CHAPTER 13

Company Directors' Key Duties and Business Judgment Rule

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Takeaways for Leading Change

Constant change and the complexity of the surrounding society affects both company decision-making and legal rules on company decision-making. Societal change creates challenging problems for companies. Versatile expertise and leadership is required in the boards of directors. From the point of view of company directors, new business models and new ways of dealing with problems lead to uncertainty both when it comes to business and when it comes to their legal duties. Directors must exercise duty of care in all their actions as members of the board, but in the normal course of business decisions must be taken quickly and without knowledge of all possible information and certainty what will happen in the future. This is why directors must have certain level of protection against liability for damages. Otherwise they would not have the courage to make the necessary decisions concerning investments, expansions of the business and risky new business strategies. Taking risks is a normal part of doing business. The shareholders benefit when directors have incentives to make complex decisions without fear of continuous threat of claims for damages. The business judgment rule has found its way also to EU countries. Directors are not held liable for the damages if the business decision has been based on adequate and appropriate processes and information. The ability to use various sources and information is one of the most important elements of the rule. Using information from diverse sources makes directors better equipped to adapt to changes in the business environment and society.

Over the course of time the limited liability company (US) – or company limited by shares (UK) – has become globally the most significant form of doing business. Currently, there are millions of limited liability companies (LLCs) in Europe and more than 270 000 LLCs even in Finland.[1] An LLC may be public or private, and at national level the regulation of companies may be divided in two separate acts: The Public Companies Act and the Private Companies Act. The main difference between public and private companies is that shares of public companies can be offered to the general public. Private company share may not. The earliest models of the LLC can be found from Italy, from the 15th century Genoese Bank of Saint George, but the historical roots of modern LLCs lie in 17th century European chartered companies (Schybergson, 1964, p. 10–12; Toiviainen, 2008, p. 258–262). Based on common historical roots, there are many similarities between limited liability companies worldwide.

Companies are primarily regulated through national legislation. In the European Union, company law is only partially harmonised and harmonisation mainly concerns public companies. The *European Model Companies Act* 2017 (EMCA 2017) was drafted by company law scholars from 22 EU countries. The EMCA is a collection of combined features of national company acts and *is not legally binding*. However, the EMCA offers a useful picture of the general principles of European company law, as it has taken into account many different approaches to company law issues. The EMCA could potentially be a tool for future European integration in the company law area. One target of the EMCA is to ensure that the legislative frame of European companies is ready for the challenges modern businesses face in the future (EMCA, 2017, p. 1). Successful company leadership requires new kind of expertise as the world and the business environment is changing rapidly. The board of directors (or corresponding) is compulsory in limited liability companies worldwide. It is responsible for the success of the company.

The directors of the company must have new kinds of leadership skills at company level – they must possess adequate expertise concerning legal and

1 For information on company forms in Finland, see the Finnish Trade Register www.prh.fi/en/kaupparekisteri.html

business matters and understand the wider background of their decisions in order to become effective leaders. Directors of the company must resolve increasingly *complex problems* concerning, for example, business strategy. This means societal challenges are inevitably reflected in the company decision-making level as well. New business models lead to uncertainty from a company directors' point of view when it comes to legal responsibilities.

The business decisions of directors must be taken carefully but quickly and without certainty of what will happen in the future. Otherwise they would not have the courage to make necessary and sometimes complex decisions. New dynamic environments are surrounded by uncertainties but the directors do not have a choice. They have to resolve problems according to valid laws and corporate governance codes.[2] For this reason, directors must have a certain level of protection against liability for damages.

The chapter describes the internationally widely recognised general principles of a LLC and outlines the key elements of directors' duties such as duty of care, skill and diligence and duty to promote the success of the company. Directors have liability for negligence. The aim of the chapter is also to clarify the contents of the so-called *business judgment rule*, a well-known rule in the USA and Europe and it is also called a "safe harbour" for directors. The rule stipulates that directors cannot be held liable for damages if a decision has been based on adequate and appropriate processes and information. The *perspective* of the article is judicial. The purpose of the article is not bound to any single national jurisdiction.

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2 Prior to the adoption of the Companies Act in 2006, UK companies were governed by common law principles (e.g., fiduciary duties). General duties have since been codified in the Act (French et al., 2016, p. 477–478).

General Features of Limited Liability Companies

Before focusing on the actual duties of directors, one must understand the most important general features of a limited liability company. LLCs offer ways to divide business risks between several shareholders. There are several shared features in LLCs worldwide. An LLC has *legal personality* of its own and it is distinct from its shareholders. Normally a company must acquire legal personality upon registration on a national trade register. There are, however, variations concerning registration and legal personality even within the EU (EMCA, 2017, p. 27). In an LLC there is indeed shareholders' limited liability for the obligations of the company. *Shareholders are not liable* for the obligations of the company and personal assets of the shareholders are safe in case of company's insolvency. Shareholders can only lose the amount they have invested. There is little doubt this has been, and continues to be, the most important feature of an LLC – and the reason for its worldwide success as the most important form of doing business.

One of the most important features of an LLC is the *purpose* of the company, which is to generate profits for shareholders. In other words, the company's value must increase unless otherwise provided in the articles of association.[3] The purpose of the company can be changed but only by stating otherwise in the articles of association. It could be, for instance, charity work or producing services at a reasonable price for the shareholders. Ensuring company management is carried out with a long-term and sustainable view is also important (EMCA, 2017, s. 1.06, comments). The company should not simply aim at short-term quarterly profit-making – on the contrary, it is the task of directors to advance long run objectives. The purpose of the company intertwines with the fact that management must always exercise reasonable care, skill and

3 See for example, the Companies Act 2006 (UK), Companies Act 2005 (Sweden), and Companies Act 2006 (Finland). Increasing value is considered the prime target in EMCA 2017, section 1.06. Some researchers have suggested that national Acts should state purpose of the company is "sustainable value within planetary boundaries" (See Sjåfjell & Mähönen, 2014, p. 59).

diligence in all activities. This means that management is legally obliged to promote the purpose of the company.[4]

Typically the company must have share capital. Due to limited liability of the shareholders, *distributing assets* to shareholders is subject to limitations. The assets of a company may only be distributed by following procedures set out in law. The most common ways to distribute assets are yearly profit distribution (dividends) to shareholders and acquisition of the company's own shares. In normal situation it is of course possible to distribute the profits to the shareholders but some strict requirements (limitations) prevail (Bourne, 2016, p. 124–132; Dignam & Lowry, 2014, p. 120–123; Ferran & Look, 2014, p. 202–231; Ruohonen, 2015). These limitations are for example balance sheet and solvency tests that need to be carried out before profit payments. In other words, the company must have the assets to pay its debts to creditors first. Only after that it is possible to distribute assets to shareholders. This principle is called *creditor protection*.

A limited liability company is a legal person. This means that someone must act on behalf of the company.[5] Normally there are two vital and *compulsory organs* in an LLC: the general meeting and management, which can consist of board of directors, a managing director and supervisory board. Management of the company is separate from the shareholders. However, British law allows shareholders the freedom to organise governance of the company quite freely.[6] Typically shareholders of a limited liability company exercise their power of decision at the general meeting (that is, shareholders' meeting). There, decisions are mostly made by the majority of the votes cast. All shares normally carry the same rights. The principle of *equal treatment* is a typical principle in national companies' acts in Europe.

4 The purpose of the company is balancing between short-term interests of current shareholders and long-term interests of future shareholders (Hannigan, 2016, p. 211).

5 For management of the company in UK legislation, see Companies Act (UK) 2006 and Bourne, (2016, p. 146–165).

6 Davies (2010, p. 12–13) emphasises there is considerable freedom to choose how the powers between shareholders and management are divided.

Usually (majority) shareholders have the right to elect the directors of the company (Pettet, 2001, p. 3).[7] The *composition of management* varies in different countries; there is no "common European standard". For instance EU law does not contain binding rules concerning the management structure of companies. According to the EMCA, in a public company the board of directors should comprise of no fewer than three members. A private company should have at least one director (EMCA, 2017, p. 174–175). In so called one-tier system there must always be the *board of directors*. In a two-tier system there must be a management board, and also a supervisory board which supervises the management board and appoints the members of the board.[8] The *director* is a member of the board.[9] This article focuses on dealing with directors of the board. Board may consist of shareholders or it may be separate from the owners. In both cases, the directors of the company must undertake several *duties*.

Key Duties of Directors

The board of directors is the most significant decision-making body in the LLC. The board is *collectively responsible* for the success of the company (Keya, 2016, p. 27). It is responsible for organising the administration of the company and the appropriate organisation of its operations. The board is also responsible for making the appropriate arrangements for control of company accounts and finances. This means the board must advance the purpose of the company, which is normally making profit for the benefit of company's shareholders. The board of directors must also supervise the managing director (CEO) of the company.

The duties and responsibilities of the directors are *surprisingly similar* in many EU countries – of course some differences also occur (Gerner-

7 For the management structure from shareholders' point of view, see Vahtera (2011, p. 209–226).

8 For example, in Germany the supervisory board is a compulsory organ which appoints the members of the board. In Finland and the UK, supervisory boards are voluntary. This article focuses on dealing with the one-tier system.

9 For management structures of companies in Europe, see EMCA (2017, p. 167–173).

Beuerle, Paech, & Schuster, 2013; EMCA, 2017, p. 221). There are many obligations imposed on directors by the law or common law principles to make sure they act fairly as representatives of the company. The director's position as a *fiduciary* means they must act on behalf of the company for proper purposes and without self-interest (Keya, 2016, p. 1, 25–26).

Many of a director's *legal duties* are recognised almost worldwide. First, the board must exercise reasonable care, skill and diligence (duty of care). This is the basis of the director's duties in all national companies' acts (EMCA, 2017, p. 204). As described in EMCA 9.03, duty of care refers to the care, skill and diligence that would be exercised by a reasonably diligent person with a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and b) the general knowledge, skill and experience that the director possesses.

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Second, directors have the duty of loyalty. Simply put, this means directors must place the company's interests ahead of their own. Third, directors must to promote the success of the company as discussed earlier. Fourth, directors have the duty to avoid conflicts of interest. Directors need to avoid situations in which he or she would have interests which conflict or may conflict with the interests of the company (Davies & Worthington, 2016, p. 540–541). In addition, they have a duty to not accept benefits, a duty to exercise independent judgment and a duty not to act outside powers. Corporate governance codes of public companies (listed companies) might impose even more requirements for directors. In the UK Corporate Governance Code 2016 there are several other requirements concerning directors' duties.

As the world changes, company directors must resolve increasingly *complex problems* within their powers and duties. It is important to understand how directors should make decisions from a legal point of view – what are their legal duties in each case. In addition, it is vital that directors gather all the necessary facts concerning the decision they are about to make. Then the directors must look into the details with reasonable care, skill and diligence. Decision-making must be rational. The directors must take into account the changing business environment, complexity of the issue and uncertainties concerning the future changes. If they fail to do so, directors may sometimes be held liable for damages they have caused as members of the board if they are not able to prove themselves right.

The directors of the board and CEO can be held *personally liable* for damages they have caused. Sometimes the court might also identify as a director a person that actually acts in the capacity of director without being formally appointed to that post (*de facto* director) or a person whose instructions the board is accustomed to follow (shadow director).[10] Due to personal liability the directors of the board should always have the *necessary expertise*. For example according to the Corporate Governance Code (UK) "the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively" (Corporate Governance Code UK, 2016, Section B.1.).

Discussion

Often directors need to make risky and complex decisions, for example investment decisions. If directors were always personally liable for the damages caused by their decisions, they might be tempted to "play safe". Due to this fact, by following a certain rule directors avoid harmful consequences for taking wrong decisions. This rule is called a *business judgment rule* (BJR), sometimes also described as a "safe harbour" for directors. The BJR is considered one of US corporate law's central doctrines (Keya, 2016, p. 261). EMCA describes the BJR as follows:

10 See e.g. EMCA (2016, Section 9.01). For a theoretical view of the business judgment rule, see Greenfield (2014, p. 217–240).

> EMCA 2017, Section 10.01 Directors' Liability
>
> (3) A director who makes a business judgement in good faith fulfils the duty [of care] under this Section if he or she:
> (a) is not interested in the subject of the business judgement;
> (b) is informed with respect to the subject of the business judgement to the extent that the director or managing director reasonably believes to be appropriate under the circumstances;
> (c) rationally believes that the business judgement is in the best interests of the company.[11]

Directors making business judgments are "interested" if they, for example, aim for personal financial benefit (self-dealing). A conflicted director does not make a business judgment in good faith and fulfil his duty of care. The director must also be informed of the contents of the business judgment and act in the best interests of the company.

The business judgment rule is an important part of the decision-making process as it concerns effectively all decisions made by directors (Savela, 2015, p. 94). Directors can be held responsible for damages they have caused as members of the board *if they fail to follow the business judgement rule*. Consequently, business judgment rule means that the *director is not liable* for the damages if the director has made the business decision based on adequate and appropriate processes and information concerning the matter. They must have acted in good faith (*bona fide*), believing that the interests of the company have been taken into account. This basically gives directors of the company freedom to make decisions within the limits described (Trask & DeGuire, 2013, p. 162–163).

It is required that director fulfils his or her *duty of care* and exercises reasonable care, skill and diligence in all his or her actions as a member of the board. All decisions must be made considering these circumstances and need to have a rational economic basis from the company's point of view (Mähönen & Villa, 2010, p. 460–461). All the *relevant information* available at the time

11 In the US, the BJR is almost identical (American Law Institute: Principles of Corporate Governance §4.01(c); EMCA, 2017, p. 223).

concerning for example the expansion of business must be collected before making decisions. However, the directors do not need to be able forecast every possible future event that might happen. This means that directors are not obliged to predict all the possible risks – but only the relevant ones.

In US corporate law, the business judgment rule is central to company law doctrine. The rule is also widely accepted in many EU countries.[12] American corporate law has had a significant influence on the company law of the European countries. In some EU countries the BJR is codified in some form, but there are not always separate provisions for this purpose.[13] Even if there are no specific provisions the BJR is taken into account when dealing with directors' decision making (Cebriá 2018). The contents of the rule is then derived from company law principles and liability provisions.

Especially in US *business judgments* are very rarely reviewed in court. Courts in some countries do not review board decisions on principle (Bainbridge, 2003). This means that the courts are not obligated to analyse whether directors have made the correct business decisions as such. Instead courts focus on analysing whether the decision was based on adequate information and appropriate process (Keya 2016, p. 216).[14] In other words, directors need to decide what information is essential for taking decisions and what is not. The rule is simple in itself but it is sometimes difficult to recognise what is essential information at the time of the decision to determine if the board's decision is within the boundaries of "normal". The directors' main duty is to find out as much as possible and carefully analyse the risks of the decision. *Risk analysis* is a crucial part of decision-making process. Both legal and market risks must be taken into account.

However, board decisions are almost always made under *uncertain circumstances*. The board must dare to do business and take new risks. If there

12 For a detailed analysis on BJR provisions in EU countries, see Gerner-Beuerle et al. (2013, 108–118). In the UK the legal regulation of business judgment is not as clear as it is, for example, in the US (Kershaw, 2009, p. 428–430).

13 These countries are Germany, Portugal, Romania, Croatia and Greece (Gerner-Beuerle et al, 2013, p. 116–117).

14 The rule is not without exception as sometimes substantive reviews can be made in extreme circumstances (Rosenberg, 2006, p. 321–322).

was no protection against uncertainty, the board would be inclined to stick to old ways, which can sometimes be the riskiest option. It is therefore clear that under the business judgment rule company directors are not liable for unsuccessful business decisions. If the board has decided to invest into a new business sector and the venture is unsuccessful, directors are not liable for the damages if they have acted duly with the BJR principles – there is no room for "second-guessing" by the court (Keya, 2016, p. 262).

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One of the most important matters concerning the business judgment rule is the *burden of proof*. The main rule is that directors are not obliged to prove they have conducted themselves diligently.[15] This means the plaintiff must first prove the board decision was taken against the BJR principle. If the plaintiff succeeds in this, the director must prove no damage was caused due to his or her actions. This is called an inversion of the burden of proof. This is why *documenting* the reasoning and material behind the decisions is very important.

The purpose of BJR is actually to protect directors against company's claims for damages. There are, however, some *significant restrictions* regarding business judgment rule (Bainbridge, 2000, p. 631–632). The scope of these restrictions varies across countries in the same way as the contents of business judgment rule. The BJR is not harmonised – and probably never will be. Some restrictions are nevertheless widely accepted in many judicial systems. Firstly, it does not apply as a safe harbor rule if the decision is against the law, for instance against the national companies act or criminal act. The rule does not apply to board decisions which breach the equal treatment of shareholders principle. Secondly, it does not protect directors who have acted deliberately against their duties or have been in gross negligence of their duties.

15 See, Cede&Co v. Technicolor Inc. 634 A.2d 345 (Delaware Supreme Court 1993; Mähönen & Villa, 2015, p. 373). Germany and Spain are exceptions (see EMCA, 2017, p. 222).

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