopted by Delaware courts. It seems to be the case that the CEO acted with gross negligence and the court review of the decision will be on the fairness of the transaction (*vaglio della legittimità della decisione*).

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

It is difficult to say. It depends on the possible value/importance/relevance of the signing of a non-competition agreement. With respect to the self-dealing transactions, the CEO should have declared the nature and the extent of any interest that he had (directly or indirectly) in the proposed transaction with a related party, and it was for the board to decide whether to execute it or not (Art. 2391 (1) Civil Code). In that case the board's resolution should have appropriately justified the reasons for entering into the transaction.

When the resolution taken is not in compliance with Art. 2391 (1) Civil Code and it proves to be potentially harmful to the company's interests (*danno potenziale*), it is voidable if the vote of the interested director (the CEO in this case) was essential for passing the resolution (*prova di resistenza*), or if the board did not adequately justify the reasons and the opportunity for entering into the transaction.

It is surely possible that the duty of care (placed on the members of the remuneration committee, for example) could be used to constrain excessive remuneration.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

This is likely to be the case as members of the company's internal audit committee are supposed to be able to identify the true nature of the ostensibly arms-length transactions in carrying out their duties in accordance with the knowledge, skill and experience that may reasonably be expected of an average director carrying out a similar role (*la diligenza richiesta dalla natura dell'incarico*). Not to mention the specific care and competence that the member of the internal audit committee possible had (*le specifiche competenze*) and of which nothing is known (Art. 2392 (1) Civil Code).

In general terms and outside the present case, where duties are vested in the executive committee or individually in the CEO, members of the board are jointly and severally liable for the damages caused by a resolution taken in breach of the duty of care (Art. 2392 (1) Civil Code) or even for *culpa in vigilando* (Art. 2392 (2) Civil Code). The only exception is the case where a director's dissenting opinion is recorded in the minutes of the board's meeting and the director notifies in writing the chairman of the statutory board of the issue (Art. 2392 (3) Civil Code).

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

A minority shareholder can enforce the claim against the CEO or another director for breach of their duties. The Civil Code allows a group of shareholders representing at least one fifth of the outstanding corporate capital or a different percentage as set out in the articles (which cannot exceed in any case one third of the corporate capital - Art. 2393 (1) bis Civil Code) to enforce the company's rights against the directors. In bringing a derivative action, shareholders act on behalf of the company so that the award will compensate only the company for its loss. If the claim is successful the company will indemnify the claimants against the costs incurred in bringing the proceedings, unless the costs are imposed on the losing party or the losses can be recovered upon direct enforcement against that party (Art. 2393 (5) *bis* Civil Code). However, if the claim is settled or is not successful, the claimants do not have any right to indemnification of any expenses occurred.

That said on the power of minority shareholders to bring a claim against the CEO or another director for breach of their duties, it must be remembered that the default rule under the Civil Code is that, even if a public company is subject to liquidation, shareholders, by way of ordinary resolution, can direct the board (Art. 2393 (1) Civil Code) to commence litigation in relation to an alleged breach of a director's duty vis-à-vis the company (Art. 2364 (1) no 4 Civil Code).

Alternatively, following a recent amendment of the Civil Code (pursuant to law no 262 of 2005) the board of statutory auditors is entitled to take such decision by a qualified majority of two thirds of the board members (Art. 2393 (3) Civil Code).

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  Director A will be held liable for the breach of his duty of loyalty to the company. Under Italian law, directors have to disclose any interest in transactions with the company. The duty is set out under Article 2391 of the Civil Code and it imposes on a director a duty to declare the nature and the extent of any interest that he has (directly or indirectly) in a proposed transaction with the company. In case the resolution taken by the board proves to be potentially harmful to the company's interests (*danno potenziale*) (as it is the case described in the hypothetical), such decision is voidable when the director's interest was not disclosed and the vote of the interested director was essential for passing the resolution (*prova di resistenza*), or when the board did not adequately justify the reasons and the opportunity for entering into the transaction.

  The director will also have to pay damages caused to the company from his conduct (Art. 2391 (4) Civil Code).

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

  If director A discloses his interest in Target to the board of Bidder, he is entitled to vote on the conflicted interest transaction. If the resolution taken by the board proves to be potentially harmful to the company's interests (*danno potenziale*), such decision is voidable when the board did not adequately justify the reasons and the opportunity for entering into the transaction.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

The director will be liable, as pursuant to Art. 2364 (1) no. 5 Civil Code shareholders do not have the default power to ratify managerial decisions (even when stated in the articles, the resolution does not operate as a liability waiver for the director). Resolutions that do not comply with the articles or the law may be challenged by shareholders representing at least 5% of the voting share capital (or a lower percentage as stated in the articles - in the case of listed companies the default rule is 1/1000 shareholding). If that percentage cannot be reached, minority shareholders are entitled to claim compensation for damages (the resolution remains valid in this latter case, see Art. 2377 (4) Civil Code).[83]

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

From the facts described in the hypothetical, it is possible to conclude that director A knew about the business opportunity while acting as director for Bidder and that therefore he exploited the opportunity for his own interest (possibly) in breach of his duty of loyalty.

Under Italian law the rule codifying 'corporate opportunities' is set out under Article 2391 (5) Civil Code: a director is liable when he exploits, for his own benefit or that of third parties, a business opportunity obtained in connection with his managerial position.

In the absence of court decisions, it is questionable from the wording of Article 2391 (5) Civil Code whether 'corporate opportunities' have to be in the company's line of business, whether it matters that the director discovered the opportunity outside his office hours or whether the company must be able to take advantage of the information or opportunity (capability fact). The prevailing academic view is that the answer to the three uncertainties must be in the negative.[84]

That said on the specific case and on corporate opportunities, Italian law also has a no-competition rule under Article 2390 Civil Code according to which directors cannot be members of a competing unlimited liability company, carry on competitive business activities on their own account or for the account of third parties, or be appointed as directors or general managers (*direttori generali*) in competing companies, unless authorised by shareholder resolution. Directors' liability in this case is not based on the material negative economic consequences of their actions (i.e. there is no need to give evidence of damage), but on the potential risk that such consequences could occur. It is the fiduciary relationship (no-conflict) with the company that prevails and that is the basis of liability.

[83] See Cassazione 9905/2008 on this issue.
[84] See MC Corradi 'Le opportunita' di affari all'ultimo comma dell'art. 2391 c.c.: profili interpretativi tra <<societa'>> e <<impresa>>' (2011) Giurisprudenza Commerciale 597.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

  Yes, (possibly by way of analogy) as expressly established for employees of the company under Art. 2105 and 2598 Civil Code.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

  See comments under 2 on self-dealing transactions and 4 with respect to capability facts.

The Netherlands

Hypothetical I

1. Solely based on these given data it is not very likely that the parent company will be successfully held liable. Piercing the corporate veil in The Netherlands can only be effected on the basis of a tort claim (Article 6:162 DCC). Merely the payment of a contingent bonus to the subsidiary directors will not be sufficient ground to hold the parent company liable against those who suffered damage from the use of the defective drug. Please note that in answering this question I have not taken into account the impact of any specific product liability regulation that might be applicable.

2. Again also the possible liability of the directors of the parent company via-à-vis those who suffered damage from the use of the drug must be based on tort. Perhaps if the subsidiary directors were concretely instructed, on pain of being dismissed, by the parent directors to cover up towards the regulating officials, the fact that some tests were not performed, there might be ground for a liability claim.

Hypothetical II

1. There is no specific regulation in Dutch law preventing directors from entering into particularly risky transactions. Moreover, in this case, the risk seems to be rather calculated and it would be difficult in court proceedings, *e.g*. aimed at personnel liability of the directors towards the company, to blame them for the consequences of the sudden sovereign debt crisis and the worldwide economical crisis following from that. Of course it all depends on the level of predictability of that crisis, for a standard and careful company director that is, at the time the transaction was entered into.

2. Dutch law does not provide for and require a formal change of attitude of company directors, *i.e*. from shareholder interests to creditors' interests, in the vicinity of insolvency. Neither does it contain a "wrongful trading" rule similar to that existing in the UK. However, there is case law from the Dutch Supreme Court on the basis of which a company director can be held liable towards a third party (creditor) with whom he entered into a contract on the company's behalf at a moment that he realized or should have realized that the company would neither be able to fulfill its obligations under that contract nor would there be sufficient assets for the creditor's recourse. Such acting constitutes an act of tort, making the director personally liable towards the unpaid creditor. This is the so-called "Beklamel-rule", named after the said Supreme Court decision. This rule is rather often applied in liability cases before the lower courts.

Hypothetical III

1. The Netherlands applies the so-called stakeholder model as the leading concept underlying its company law system. As a consequence, a company director should at all times take due care of the company's interest defined in a rather broad sense, so including shareholders', workers', creditors' interests and even interests such as the environment, human rights et cetera. By accepting the excessive risks as described in the given case, even after being severely warned, the CEO obviously seems to have violated this duty of care. In terms of Dutch case law: he is likely to be considered "severely culpable" (in Dutch: *ernstig verwijt*) in court proceedings. This could make him personally liable not only towards the company, but

   also in bankruptcy towards the trustee for the deficit of the estate and even towards individual creditors for their damage. It is difficult to say in general terms when so-called red flags hang out so obviously that a director crosses the line of legality by continuing such transactions. It all depends on the circumstances of the case at hand.

2. As of 1 January 2013 new legislation on conflicts of interests will become effective in the Netherlands, under which no conflicted director may participate in the relevant sensitive corporate decision-making. However, his participation will not affect the legality of the decision taken by the board, nor of the transaction entered into following the decision. The company is still bound by it, provided that it has been validly represented at the time of the transaction. Under recent specific legislation the company may, in extreme situations, "claw back" excessive payments made to the former director.

3. Members of the Supervisory Board (or non executive board members) – being a member of the Audit Committee or not - could also be held liable for not being cautious enough while monitoring the CEO's actions. The same basic norm applies here; they should also take sufficient care when fulfilling their specific supervisory task and the establishment of "severe culpability" could make them liable as well. In case law the specific knowledge and expertise a member of the supervisory board is deemed to have could be a factor determining the outcome in court proceedings. However, no specific legislation applies here. As a rule, board members bear a collective responsibility for the performance of the company. In connection with this principle they may be jointly and severally liable for the company's failure. At the same time some tasks and responsibilities may be allocated among different board members, so indeed board members are incentivised to monitor each other's performance and do well to get adequately and timely informed thereof.

4. Only company directors can bring a claim on behalf of the company. In bankruptcy the trustee represents the company to that end. There is no such thing as a derivative action under Dutch company law. However, under the rules of the so-called inquiry proceedings a shareholder – or a group of shareholders acting jointly – with a stake of at least 10% in the company, may request the Enterprise Chamber of the Amsterdam Court of Appeals "(EC") to appoint an outside expert to investigate the company's affairs, or a certain aspect thereof during a specific timeframe. If the report of the expert shows malperformance (*wanbeleid*) on the part of the company – for which the former directors bear special responsibility – the EC may take various measures at the shareholder's request, such as the dismissal of directors, the amendment of the articles of association and the temporary transfer of shares to an independent trustee. Only recently has the EC ruled that the mere fact that current management refused to hold the former management liable for its actions in itself constituted the suspicion of malperformance of the company. So one may conclude that, despite the fact a specific law on derivative actions currently lacks in The Netherlands, inquiry proceedings more or less fill that gap as they can be used as an alternative instrument to serve the goal of protecting the interests of minority shareholders.

Hypothetical IV

1. Yes, Dutch corporate law requires directors to disclose their direct or indirect interests in transactions with the company, should these constitute a conflict of interests (*tegenstrijdig belang*). A violation of this rule may, under current law, result in the company not being bound toward the third party under the relevant transaction. However, under the new law effective as of 1 January 2013 there is no longer such external effect. Conflicts of interests are then no longer a matter of representation but of corporate decision making. The transaction remains valid and binding, but the company may hold the conflicted director liable should the company suffer any damage from the said transaction.

2. Yes and yes.

3. Only if the Supervisory Board is also conflicted, the shareholders meeting is authorised to ratify the decision to perform the transaction. In his role as a shareholder the conflicted

director may vote on the issue in the shareholders meeting. For the protection of the interests of minority shareholders I refer to what I have stated about the workings of Dutch inquiry proceedings mentioned under Question III.4.

4. Again (I fear that you will find me boring), the issue of corporate opportunities under Dutch law is dealt with under the wide normative umbrella of liability actions based on tort. In case law by lower courts it has been recognised that the mere fact that a director competes, through his stake in another company, with the company he is serving as director in itself does not constitute an act of tort and make him liable towards the latter. Additional circumstances must be put forward by the claimant. As to the protection of minority shareholders please again be referred to what I have stated in answering Question III.4 above.

5. Also if a *former* director exploits corporate opportunities to his own benefit and to the detriment of the company he used to serve as a director, he can be held liable by the latter because of his violation of unwritten duties of care based on tort. There is no dogmatic impediment for such action under Dutch law.

6. Under Dutch law I would say that the director is still conflicted, since pending a decision of Bidder, Rival is contemplating a competing offer, and the director knows it. The fact that Bidder forgoes an offer does not change that situation. Director A may not participate in the decision-making of the board of Bidder.

Portugal

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

  As a company law matter, the liability of the parent company would depend primarily on the type of inter-corporate linkage between the parent and the subsidiary, that is, on the type of corporate group at stake. In the case of a legal group – that is, the parent company holding a 100% shareholding or entering into a subordination agreement with each subsidiary (articles 488 and 493 of the Portuguese Code of Commercial Companies), the parent would bear unlimited liability for any unpaid debts of the subsidiaries arising from the product liability claim (art. 501 of the same Code). In the case of a pure "de facto group" – where the parent controlled their subsidiaries via a majority shareholding or otherwise –, the liability of the parent would be much more difficult to establish, except where the involuntary creditors (affected consumers) prove that the parent caused the subsidiary directors to take the managerial decisions in question (art. 83 of the same Code) or if the court decided to pierce the corporate veil of the subsidiaries in order to impute the liability to the controlling parent.

- *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

  Again, the answer would depend on the concrete type of group at stake (see above 1). In case of a legal group – where the law imposes on directors of the parent company a general duty of diligent management concerning the group as a whole (art. 504 of the Code) –, the parent's directors could also be held liable if the affected drug consumers proved that there was a breach of the standards of orderly and diligent group management (e.g., instructions issued to the subsidiary in order to skip planned pharmaceutical safety protocols). In the case of a factual group, an eventual liability of the directors of the parent would be extremely difficult to establish, except in egregious cases of disregard of the corporate entity doctrine (as shadow directors).

<u>Hypothetical II: Duties in the vicinity of insolvency</u>

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalize the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalize the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in lime with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

  As a matter of principle, the fiduciary duties of directors only prevent them from entering into business transactions or to take managerial decisions which involve disproportionate or unreasonable financial or economic risks to the company. If the director proves that a concrete business transaction has been taken in an informed way, free of any personal interest and according to the standard of entrepreneurial rationality, he is presumed to have acted in compliance with his fiduciary duties and is thus exempted from any liability (articles 64(1)(a) and 72(2) of the Portuguese Code of Commercial Companies).

- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

  The concept of "vicinity of insolvency" is not expressly acknowledged by the law or the courts, neither is there any specific legal provision directly providing for a shift of directors' duties in such a case. Nevertheless, if the accounts of the company show that half of the share capital is lost or there are reasonable grounds to believe that such loss might occur, the directors must immediately convene a general shareholders' meeting (article 35 Portuguese Code of Commercial Companies). Moreover, if the company assets are clearly insufficient to cover the liabilities according to applicable accounting rules, directors have a duty to start insolvency proceedings within 60 days (Code of Insolvency, Article 3(2), 18 and 19).

- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

  The answer is uncertain as it would depend on the way in which national courts would construct and apply the general standard of entrepreneurial rationality in the concrete case, provided for by article 72(2) of the said Code, and there is still no case law or jurisprudence on this particular type of business decision (investment on derivatives). As a matter of principle, I would submit that a decision on massive investments in crude oil futures by the board of directors of an oil trading company would be in line with the director's fiduciary duties only insofar as the investment had a hedging purpose (i.e., protection against the volatility of the oil prices) and not a speculation purpose (simply gambling on the rise or fall of prices, even when supported by accurate market predictions and justified by the need to recapitalize the company).

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralized debt obligations (CDOs) backed by residential mortgage backed securities, including lower rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  Yes, in principle the CEO would be held liable under Portuguese Law. As mentioned above (Case II, 1), the directors are protected by a business judgment rule only insofar as risky business decisions are in line with the general standard of entrepreneurial rationality (article 72(2) of the Portuguese Code of Commercial Companies). In my opinion, it would certainly be difficult for a director to prove or to justify the rationality of managerial decisions consisting in massive risky investments with collaterals that were consistently regarded as weak or overvalued by the economic and financial community long after 2005. Of course, as also mentioned above (Case II, 3), the answer would ultimately depend on the way in which national courts construct and apply the legal standard of entrepreneurial rationality in the case at hand.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  Yes. According to Portuguese Law, the remuneration of the members of the directors (including the CEO and Executive Directors) shall be approved by the general meeting of shareholders or by a special remuneration committee nominated by the shareholders (article 399 of the Code of Commercial Companies). Moreover, it is up to the shareholders to decide on the existence of any pension schemes indemnities (articles 402 of the said Code), and the validity of golden parachute schemes is doubtful. In any case, the board of directors has no legal power on its own to fix the remuneration of its members or to enter into resignation agreements with any of them.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  Yes. The members of the Audit Committee are in charge of carefully monitoring the performance of the executive directors in managing the company (Code of Commercial Companies, article 423-F), being subject to a particularly high standard of professional care (article 64(2)). The non-executive members would certainly be in breach of their duty of care if they failed to identify the wrongdoing of the CEO due to the lack of appropriate monitoring.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

  A derivative action ("ut singuli") may be brought by minority shareholders owning at least 5% of the share capital (or, in the case of listed companies, 2%), in order to claim damages in favour of the company for the loss suffered (Code of Commercial Companies, article 77(1)). This derivative action is only permissible if the company decided not to bring a corporate liability action against the director (or failed to bring it within 6 months) and if the plaintiffs were shareholders at the time when the derivative action is brought. The plaintiff shareholders shall bear the legal expenses and no reimbursement is owed by the company (Code of Commercial Companies, article 77(2)).

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in*

Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.

According to Portuguese law, directors are bound by a duty of loyalty towards the company, which aims at prohibiting any type of conflict of interest (Code of Commercial Companies, article 64(1)(b)). Therefore, under this general duty, director A would be required to disclose the majority stockholding owned in the Target company to the board of directors of the Bidder. Moreover, directors are obliged to inform the chairman of the board of directors of any situation of conflict of interest and are prohibited from voting in decisions of the board related to matters in which they have, directly or through a third party, a conflict of interest with the company (Code of Commercial Companies, article 410(6)). Therefore, director A was required to inform the chairman of the said conflict and could not vote on such issue. In case of violation of these provisions, the board decision would be voidable (Code of Commercial Companies, article 411 (3)) and the director could incur liability for breach of his fiduciary duties in the general terms.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

As mentioned above (see 1), director A would be prevented from voting when the board of the Bidder decides on the conflicted interest transaction (acquisition of assets of Target). However, the board's approval of the acquisition would be valid if the following conditions were satisfied: a) director A complied with his duty to disclose the conflict of interest to the chairman of the board; b) director A did not vote in the board decision; c) the decision was approved by the required legal or statutory majority of directors.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

The general meeting of shareholders of the Bidder may authorise a related-party transaction insofar as such transaction can be considered as being in the best interests of the company itself, and the disclosure duties regarding such transactions have been complied with in the annual accounts of the company (Code of Commercial Companies, article 66-A (2), IAS 24) and, in the case of listed companies, in the information disclosed to the market (Code of Securities, article 246). If director A was also a shareholder, he/she may not vote in the general meeting resolution on the matter in which he/she has a conflict of interest (Code of Commercial Companies, article 384 (6)). Minority shareholders may dispute the resolution of the general meeting in the courts by proving that the conflicted shareholder/director A voted in violation of the legal prohibition, that his/her vote was decisive for the resolution, and that the resolution was approved to the detriment of the company's interests or the interests of its minority shareholders (Code of Commercial Companies, article 58 (1 (b)).

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

According to Portuguese law, a director breaches his duty of loyalty if he performs functions in a competitor company or if he makes use of a corporate opportunity without the consent of the shareholders or the general and supervisory board (Code of Commercial Companies, articles 254, 398(3) and 428). Even if the conduct of director A would not be considered as amounting to a "competing activity", the fact remains that he/she could be made be liable under the "corporate opportunities doctrine", since the acquisition of assets of Target consists in a business opportunity of which the director becomes aware while performing his functions, which falls within the scope of activity of the Bidder company, and in which this company has an objectively relevant interest.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

In spite of the absence of any legal provision or case law on this matter, according to some Portuguese commentators the general prohibition of using corporate opportunities is also applicable to directors who have resigned from office in order to exploit a specific existing opportunity, thus giving rise to the director's liability for breach of fiduciary duties.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

As mentioned above (see 1 and 2), directors are prevented from voting in any decision of the board related to matters in which they may have, directly or indirectly, a conflict of interest with the company (Code of Commercial Companies, article 410(6)). Thus, conflicted director A could not vote in such a board decision, since he has an (indirect) interest in it given the position held in the competing company (Rival) potentially involved in the same transaction. However, director A would be exempted from liability if the general meeting of shareholders permitted him/her to exploit the business opportunity or if the board of directors decided that the company should not pursue the opportunity.

Romania

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

1. *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

- First of all, it should be made clear that Romania does not currently have a codified set of rules regarding corporate groups. Therefore, the answers that shall be provided here are based solely on general provisions, such as the Civil Code, which also applies to companies.

- The parent company can be held liable under the provisions of Article 1.369 of the New Civil Code, which state that 'any person who incited or determined another person to cause damages, or knowingly benefited from an illicit act shall be jointly held liable with the originator'. The liability of the parent company depends on the subjective attitude of its directors. If they only wanted to boost up the activity of the subsidiary's directors, the parent company will not be held liable. On the other hand, if they knowingly incited the directors of the subsidiary to break the law, the parent company might be held liable. The judgments delivered by the ECJ in the 'Akzo Nobel' and 'Lombard Club' cases steer this conclusion in the same direction.

2. *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

The rule in the Romanian law is that the acts of the company's officers are the acts of the company itself (Art. 219 of the New Civil Code). Therefore, the person that shall be held liable in the first place is the parent company. The directors of the parent company hold only a subsidiary liability, meaning that after the parent company has covered the damages, it is entitled to pursue a civil action against its directors for the recovery of the amount of money paid. Only in exceptional conditions would a director of an 'in bonis' company be held liable directly if he acted outside of his responsibilities (the French-origin theory of the 'faute séparable').

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

1. *Do fiduciary duties prevent directors from entering into particularly risky transactions?*

   Article 1441 (1) of the Companies Law (Law no. 31/1990) contains the fiduciary duty of care and skill. Paragraph (2) of the same article is essentially the business judgment rule imported from US law. Thus, the directors shall not be held liable if they make business decisions on an informed basis and, based on reasonable reasons, they consider that they are acting in the interest of the company.

2. *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*

   Romanian Insolvency Law (Law no. 85/2006) does not deal with the modifications that take place in the directors' duties in the vicinity of insolvency. The law does not even operate with this term, but rather with the notion of 'imminent insolvency'. The most notable change in the directors' duties (especially in the legal regime and conditions of application) is provided for in Article 138 of the Insolvency Law, which gives any interested person (especially the creditors of the company) the right to claim damages directly from the de jure directors and/or de facto, shadow directors, but only after the insolvency proceedings are opened.

3. *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders, or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

   The Insolvency Law (Article 27) stipulates that the company's directors must file for insolvency within 30 days of the date when the insolvency occurred. Also, the directors can (this is not a binding obligation) file for insolvency if the company is in the vicinity of insolvency (imminent insolvency). There is no provision regarding the directors' duties to act in the interest of creditors during the imminent insolvency period.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in

2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  The CEO is liable because he cannot argue that he acted on an informed basis when deciding to invest in CDO's.

  - *How does the duty of care address excessive risk-taking by the managers? Are managers protected by a business judgment rule when they make risky decisions under conditions of uncertainty?*

    There is no legal provision or case-law on the correlation between the duty of care and excessive risk-taking besides the business judgment rule enacted in Art. 144[1] of the Companies Law. Under Romanian law, managers are protected as far as they make a business decision on an informed basis and, based on reasonable reasons, they consider that they are acting in the interest of the company.

  - *When do warning signs ('red flags') become so obvious that initially permissible risk-taking constitutes a violation of the duty of care?*

If the information available to the manager indicates that the business decision he is about to make will expose the company to losses, or when the manager does not act in the interest of the company (by mistake or consciously).

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

The directors breached their fiduciary duty of care (although there is no case-law in Romania regarding this issue), and also the obligation set forth in Art. 153[18] (4) of the Companies Law which states that the board of directors must take into account the economic situation of the company and the responsibilities of the CEO when setting the remuneration or other advantages.

- *Who decides on transactions of one of the directors with the company (related party transactions)?*

  The board of directors without the participation of the director involved in the transaction. The director must immediately inform the auditor.

- *Is the duty of care used to constrain excessive executive remuneration?*

  As far as we know, there is no case-law regarding this issue, although legal grounds for bringing such an action do exist.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

The internal auditors are liable for negligence because: i) they are agents in a type of agency contract (in fact, a mandate contract) and ii) the agent who is remunerated for his services must perform his duties according to the standard of the 'prudent man', meaning that negligence is a ground for liability.

- *Does the standard of care depend on the position of the director in the company and his/her expertise? Accordingly, would members of the audit committee be held to a higher standard of care than other directors?*

  It is unclear. But, in view of the abstract standard of the 'prudent man' differentiations can be made with regard to the position held in the company.

- *Are directors required to monitor their colleagues on the board? Would they be in breach of the duty of care if they could have identified wrongdoing by another board member but* *failed to do so? To what extent are they entitled to rely on the integrity of and the careful discharge of the duties by the other board members?*

The directors are not required by law to monitor their colleagues. Despite this, the law provides a natural incentive for the directors to abstain and inform the internal auditors about any breach of fiduciary or statutory duties, as they are protected from any liability if they do so.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

Yes. The shareholder(s) must hold at least 5% of the share capital to enforce the claim.

- *Who can bring a claim on behalf of the company?*

The general meeting or individual shareholders holding at least 5% of the share capital, but only if the GM refuses to bring the claim.

- *Does the derivative action exist? If not, how does the law ensure that minority shareholders are protected against collusive behaviour by the majority and the directors?*

Yes.

- *What is the threshold to bring a derivative action?*

5% of the share capital.

- *Do conditions exist that must be satisfied before a court will allow a derivative action to proceed (for example, will the court review whether the action is in the interest of the company or frivolous)?*

No.

- *Who bears the costs for a derivative action?*

The minority shareholders, but they can be reimbursed by the company if the action is successful.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  Article 144[3] of the Companies Law stipulates that directors must disclose to the other board members their interest or their relative's interest regarding that transaction, and to refrain from participating in the meeting. If the director violates the disclosure and abstention obligations, the transaction is valid and the director has to pay damages. On the other hand, if the counter-party of the transaction was or should have been aware of the true scope of the transaction, then the transaction would be voidable and, if certain conditions are met, even void.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

  The interested director has to abstain from participating in the meeting. If the director fulfils his obligations of abstention and non-participation the transaction approved by the other board members is valid.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

  It is unclear whether the shareholders can authorise or ratify a related-party transaction. If we analyse the situation in depth, we will come to the conclusion that the answer can be either positive or negative. If we take into consideration the fact that the law states that related-party transactions are voidable if the conditions required are met, we will come to the conclusion that the transaction can be authorised or ratified by the shareholders, thus making it valid. If we look at the problem from a different angle, that of the company's interest, we come to the conclusion that a transaction which is contrary to the company's interest is void and, therefore, not authorised.

  In any case, the conflicted director cannot vote on such a resolution pursuant to Article 127 of the Companies Law.

  Minority shareholders can bring an action for the voidance of the resolution authorising the transaction (Article 132 of the Companies Law), or they can directly ask the voidance of the transaction (Art. 215 of the New Civile Code) if the transaction is not in the company's interest.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

There is no corporate opportunities doctrine in Romanian Law. The substitute is the non-compete obligation set forth in Art. 153[15] of the Companies Law. The rule is not accurate as it refers only to managing directors and members of the management board (in the two-tier board system). If a managing director wants to pursue competing activities, directly or through another company, he must first obtain the approval of the board.

The shareholders can bring an action against the director who breached his duty of loyalty under Art. 144[1] par. (1) of the Companies Law.

In the case above, we think it is rather a question regarding the duty of confidentiality of the director.

Under the Romanian law, if the director breaches his non-compete obligation his contract with the company shall be terminated and the company may ask for damages in court. Basically, the effect of both legal institutions is the same: the company is entitled to be reimbursed for the losses.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

According to the Romanian law, the fiduciary duty of loyalty (part of which is the non-compete duty) ceases to exist when the director resigns (or the contract is terminated by other means). Since this is a newly enacted duty (2006), there is no relevant case-law on the matter, but it is safe to assume that acts which are in connection with the period of time when the director was in office can constitute a breach of the non-compete duty even though the respective acts took place after the resignation of the director.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

It is unclear whether duty not to compete applies. The non-compete duty is drafted in more general terms than the corporate opportunities doctrine. Therefore, if the board decides to approve the director's request to fill a similar position in a competing company, the authorisation is granted with regard to all future transactions, and not on a case-by-case basis.

Theoretically, the company acting through its board of directors can waive the non-compete duty of the director. Anyway, the conflicted director is prohibited from participating in the decision of the board.

Slovenia

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

1. *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

   The Slovenian Companies Act stipulates that subsidiary companies are legally independent and shall be liable for their liabilities with all their assets. The Companies Act does not establish automatic liability of the parent company for the liabilities of a subsidiary. In circumstances comparable to the facts above (i.e. actual concern) the parent company may not use its influence to induce a subsidiary company to carry out harmful transactions for itself, or to do something or fail to do something to its own detriment, unless the parent company compensates the subsidiary company for the loss. The liability of a parent company would be established if a parent company induces a subsidiary company to carry out a legal transaction which is detrimental to it, or to do something or not do something to its own detriment, without actually compensating for the loss by the end of the financial year or without providing the right to benefits determined for compensation.

2. *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

The Slovenian Companies Act stipulates that in addition to the parent company, those statutory representatives of the parent company who induced the subsidiary company to carry out the legal transaction or measure which is detrimental to it shall also be jointly and severally liable.

The members shall be liable (disregard of the legal personality) for the liabilities of the company in the following cases:

- if they abused the company as a legal person in order to attain an aim which is forbidden to them as individuals,

- if they abused the company as a legal person thereby causing damage to their creditors,

- if in violation of the law they used the assets of the company as a legal person as their own personal assets, or

- if for their own benefit or for the benefit of some other person they reduced the assets of the company even if they knew or should have known that the company would not be capable of meeting its liabilities to third persons.

Hypothetical II: Duties in the vicinity of insolvency

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*
- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' defined?)*
- *What is the legal response to above situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders, or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

[No answer.]

<u>Hypothetical III: Duty of care</u>

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis

necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  The LCC-1 prescribes for the Management and Supervisory Board members the duty of care, using the standard of a conscientious and fair manager. The duty of care and liability of supervisory board members and members of the board of directors is subject to the appropriate application of the LCC-1 provisions on the duty of care and liability of management board members.

  It is laid down in the LCC-1 that, in performing their tasks on behalf of the company, the members of the management or supervisory body must act with the diligence of a conscientious and fair manager and protect the business secrets of the company.

  The members of the management or supervisory body are jointly and severally liable to the company for damage arising as a consequence of a violation of their tasks, unless they demonstrate that they fulfilled their duties fairly and conscientiously.

  The members of the Management body, in performing their tasks on behalf of the company must act with the diligence of a conscientious and fair manager (duty of care, as legal standard).

  The members of the management body are liable to the company for damage arising as a consequence of a violation of their tasks, unless they demonstrate that they have fulfilled their duties fairly and conscientiously (reversed burden of proof).

  The members of the management body are jointly and severally liable to the company (in some cases also to the creditors) for damage caused in the course of managing the business.

  Members of the management or supervisory body are not obliged to reimburse the company for damage if the act that caused damage to the company was based on a lawful resolution passed by the general meeting. The liability of the members of the management is not excluded on the basis that an act was approved by the management or supervisory body.

A compensation claim by the company against members of the management or supervisory body may also be pursued by creditors of the company, if the company is unable to repay them.

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  Issues:

  - *Who decides on transactions of one of the directors with the company (related party transactions)?*

    Supervisory board in the two tier system and board of directors in the one tier system.

  - *Is the duty of care used to constrain excessive executive remuneration?*

    Normally yes.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  Issues:

  - *Does the standard of care depend on the position of the director in the company and his/her expertise? Accordingly, would members of the audit committee be held to a higher standard of care than other directors?*

    In principle, the same standard of care applies to all directors (members of the board). However, members of the audit committee would additionally be held to a standard of care taking account of their audit expertise.

  - *Are directors required to monitor their colleagues on the board?*

    They are not explicitly obliged to do so.

  - *Would they be in breach of the duty of care if they could have identified wrongdoing by another board member but failed to do so?*

    If they would, acting so, breach the duty they owe to the company.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

  Issues:

  - *Who can bring a claim on behalf of the company?*

    Directors and the president of the supervisory board; in addition also minority shareholders. Where an action is filed against a person still performing the duties of a member of the management or controlling organ, the assembly shall appoint a special representative who represents the company in the proceedings before the court.

  - *Does the derivative action exist?*

    Yes.

  - *What is the threshold to bring a derivative action?*

    10% of shares or shares of at least 400,000 euro nominal value; where a proposal for bringing an action is not accepted or if the assembly does not appoint a special representative or if the management or special representative does not operate in accordance with the decision of the general meeting, a lawsuit may be filed by minority shareholders on their own behalf and on behalf of the company.

  - *Do conditions exist that must be satisfied before a court will allow a derivative action to proceed (for example, will the court review whether the action is in the interest of the company or frivolous)?*

    No particular conditions listed by law. The court will check only if a legal ground for the action exists.

  - *Who bears the costs for a derivative action?*

    The costs and expenses are covered by the company.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  If directors have a personal interest in a transaction with the company, they must disclose the conflict of interest to the board and to the internal auditors, and refrain from participating in the decision on the transaction.

  If the director violates the disclosure obligation, is the transaction void or voidable or does the director have to pay damages?

  If the consent of the supervisory board or general meeting has not been given, it shall be deemed that the transaction is null and void. The general meeting may pass a resolution approving the transaction. In that case, the transaction is not null and void, but the director continues to be liable for violating his disclosure obligations.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

  Issue: Does the interested director have to abstain from voting when the board decides on the conflicted interest transaction?

  Yes, there is an explicit legal provision on that.

  If he/she fully informs the board and abstains from voting and the board approves the transaction, is it valid?

  Yes.

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

  Issue: Can the shareholders authorise or ratify a related-party transaction?

No, it is up to the board (supervisory board or board of directors) to decide on consent. The general meeting decides only in case there is no board.

Can the conflicted director vote on such a resolution if he/she is also shareholder?

No, but it is not explicitly laid down in the law.

How is minority shareholder protection ensured? For example, can the minority shareholder appeal to the courts and claim that the transaction was not in the company's interest?

It is not regulated in the law in the context of conflicts of interest, but the institute of special audit can be used in such cases by minority shareholders.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

There are only legal rules referring to a ban of competition.

Members in an unlimited company, general partners in a limited partnership, members and managers in a limited liability company, members of the management board and supervisory board of a public limited company and procurators may not participate in any of these roles or be an employee in any other company, or as an entrepreneur pursue an activity, which is or could present competition to the activities of the first company.

The founding act of a company may set conditions under which the persons referred to above may participate in a competing company. It may provide that the ban on competition shall continue after a person has lost the position, but the ban must not last more than two years.

If a person violates the ban on competition the company may claim compensation. The company may also require the offender to cede to the company any operations concluded for his own account as operations concluded for the account of the company, or require the offender to transfer to it any benefits from operations concluded for his own account, or to cede to the company his right to compensation.

A special provision on a ban on competition exists for directors (members of the management board). A member of the management board may not pursue an activity with a view to profit in the area of the company's activity without the consent of the supervisory board, nor conclude operations for his own account or for the account of another person.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

Issue: Does the prohibition to exploit corporate opportunities (or the duty not to compete) continue to bind the director after resignation?

See the previous answer.

If the duty continues to apply, how is this dogmatically justified? For example, under English law the prohibition to exploit corporate opportunities derives from the fiduciary position that a director occupies. When a director resigns, fiduciary duties cease to exist. However, the English courts argued that the director violated the duty of loyalty by resigning in order to exploit an opportunity that was, at the time of resignation, already a so-called maturing business opportunity.

It is up to the shareholders to establish such conditions for directors in the founding act (articles of incorporation). In such a case the ban on competition shall continue after the director has lost the position (but not for more than two years). The ban on competition after termination of office can also be contractual (agreed in the contract between the director and the company).

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

The decision is in the hands of the supervisory board; anyhow, a member of the management board may not pursue an activity for profit in the area of the company's activity without the consent of the supervisory board. If such consent is given because the company has no interest, the director may pursue such business.

Can the conflicted director participate in the decision of the board?

No.

Spain

Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

1. *Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?*

   Probably not. The facto/shadow director doctrines are used only in “simple and easy” cases, and not always successfully. Although these doctrines might work for some purposes, they are not a working concept to make the controlling shareholder liable.

2. *Under which circumstances would the directors of the parent company face a liability risk in those circumstances?*

In this case, the director could be liable if he speeded up the process and covered it up.

<u>Hypothetical II: Duties in the vicinity of insolvency</u>

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices follo fail to convene the mandatory general meeting within two months to adopt a decision on dissolution wing the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Do fiduciary duties prevent directors from entering into particularly risky transactions?*
- *At which point in time does the law provide for additional duties of directors or the change of existing duties in situations of financial distress? (i.e. how is 'vicinity of insolvency' be defined?)*
- *What is the legal response to below situation? For example, the law may provide that the directors have to take primarily the creditors' interests into account, rather than those of the shareholders, or the company must cease to trade and the directors file for the opening of insolvency proceedings.*

Risky transactions are not per se undesirable. But, of course, depending on the circumstances, they may not be recommended: this judgment falls into the standard of the duty of care. The law does not provide additional duties in situations of financial distress, nor a concept or a definition of 'vicinity of insolvency'. But the two years before the company is declared insolvent by the Court are known as the suspicious period, mainly because claw-back actions cover that period of time, and directors who have been in office during that period, although they may no longer be, can be held liable according to the special liability section of the bankruptcy proceedings.

In the case above the directors may face liability in case they failed to convene the mandatory general meeting within two months to adopt a decision on dissolution. Insolvency is defined as the situation where the debtor cannot regularly discharge its obligations. This provision applies when the dissolution is the consequence of insufficiency of assets. In such a case, directors are liable vis-à-vis company creditors holding unpaid claims arising after the insufficiency of assets.

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

Questions:

- *Is the CEO liable for annual loss suffered by the company in 2008?*

  The business judgment rule should be applied if the director is well informed, the decision is not illegal, and there is not a conflict of interests. I do not think that the CEO could be liable. It is very hard to prove gross negligence, that he made risky decisions at the time (probably, there were other companies acting in the same way, and opinions and predictions at the time were not unanimous).

- *Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?*

  Issues:

  - *Who decides on transactions of one of the directors with the company (related party transactions)?*
  - *Is the duty of care used to constrain excessive executive remuneration?*

  Related party transactions are decided by the board. The way to prevent excessive remuneration in the law's view is through the approval by the general meeting in case of stock options, and the clarification of the remuneration system in the articles of association.

- *Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?*

  Issues:

  - *Does the standard of care depend on the position of the director in the company and his/her expertise? Accordingly, would members of the audit committee be held to a higher standard of care than other directors?*

    Yes, executive directors could be said to be, in practice, subject to a higher standard, but it does not seem to be the case that the members of the audit committee would be under a higher standard in practice. There is not even a requirement of expertise in order to be a member of the audit committee (it is a requirement that independent directors are on the committee).

  - *Are directors required to monitor their colleagues on the board? Would they be in breach of the duty of care if they could have identified wrongdoing by another board member but failed to do so? To what extent are they entitled to* *rely on the integrity of and the careful discharge of the duties by the other board members?*

Outside directors are not liable for the actions of the executive management unless in cases of fault *in eligendo*, *in vigilando* or *in instruendo*. On the other hand, they are liable to the company if they negligently perform the tasks that are assigned to them as non-executive directors. Monitoring is one of them. If the breach is the result of a decision of the board, all board members are jointly and severally liable for damages caused to the company, except those who voted against the decision and took steps to prevent it or its harmful consequences.

- *Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?*

  The directors are the ones who can bring a claim on behalf of the company. However, minority shareholders have standing to bring a derivative action if they own 5% of the share capital. No other special conditions must be satisfied for the derivative action. The costs of the process are borne by the losing party (with some restrictions). Notice that derivative actions are rare.

Hypothetical IV: Duty of loyalty

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- *Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.*

  Company Law requires directors to disclose conflicts of interests and abstain from voting (art. 229 LSC). The decision could be voidable ex. art. 251 LSC, but the mere violation of the procedural rules applied to conflicted transactions does not make the resolution per se unlawful (doctrine of "resistance": the resolution should be deemed valid if, even if the rule had been observed, the resolution would have been adopted). Nevertheless, the infringing director may be liable when the decision has caused damage.

- *As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.*

  If the interested director observes disclosure and abstention duties, the decision should be valid from a procedural perspective. However, besides the procedural dimension, the decision may be challenged on substantive grounds (e.g., if it is not in the company's best interest).

- *As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.*

  Normally, related party transactions are not ratified by the general meeting. The minority shareholders can protect their interests by challenging the board's decision (but the minority can only challenge a board resolution if they represent 5% of the company's share capital) or by suing for damages. If the transaction is also approved by the general meeting – say, a capital increase or decrease – the minority is better protected: Any shareholder can bring a lawsuit and challenge the decision. However, it may typically be very hard to prove that the transaction harms minority shareholders. A high percentage of the successful claims are granted based on the violation of procedural rules. It is hard to win a case on substantive grounds.

- *Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.*

  Traditionally, the mechanism to protect the shareholders was the removal of the competing director. In this case, the general meeting is entitled to dismiss the director. After the Law changed in the aftermath of Enron and related scandals, the traditional prohibition to compete has been kept (art. 228 LSC), but the prohibition to exploit corporate opportunities has been added (art. 230 LSC). Both rules can be applicable, but it is not clear how the two rules should be coordinated.

- *As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.*

  I am not aware of any judicial ruling on the point, but it seems clear that if the corporate opportunity arises while the director is part of the board, he is not allowed to exploit it, even if the action of exploitation takes place later. Resignation makes no difference.

- *As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.*

  If the company is not interested in the transaction, the corporate opportunities provision does not apply. The conflicted director should abstain from participating in the decision of the board of directors resolving that the company should not pursue the opportunity.

The United Kingdom

<u>Hypothetical I: Liability of the parent and directors of the parent for breaches of duty at the level of the subsidiary</u>

A pharmaceutical company is currently developing two new drugs. After assessing the potential liability risks associated with the future products, the directors of the pharmaceutical company decide to incorporate two separate private limited companies, each taking over the development, research and future marketing of one of the two drugs.

The directors of the pharmaceutical company appoint the two project managers as directors of the two subsidiary companies. The two subsidiary companies enter into an agreement allowing them access to the parent company's research facilities. According to the subsidiary's articles of association, all major strategic decisions regarding the research, development and marketing of the drugs are subject to approval by their sole shareholder, the pharmaceutical company. The employees working for the subsidiaries are formally still employed with the parent company, but are posted with the subsidiaries under an agreement entered into by the parent company and the two subsidiaries upon formation of the two companies.

When the directors of the parent company learn about competitors working on similar projects, they try to accelerate the development process of the two drugs. They award substantial bonuses to the subsidiary's directors, contingent on the drugs receiving regulatory approval within the next 6 months. The original schedule provided for further tests, which would take at least 12 months.

Primarily because of the contingent bonus payment, the directors of the subsidiaries skip some of the planned tests and studies, and cover up this decision in their filings for regulatory approval.

The two drugs gain regulatory approval within the 6 month time span, and are successfully marketed shortly after that.

Two years after the initial marketing, independent studies reveal that one of the drugs causes a rare form of lethal cancer, exposing the relevant subsidiary to enormous product liability claims that far exceed its net assets. The drug developed by the other subsidiary proves to be safe and leads to substantial profits.

- Is it possible that the parent company would be liable in circumstances comparable to the stylised facts above?
- Under which circumstances would the directors of the parent company face a liability risk in those circumstances?

    - *De-facto director: It is unlikely that a court would find that the parent company is a de facto director. To become a de-facto director a person must assume responsibility as a de facto director, which does not appear to be the case on the basis of the hypothetical. The fact that parent company directors are also subsidiary directors does not make the parent company a de-facto director.*

- *Shadow director: a person is a shadow director where the directors are accustomed to act in accordance with the instructions of that person. What one needs to identify is a pattern of behaviour in which the directors do not exercise their own judgment, but rather do as the "shadow director" has instructed. On the facts it seems unlikely that the parent is a shadow director. The parent uses incentives to mould subsidiary director decision-making. Such incentives at this level of the corporate structure would arguably not be required if the parent was used to simply telling the actual directors what to do. Furthermore, under UK law it is unclear what duties in fact apply to shadow directors.*
- *Group liability: it would not be possible to pierce the corporate veil on these facts. There is scope to argue that the parent owes directly a duty of care in tort to the subsidiary customers on these facts – particularly the control the parent assumes in relation to the drug development and approval process. Recent UK tort case law in the context of parent duties owed to subsidiary employees supports this, but it is not clear that this authority can be extended beyond this setting.*
- *Insolvency law would not provide a solution on these facts.*

<u>Hypothetical II: Duties in the vicinity of insolvency</u>

After making losses for three consecutive years, an oil trading company's equity ratio (equity divided by total assets) has fallen below [1% - 5% - 10%]. On average, comparable companies in the same line of business have an equity ratio of about 25%.

The company still has substantial assets, but the thin equity cushion makes it hard for the company to pursue its core business, as trading partners demand higher prices to compensate them for the perceived higher risk of the company's operations.

The company's directors evaluate different possibilities to improve the business prospects of the company. They attribute past trading losses to the substantially higher volatility of oil prices following the financial crisis, and maintain the view that the company's business model is sustainable in the long run. After exploring the possibility to raise new equity to recapitalise the business, they conclude that current market conditions would force them to issue new shares at prohibitively low prices, which would lead to a substantial dilution of their current shareholders.

After analysing the market conditions, the directors come to the conclusion that the market price for crude oil is bound to rise significantly over the next year, particularly due to high anticipated demand from emerging market economies. In an attempt to recapitalise the company the directors decide to invest heavily in crude oil futures. They expect that the anticipated increase in oil prices will lead to substantial gains from this transaction, bringing the equity ratio back in line with the industry average, and thus allowing the company to resume their trading operations at more sustainable conditions.

The directors are aware that a sudden substantial fall in oil prices could potentially wipe out the remaining equity of the firm, but they consider the likelihood of this happening to be very low.

Shortly after entering into the forward sale agreement, worries about a sovereign debt crisis lead to a revision of worldwide economic growth forecasts. The price of crude oil falls more than 10% on a single day, the worst one day performance in many years. As the company cannot fulfil the margin calls on its forward sales contracts, the positions are closed by the counterparty. The closed positions have a negative value exceeding the company's equity, leading to the company's over-indebtedness. Trading partners refuse to enter into transactions with the company due to its financial position, and banks close all existing credit lines of the company.

- *Fiduciary duties: when a company is operating in the zone of / approaching cash flow insolvency the duties owed to the company (section 172 Companies Act 2006) become duties to promote the success of the company for the benefit of both creditors and shareholders and to take due care in so doing. When insolvent those duties are then to promote the interests of the creditors alone and to take care in so doing. The law remains somewhat unclear on what is the "verge" of insolvency and in what ways creditor interests are taken into account in this zone (priority versus plurality). On these facts the risk of failure that is apparent would mean that the interests of creditors would intrude. However, the business judgment taken to buy the futures would be judged according to the section 172 standard, which is a subjective standard (in practice a rationality standard). There appeared at the time to be a sound basis for this decision, accordingly there would be no breach. In relation to the duty of care the facts suggest that due care was taken which would comply with the UK's dual subjective / objective care standard.*
- *Wrongful trading: although wrongful trading could provide a remedy when taking risky decisions in the zone of insolvency, the facts suggest (low probability of price drop) that this would not provide a remedy in this context. The remedy imposes creditor-regarding obligations when a director should have realised there was no way of avoiding insolvent liquidation. The law has not attempted to define the probability of avoidance required by this provision. The low probability suggested in the facts would not be sufficient.*

Hypothetical III: Duty of care

A large banking institution is engaged in retail as well as investment banking. In 2000, a new CEO was appointed, who also sits on the board of directors. The CEO made the decision to invest heavily in collateralised debt obligations (CDOs) backed by residential mortgage-backed securities, including lower-rated securities that pooled subprime mortgages to borrowers with weak credit history. The investments were initially successful, generating high profits for the company. However, beginning in 2005, house prices, particularly in the United States, began to decrease. Defaults and foreclosures increased and the income from residential mortgages fell rapidly.

As early as May 2005, economist Paul Krugman had warned of signs that the US housing market was approaching the final stages of a speculative bubble. Early in 2007, a large US subprime lender filed for bankruptcy protection and a number of investors announced write downs of several billion dollars on their structured finance commitments. In July, 2007, Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages. At the end of 2007, two hedge funds that had invested heavily in subprime mortgages declared bankruptcy. In spite of these warning signs, the CEO had continued to invest in CDOs until shortly before the Lehman bankruptcy in September 2008, accumulating a total exposure of more than 20 billion Euro/Pounds/… . The subprime mortgage crisis necessitated massive write downs, leading to an annual loss of eight billion in 2008, which can be attributed in equal measure to the CDO transactions undertaken in 2005-2008.

The CEO resigned in October 2008. As part of the resignation, the CEO entered into an agreement with the company providing that he would receive 50 million Euro/Pounds/… upon his departure, including bonus and stock options, and in addition an office, administrative assistant, car and driver until he would commence full time employment with another employer. In exchange, the CEO signed a non-compete agreement and a release of claims against the company. The agreement with the CEO was approved by all directors (the CEO abstaining from voting), acting on behalf of the company.

After the CEO's departure and with a new management team in place, it transpires that the old CEO had used a number of ostensibly arms-length transactions with investment firms that were, however, controlled by the CEO's nominees, to transfer assets at an undervalue to a company owned by the CEO on the Cayman Islands. When the true nature of these transactions becomes known, the assets are no longer recoverable.

<u>Questions</u>:

- Is the CEO liable for annual loss suffered by the company in 2008?

The UK does not have a US style business judgment rule, but in effect business decisions are similarly regulated. The standard that applies to the business decision - as distinct from the care taken in making the decision - is a subjective standard: to do what you consider promotes the success of the company for the benefit of the shareholders. Although there is some disagreement on this point, UK law does not require "reasonable decisions". In practice, this results in the application of a rationality or plausibility standard: could the decision rationally or plausibly have made sense in the shareholders' interests (assuming no verge of insolvency problem) at the time the decision was made. Clearly that is possible in this case even if some market participants claimed that the market was heading towards impending doom.

The duty of care as applied to decisions requires a reasonable decision-making process (as assessed by a dual subjective / objective reasonable director standard). The facts do not suggest that inadequate care was taken in deciding to make the sub-prime investments in a market in which everyone else (i.e., the average director) continued to party.

- Have the directors (other than the CEO) breached their fiduciary duties by approving the agreement in conjunction with the resignation of the outgoing CEO?

  Decision-making: this decision in a company that is UK Corporate Governance Code compliant would be made by the remuneration committee that consists only of independent non-executive directors.

  Duty of care: The decision to make the resignation pay award is more problematic. But again a case that this was in the company's interests can be made depending on the plausible assessment of the value of the release and the non-compete – at the time it was entered into. At the time major figures in UK banks resigned their posts in the early stages of the crisis it was not unreasonable to expect that those figures would work again in the sector. That proved to be inaccurate, but duty compliance is determined at the time the decision was made.

- Have the members of the company's internal audit committee (of which the CEO was not a member) breached their fiduciary duties by not identifying the true nature of the ostensibly arms-length transactions and are they, accordingly, liable for the loss suffered by the company as a consequence of the transactions? Have the other directors (except the CEO) breached their duties?

  The facts are not full enough to give clear direction on this issue. The non-arms-length transactions raise questions about the duty of care and monitoring and internal controls, particularly for directors who undertake particular responsibility for those controls. The duty of care in the UK does not allow directors to delegate power and then absolve themselves of responsibility for the exercise of that power. Furthermore, this duty takes account of the role and function of the director (e.g., audit committee member). However, the facts of the hypothetical do not provide much information to judge duty compliance in this regard. If the directors had taken care to ensure that internal controls were in place to provide for the reporting of such transactions, then the failure to actually report them to the directors would not result in a breach of duty. If on the other hand directors were aware of these red flags but had not taken steps to do anything about them then clearly this raises duty of care issues directly in relation to these transactions. It would also be relevant information more generally about care compliance in relation to these directors and the resignation pay-off.

- Assuming that the company has a claim against the CEO or another director pursuant to one or more of the above questions, can a minority shareholder enforce the claim?

  Issues:

  Who can bring a claim on behalf of the company? *Any shareholder regardless of when the share was purchased if the court gives permission to continue a derivative action.*

  Does the derivative action exist? If not, how does the law ensure that minority shareholders are protected against collusive behaviour by the majority and the directors? *Yes a derivative action is permissible with the permission of the court. UK law also provides an unfair prejudice remedy that in some instances may be used to protect the shareholders (depending on the circumstances this remedy may create additional substantive protection or be a means to enforce other rights).*

  What is the threshold to bring a derivative action? *Court approval*

  Do conditions exist that must be satisfied before a court will allow a derivative action to proceed (for example, will the court review whether the action is in the interest of the company or frivolous)? *Yes, multiple conditions focused around good faith, company interest, and shareholder views (probable view) of the litigation.*

  Who bears the costs for a derivative action? *Normal cost rules apply unless an indemnification order is awarded in favour of the derivative litigant to cover her costs (win or lose).*

<u>Hypothetical IV: Duty of loyalty</u>

A mining company ('Bidder') considers expanding business operations. The board identifies assets held by another company ('Target') as a possible acquisition. The following scenarios ask you to consider the liability of a director ('A') on the board of Bidder.

- Director A is also majority shareholder in Target, holding 60 percent of the outstanding share capital of the company. As majority shareholder of Target, he is interested in an acquisition that is beneficial to Target. He proposes that Bidder purchase the assets for 10 million Euro/Pounds/…, knowing that the value ranges between 7 and 8 million. Director A does not disclose his interest in Target to the board of Bidder. A majority of the directors approves the acquisition. A's vote was not decisive for the positive vote.

  Does the law require directors to disclose direct or indirect interests in transactions with the company? *Yes.*

  Is this duty laid down in the companies act or does it derive from the fiduciary position of the director? *The duty is laid down in the Act, but common law rules will apply if there is non-compliance.*

  If the director violates the disclosure obligation, is the transaction void or voidable or does the director have to pay damages? *The transaction is voidable. Possible remedies include equitable compensation and accounting for profits.*

- As in scenario 1, but Director A discloses his interest in Target to the board of Bidder, and a majority of the uninterested directors approves the acquisition.

  Issue: Does the interested director have to abstain from voting when the board decides on the conflicted interest transaction? *It depends on the articles of association. Typically yes.*

  If he/she fully informs the board and abstains from voting and the board approves the transaction, is it valid? *Yes.*

- As in scenario 1, but when the shareholders of Bidder learn of A's interest in Target, they ratify the transaction, believing that it is in the company's interests.

  Issue: Can the shareholders authorise or ratify a related-party transaction? *Yes.*

  Can the conflicted director vote on such a resolution if he/she is also shareholder? *She can vote but the votes will not be counted for the purposes of the ratification resolution, so effectively no.*

How is minority shareholder protection ensured? For example, can the minority shareholder appeal to the courts and claim that the transaction was not in the company's interest? *A non-disclosed or approved transaction is a breach of duty which can be enforced derivatively (subject to the conditions outlined above). The claim would not be that the transaction is not in the company's interest, rather a claim for breach of the applicable duty requiring disclosure.*

- Director A is majority shareholder and managing director in a competitor of bidder ('Rival'), which is also active in the mining business. The assets held by Target that Bidder seeks to acquire consist in claims near Rival's own mining territories. Director A is of the opinion that the assets are more valuable for Rival than for Bidder. He therefore arranges for Rival to make a competing and higher offer than Bidder, and Target accordingly decides to sell the assets to the former company.

Issue: Does a corporate opportunities doctrine exist? *Yes.*

If yes, when does it apply (for example, only if the opportunity falls within the company's line of business and the company is legally and financially able to pursue the opportunity, or are all business opportunities caught that would be theoretically of value to the company)? *All business opportunities under current case law. Financial capacity is irrelevant. No line of business restriction (currently).*

If not, what are alternative mechanisms to protect the company and the (minority) shareholders? Is the duty not to compete with the company a substitute for the duty-of-loyalty based corporate opportunities doctrine? Is it equally effective? *N/A*

- As in scenario 4, but A resigns from his position as director of Bidder before Rival makes the competing offer.

Issue: Does the prohibition to exploit corporate opportunities (or the duty not to compete) continue to bind the director after resignation? *Yes.*

If the duty continues to apply, how is this dogmatically justified? *In two ways: (1) as the continuing application of the fiduciary duty to opportunities identified during the director's tenure or (2) (under pre-Companies Act 2006 case law) on a proprietary type basis – that under certain conditions the opportunity belongs to the company (the maturing business opportunity approach).*

- As in scenario 4, but after an initial expression of interest by Bidder in acquiring the assets and before Rival has taken any steps to make a competing offer, the Bidder board determines that an investment of that size is not advisable at the present time in light of Bidder's weak financial position.

Issue: See the remark regarding scenario 4. Does the corporate opportunities doctrine (or the duty not to compete) even apply if the board of directors resolves that the

company should not pursue the opportunity? *This is not clear. But a strong case can be made that it does.*

Can the conflicted director participate in the decision of the board? *Traditionally the non-involvement of the director would not be sufficient to allow the opportunity to be taken. The codification of this provision in the Companies Act opens some room to argue that this rule no longer applies. However, participation (even minority participation) would most likely result in the opportunity not being available to the director.*

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