KNOETZL

# THE BUSINESS JUDGMENT RULE

## A SAFE HARBOUR FOR BOARD MEMBERS

Business decisions that seem reasonable when taken may turn out to have unexpected, possibly even disastrous, consequences. In the aftermath, courts may be called upon to review – with the "benefit" of hindsight[1] – whether the board members[2] are liable for resulting damages[3]. In many situations there is, however, not necessarily a "right" and a "wrong" decision; indeed, often arguments can be made for several alternative or even conflicting decisions. So are the managing directors and supervisory board members personally liable for losses caused by decisions, that – with hindsight – proved negative for the company[4] ? Are the (civil) courts allowed to question the content of these business decisions? The answer under the business judgement rule ("BJR") that has recently[5] been formally introduced into Austrian[6] law is: not if the board members adhere to the set of rules governing the decision.-making process.

KNOWHOW

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## GUIDELINES AT A GLANCE

- Remain within your scope of competence/authority
- Familiarize and adhere to the mandatory laws
- Disclose and manage conflicts of interest
- A solid information basis before decisions is important
- High impact decisions require more preperation consider consulting external advisors
- The decision should in the best intrests of the company

*Let us consider as an example the case of a CEO who recommended the acquisition of a subsidiary; because of time constraints – his[7] direct competitor had already submitted a bid for this strategically important target – only a superficial due diligence was performed. After winning the bidding war and subsequent testing of the target's products, the CEO is dismayed to discover that the key products of that subsidiary are unmarketable; the investment is a write-off.*

*Can the shareholders demand that the company hold the CEO liable?*

*In order for the answer to that question to be "no", his decision must fulfil the following criteria:*

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## IS IT A BUSINESS DECISION?

The first step in the decision-making process is to check if
a) the director is authorized to make the decision,
b) that decision does not violate mandatory rules.

a) Authorization: If the company's statutes or the management board's by-laws provide that the decision requires the (unanimous/majority) decision of all management board members or a resolution of the Supervisory Board or of the shareholders, the director loses his safe harbour if he decides absent the required consent/resolution. The same is true if the decision falls outside of the scope of the company's objectives.

The director will generally have no discretion in this regard: he cannot argue that one of the shareholders or supervisory board members was on holiday and could not be reached in time for a circular resolution or a meeting. Once he oversteps his competence, he loses the safe harbour of the BJR.

b) Violation of mandatory laws: If the decision violates applicable compulsory laws it is not deemed a question of "business judgement", it is simply wrong

*For example, if the acquisition of the shares was in clear violation of anti-trust provisions, the director will not be able to argue that he was acting in good faith and in the company's best interest.*

*If, however, the applicability of the anti-trust provisions is unclear and the director has obtained an appropriate legal opinion[8], he should be able to successfully argue lack of culpability.*

Typical examples of mandatory provisions are capital maintenance rules, directors' obligation to apply for insolvency, criminal provisions (in particular breach of trust), statutory reporting rules and standards, tax laws etc[9].

*If, however, the law or the statutes give scope of discretion, the use of such discretion will often qualify as a business decision. For example, there is no general statutory rule requiring directors to obtain the shareholder's approval for investment decisions[10]. If the company's statutes, the board's by-laws and the director's contract contain no specific approval requirements, it is in the board's discretion to decide whether to invest and whether to make the decision on its own or to obtain the approval of the shareholders. If, however, the company has a Supervisory Board, the mandatory rule of Sec 30j of the Act on Companies with Limited Liability applies, making it compulsory for the directors to obtain the Supervisory Board's approval for investments over a certain threshold. If they fail to do so, they will lose the safe harbour.*

## IS THE DECISION BEING MADE WITHOUT ANY UNDUE INFLUENCES?

Before taking the decision the manager must check that he (the board) is not being influenced by "off-topic" issues or special (private) interests.

- Self dealing: It is self-explanatory that this will include any form of self-dealing.
- Other special interests/connections: Similarly any other form of special personal, political, commercial or other connection with or interest in the transaction should be disclosed and, if the director cannot exclude that he has been influenced by such connection, he should abstain from involvement in the decision where possible.

*E.g. if the director's cousin or close friend in our case is a shareholder of the target company, he would be well-advised to disclose this relationship to and obtain approval from the shareholders/ the supervisory board and to refrain from participating in this particular decision.*

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Whether the influences are "undue" will depend on the specific circumstances: if a political party is one of the main customers of the company, considering that party's wishes may be commercially justifiable rather than "undue".

- Employees or board members of parent or group companies: A situation that may be less self-explanatory but more frequent is where an Austrian company is part of a larger group. The director of a local subsidiary is often employed by the parent or by another group company. If the local subsidiary is not wholly owned by that parent company, its interests may not coincide with the parent company's interests. How can the director ensure that he is not being influenced by the interests of his employer? Such lack of influence would be extremely hard to prove; consequently such situations are best avoided entirely. The same is true for holding board memberships/directorships in both a parent/group company and in an Austrian subsidiary.

## IS THERE A SUFFICIENT INFORMATION BASIS FOR THE DECISION?

- All vs. "sufficient" information: While he is not required to collect all information, a director has to collect sufficient information. When is the information "sufficient"? This is an objective criterion and will depend on the timing as well as on the nature, size and potential risks associated with the decision and, more generally, on the nature, size, financial standing and market position of the company.

  More resources will be appropriate for decisions that can potentially affect the financial wellbeing of the company (affect a substantial portion of its equity or working capital) or are outside of the normal course of business than for lower-impact or more standard decisions.

  *For example, before the director decides whether to file a claim for EUR 30 million in damages against contractors for a faulty building or whether to settle out-of-court, it may well be appropriate to invest EUR 30,000 or more for expert opinions to find the cause of the structural problems.*

  *In our example case the director is under time constraints: collecting all reasonably available information will generally include an in-depth due diligence review (financial, legal, technical, regulatory etc., depending on the type and size of the target). However, the time required for this review means that he may not able to put in a bid in due time and thus risk losing an important strategic target company to a competitor. The decision how much information to collect is here itself a business decision.*

- Documentation: A separate question is whether the decision-making process has been sufficiently documented. Management decisions are often complex processes in which employees, advisors, creditors, suppliers, customers, authorities and/or other stakeholders are involved. If all meetings, conversations and negotiations have to be documented, this would increase the costs of each transaction and substantially slow down the decision-making process. On the other hand, lack of (contemporaneous) documentation may make it hard to prove that the information basis was sufficiently solid – and what that information was – in subsequent proceedings in court. Consequently, the riskier and more high-impact a decision is and the more it deviates from the ordinary course of business, the better it should be documented.

## CAN THE MANAGER (JUSTIFIABLY) BELIEVE THAT HIS DECISION IS IN THE BEST INTERESTS OF THE COMPANY?

Provided the manager is acting on a sufficiently informed basis and without any undue influences, he is free to weigh the benefits and risks and decide in a way he believes is in the best interests of the company. He is not required to choose the least risky alternative or the decision with the smallest number of drawbacks.

The clear outer limit is bad faith. That is self-explanatory and will seldom be the primary issue. The second limit is more ambiguous and leaves some room for interpretation: Is the director's action indefensible[11] or can he argue some form of plausible rational justification?

Actions that are justifiable for large, financially stable corporations may be indefensible for smaller or less financially sound companies. The higher the risk to the company, the greater the potential benefit and/or the mitigating actions must be. If the risks are high but unlikely, they are more justifiable than risks whose realisation is more likely.

*It would for example in most cases be unjustifiable for a large corporation to base its entire hedging policy on a sole instrument. It would, on the other hand, not be unreasonable for the same corporation to apply a portfolio of risky instruments in its hedging policy.*

*Similarly, in our example the decision would fail the test if the director decided to pay a substantial share purchase price without any form of due diligence review and without any liability of the sellers for representations and warranties.*

*If on the other hand there are time constraints and/or substantial downsides to a failure to acquire the target company, as described in our example, it is certainly not indefensible for the director*

*to pursue the investment without the full set of information, provided he mitigates the risks in other ways: e.g.*

- *he can fast-track at least a legal and financial due diligence review (presumably for higher fees) at a high level (the minimum due diligence will depend on the nature of the business) and address any concerns raised with the sellers/ management of the target;*
- *he can personally and with his internal/external experts speak to the key staff members of the target and address any concerns that arise with the sellers/management of the target company;*
- *he can attempt to negotiate reasonable representations and warranties in the share purchase agreement, combined if possible with (substantial) personal liability of the managing directors of the target and of the selling shareholders, ideally in combination with a low base price/ higher earn-out clause, depending on the creditworthiness of the sellers and management of the target. The sellers' willingness to negotiate will of course depend inter alia on the competing bid;*
- *depending on the nature of the company, he can personally view manufacturing plants, relevant assets, key products;*
- *other mitigating actions as are suitable in the specific circumstances.*

## CLOSING REMARKS

- **What are the changes?** The Austrian legislator and courts have in the past been willing to recognise that risks are inherent in every business and it is the board's job to manage these risks, but not to assume the risks. Providing the board members have not exceeded their competence or violated laws, the threshold for liability has been quite high, i.e. only when decisions were held to be "unjustifiable" or "clearly incorrect" or when managers had "blatantly overstepped" their latitude for judgement[12].
  The difficulty was that it is not possible to predict what risk-averse judges with hindsight bias may hold to be "clearly incorrect". The international trend is to ensure that managers do not feel "straight-jacketed" by the fear that they may become personally (civilly or criminally) liable for risky decisions. With the legislative introduction of the business judgement rule into Austrian law and the first application of the BJR by the Austrian Supreme Court (6 Ob 160/15w), board members should now have more legal certainty and clarity on how to structure their decision-making process in order to avoid bearing the legal blame when risky transactions cause losses.
- What if the decision fails the safe harbour test? In this case – e.g. if the information basis is not held to be sufficient - this does not automatically mean that the board member becomes liable for negative consequences of his decision. Some leading experts do, however, warn that in this case the threshold will be substantially lower: negligence will be a sufficient basis for his liability, rather than the rather higher threshold of "overall unjustifiability" used by the Supreme Court to date.
- Who has the burden of proof? One of the main differences to the US concept of the business judgement rule is that, under Austrian law, the burden of proof is not reversed . This means that the general burden of proof rules apply: the board member will generally have to bear the burden of proof that he justifiably believed that he was acting in the best interests of the company and that he had amassed sufficient information. Provided the claimant has at least alleged facts regarding undue influence or conflicts of interest, the director will also have the burden of proof that he was not unduly influenced by improper factors or interests.
- **If the decision passes the safe harbour test, is the director safe from criminal prosecution?** One of the initial ideas behind the introduction of the BJR was that where the director's decision does not trigger civil/corporate liability, it should also not be criminalised. Since the (newly modified) breach of trust provision does not, in fact, explicitly refer to the BJR provisions, it remains to be seen whether the criminal courts will follow the – in our view convincing – view that, where the decision meets the BJR test, the board member has not breached his duties and is thus not criminally liable.