Duties and liabilities of company directors under German and Estonian law: a comparative analysis

KARIN MADISSON

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The present paper is the publication of her distinction-awarded Master’s thesis defended at the Riga Graduate School of Law in June, 2011.

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SUMMARY

Management board members are expected to work actively to ensure a company’s operational sustainability and optimize its profit. In the process, they must act in situations where the consequences of their actions cannot be clearly and unambiguously predicted and the decisions made are often rather risky. Such risky decisions may generate profits, but also losses to the company. To ensure sufficient freedom of action for board members while also protecting the interests of persons associated with a company, clear rules of procedure are required. The situation can be compared to a board game where all players have their own roles and goals, but the rules of the game are identical and known to everyone. It is important that legislation and case law provide guidance to both owners and management board members on the extent to which the board’s actions are acceptable and when they could result in liability. If the boundaries are too hazy or where board members may face liability even when acting in best faith, the position of a director might become “a job nobody wants”.

Some duties of management board members are very precise (e.g. organizing the bookkeeping of the company, disclosing specific information or filing a bankruptcy application on time). In this case, the appropriate question when considering the extent of liability is: What was the board member obligated to do? However, laws cannot regulate all the different situations that might be encountered in the course of business, and they do not need to. For that purpose, certain “core” principles to be followed in all management situations have been established for board members. For such obligations, the question is: How should the board member act? These are related to the level of care, skills and knowledge rather than to the content of the obligations of a director. These principles are the duty of care and the duty of loyalty. A management board member cannot be expected to be aware of all legal norms which may affect the company’s activities or to foresee all the consequences of their actions, but they must be informed on the level of a prudent businessman and be able to make sound decisions based on that information.
This master’s thesis deals with issues related to the duties and responsibilities of board members. Through all of its issues, it focuses on the question of how a management board member must behave in order to avoid liability, and whether and how such liability can be reduced or limited. The work highlights the weaknesses and further regulation needs in the area and offers possible solutions. In the paper, the author suggests a number of ways to exclude or limit the liability of board members. Some of them can be derived from the behaviour of board members themselves (e.g. organization of work among the board members), some are opportunities arising under the law (e.g. expiry of the limitation period), some are related by transactions (e.g. D&O liability insurance, indemnification, allocation of duties by rules of procedure) and some arise from the decisions of management bodies (e.g. waiver, consent of a superior body).

The main incentive for selecting this topic arose from the fact that the Estonian legal system and enterprise sector are very “young” and therefore still lack complete and unambiguous legislation and practices that would help companies evaluate the activities of their management bodies. This may lead to unfavourable consequences for the companies themselves, the members of their management bodies and persons who engage in legal relationships with the companies. Furthermore, the national regulations existing in this field are very different.

The research method of this thesis is comparative analysis and the main sources are Estonian and German legislation and case law. German law was chosen because the Estonian system of directors’ duties and liabilities closely follows the German model. This is due to the close historical and legal ties between the two countries. For issues where German and Estonian legislation do not offer good solutions, examples have been given based on the laws of the United States and Finland. As of now, the area is not subject to any essential European Union legislation, but a brief overview of the European Commission’s proposal for a 5th Company Law Directive will nevertheless be provided to show a possible EU view.

Although the Estonian legal system is rather well-developed compared to that of other Baltic countries, the range of fiduciary duties in German law appears to be
somewhat wider and more advanced than its Estonian counterpart. In this context, the author points out the main issues addressed in this work:

The main weakness of the Estonian legal system is the lack of a business judgement rule. There is essentially no regulation, case law or practice in this field. Without a business judgment rule, courts must dig into the contents of management board members’ decisions and assess their conduct from the point of view of a hypothetical “reasonable person”. The purpose of a business judgement rule is to limit the liability of board members in order to give them freedom to take reasonable risks in order to promote business growth without the fear of losing their personal assets in case of failure.

Another problematic field is conflict of interest. For example, Estonian civil law does not provide the concept of self-dealing. Furthermore, the law does not obligate a board member to inform the shareholders or supervisory board of transactions carried out between the company and a board member if those transactions are concluded in the ordinary course of business of the company or in compliance with the market price of related goods or services (i.e. on an arm’s length basis). In addition, board members do not have to inform shareholders of transactions not made on an arm’s length basis but approved by the supervisory board. Similarly to Germany, there is no obligation in Estonia to disclose information about positions held in other companies or other facts that may cause conflict of interest before a management board is nominated.

Another weakness of Estonian legislation is the lack of regulation dealing with situations where the supervisory board refuses to approve transactions planned by the management board. In Germany, the management board may submit such cases to the general meeting for decision.

In Germany, prohibition on competition is established to a much greater extent than in Estonian law and practice. Estonian law does have this regulation for employees but the rules do not extend to board members.

Estonian legislation can also be seen to lack regulation in respect of rules of management procedure and involvement of all board members as Estonian board members usually have the right of sole representation, unlike the joint right of
representation used in Germany. Unrestricted right of representation and lack of rules of procedure have been a source of many problems and disputes.

Regulation is needed in respect of companies without supervisory boards to guarantee shareholders’ involvement in transactions beyond the ordinary course of business, similarly to the competence of the supervisory board. The author finds that regulation concerning this issue is necessary for both the management who should be well aware of when the owners must be involved (now the court has, in some cases, acknowledged the implied powers of shareholders), as well as the owners themselves, for the protection of their interests.

The author opines that there is a need for provisions which would allow for the extension or suspension of limitation periods under extenuating circumstances (e.g. bankruptcy, intentional breach, providing misleading information or dissembled acts) in order to prevent abuses. Also, a shortened limitation period should be applied to submitting claims against a board member if the respective decision is adopted.

The author finds that uncertainty or lack of opportunities for limiting the personal liability of board members could inhibit the taking of reasonable economic risks by board members on behalf of the company. It is also necessary to ensure that an excessive fear of liability does not hamper the primary obligation of board members to concentrate on their main objective, namely business development.

If rules are clear enough for all players of a board game, players can concentrate on the beauty and magic of the game instead of arguing with each other about the rules. Also, a game is more interesting the more opportunities there are to use a card (or in this case, an option for limiting liability) in different situations.
INTRODUCTION
Legal persons are permitted to exercise executive power exclusively via the members of management bodies. Thus, the welfare of the legal person is directly affected by the decisions of these members. In general, a company is liable for performance of its obligations with all of its assets and the members of its management board are not personally liable for the activities of the company. However, in circumstances where a management board member violates his/her obligations, he/she may be held personally liable before the creditors, shareholders or the company. In this context, a management board member may in theory carry two types of liability – towards the company (internal liability) and towards third persons (external liability).

Owners are not involved in the management of daily operations and therefore depend on the members of management bodies to act in their interest. However, it would be naive to expect that all such members have identical views, values, and know-how that would yield similar decisions and a homogeneous representation of the entity’s interests. Clearly identified standards and principles of action provide a crucial “blueprint” for proper conduct, and compliance with official guidelines will presumably result in acceptable representation of an entity’s interests. Such guidelines can be found in legislation, rules applied to various organisations (e.g. rules for listed companies), case law and the internal regulations of companies, which should be in line with basic legal and logical principles (e.g. that owners should not interfere in daily management and limit themselves to providing general instructions). Such official guidelines are obviously important for both parties: the owner as well as the members of management bodies. For the owner, these guidelines constitute an assurance that a certain way of conduct can be expected from members of management bodies and that they will act to secure the interests, protection, and growth of the entity. For management board members, such official guidelines are a valuable source for checking that their decisions and transactions are in accordance with the interests of the company and they should thus assume no personal liability.
Indeed, management board members may be compelled to take management decisions that could damage the company. However, management board members may be forced to take such action in order to implement the company’s strategy and earn profit for the owners. The current global economic crisis has helped emphasize the importance of issues surrounding the matter at hand. Considering the turbulent economic forecast, it is reasonable to expect an increase in corporate losses and bankruptcies in the near future. Such circumstances are likely to create a situation where large numbers of executives will face difficult and complicated situations that demand tough and intricate decisions. Public awareness and criticism have been growing, together with the willingness to raise claims against directors. This has prompted increasing deliberations on what exactly the limits of liability are and how they could be adjusted.

The European Commission’s proposal for a 5th Company Law Directive, which aimed to regulate such issues in detail, was withdrawn on 11.12.2001 as it did not meet the expectations of market participants. Since then the whole field has been largely left in the member states’ competence. Even the regulation on EU companies (Societas Europaea - SE and European Corporate Society - SCE) refers to the statutes of national corporate law of the member state where a company has its seat. Thus the *lex loci delicti* principle prevails whereas this paper does not deal with choice of law questions and the draft Fifth Directive, except where the German and Estonian law significantly differ from it.

In recent years, the European Union has begun looking into these issues more diligently and has made efforts to regulate the corporate governance rules of the banking sector. On 21.05.2003, the Commission adopted an Action Plan for Modernising Company Law and Corporate Governance at EU level (Action Plan), announcing the introduction of a corporate governance statement as a short term

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1 Directorate General for Internal Market and Services. *Summary Report. Consultation and hearing on future priorities for the action plan on modernizing company law and enhancing corporate governance in the European Union* 03.05.2006, p. 3.
priority. According to the Commission, recent corporate scandals have highlighted issues related to board members’ misconduct and thereby underline the need for the Commission to pursue its Action Plan and establish an EU framework of collective responsibility for board members, including appropriate sanctions and liability.\(^4\) The Commission asked the Member States to submit opinions whether the collective responsibility of board members of a company must be regulated on the EU level\(^5\) and received support for its intention to provide for the joint liability of board members to a company (52%\(^6\)). After that, all interested parties were invited to complete a questionnaire and a summary of the responses showed that 51.9% of the respondents supported the view that board members must be responsible towards the company only. Only 4.8% of the respondents were of the opinion that there must also be liability towards groups of shareholders holding a certain percentage of the company and only 29.3% thought that there must also be liability towards all stakeholders (i.e. employees, creditors).\(^7\) A majority (58.7%) of the respondents answered “No” to the question “Should there be common sanctions at Community level for board members who do not comply with their responsibilities regarding financial statements and key non-financial information?” Nevertheless, the European Corporate Governance Forum, held on May 19th, 2009, also outlined multiple problems concerning the issue.\(^8\) At present, the matter has not been sufficiently addressed by the European Union. Some rules do exist for listed companies and there are also accounting and disclosure rules for unlisted companies.

This paper focuses on how management board members should act to avoid liability, and whether and how the liability of management board members can be


\(^6\) Author comment: Geographical coverage was extensive, with more than 200 responses from 18 Member States. Approximately half the responses were from the business community; the other half came from other stakeholders.

\(^7\) European Commission. Synthesis of the IPM-consultation, including substantiated comments received beyond. Brussels, G5 D(2004), p. 3.

\(^8\) European Corporate Governance Forum, Minutes of the meeting of 19.05.2009, pp. 4-5.
limited or excluded. To analyse the possibilities for limitation or exclusion of liability, the obligatory patterns of conduct of management board members and the grounds and conditions for their liability must first be established. The aim of this paper is to identify problem areas and shortcomings in the Estonian legal system by comparing relevant provisions with German legislation, to explore the potential ways of improvement and to recommend solutions. The subject of this paper was chosen primarily because the fundamental laws of Estonia have created a legal landscape lacking a coherent and comprehensive structure and guidelines to assist in evaluating the activities and processes of management bodies, and fail to provide solutions to a number of related issues.

The research method of this thesis is comparative analysis. The main sources are Estonian and German laws and case law. German law was chosen for comparison because the Estonian Commercial Code was drafted on a German legal foundation and Estonia’s legal landscape has evolved to closely mimic German principles and court practices. For issues where German or Estonian legislation do not provide effective solutions, examples have been brought in from the U.S., the cradle of some principles later also adopted in Europe. Some examples have additionally been brought from Finnish legislation because the Finnish Companies Act underwent an important corporate law reform in 2006 and comparison with Finland is especially relevant and potentially influential in view of a significant presence of the Finnish trade and business community in Estonia. Lastly, this work also examines important non-legislative sources: case law and papers by legal scholars. A complete list of works referenced is attached to the paper. Legislation is referenced in this work as of 01.05.2011.

The paper consists of two main sections which are further divided into subsections. The first section concerns the liability of management board members and general rules for their conduct, such as the duty of care and duty of loyalty. The paper does not deal with specific duties of management board members. Instead, subsections 1.1.2 and 1.2.2 provide the general principles that management board members should follow in the performance of their duties. This range of issues has only been dealt with to the extent needed to understand how the liability of
management board members can be excluded or limited, as described in the second section. The second section looks into whether and on what conditions a management board member’s liability can be excluded or limited. The second section is subdivided by the various possibilities for such escape that may be provided in agreements or by the law. Each chapter begins with an overview of general principles, followed by a more detailed analysis of the subject of the chapter. All chapters are subdivided according to the choice of comparison between Germany and Estonia.

This work focuses on German GmbH (Gesellschaften mit beschränkter Haftung) and AG (Aktiengesellschaft) and Estonian OÜ (Osaühing) and AS (Aktsiaselts). In these two types of companies, owners are not personally liable for the company’s debts. Certain specific corporate governance rules apply to credit institutions, insurance companies, investment funds, and investment companies, but these have been excluded from the scope of this work. The terms “management board member”, “board member”, “director” and “managing director” will have an identical meaning in this paper.

This work covers primarily the obligations and liabilities of management board members in non-listed companies. The paper does not specifically cover division of the burden of proof between parties, which, although an important issue in practice, could not be sufficiently explored within the confines of this paper. Due to the limited scope of this work, issues of criminal and administrative liability have also been excluded.
1 Management Board Members’ Liability

In Germany and also in Estonia, not all standards of conduct and responsibilities of board members are compiled into one single law. Many strictly enforceable board member obligations are specified by different laws, and general conducts are outlined in terms of what constitutes appropriate behaviour. Some duties of management board members are very precise (e.g. organizing bookkeeping, disclosing specific information or filing a bankruptcy application on time). In this case, the appropriate question when considering liability is: What was the board member obligated to do? Anyhow, certain “core” principles must be followed in all management situations whether these are stated in the law or not. For such obligations, the question is: How should the board member act? These are related to the level of care, skills and knowledge rather than to the content of the obligations of a director. These principles are duty of care and duty of loyalty.

“Already in the ancient Rome, the principal of "bonus pater familia" a.k.a. "the good family father" was required to be followed whenever acting on behalf of another. By analogy, the member of the managing body is obligated to show the care for the matters of the business entity in the same manner as a father of a family cares for his wife and children.”

“The concept of loyalty is an important part of ethics. Plato originally said that only a man who is just can be loyal, and that loyalty is a condition of genuine philosophy. The philosopher Josiah Royce said it was the supreme moral good, and that one’s devotion to an object mattered more than the merits of the object itself. Loyalty is a quality one should look for in a friend.” The duty of loyalty of a member of the management body is, first and foremost, a duty to put the legal person’s interests first, before self-interest and the interests of third persons. The loyalty principle is

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fundamental and acting loyally means that each utility resource of the business entity is considered credible and separable, even when the business entity has a single owner or when all shareholders are in full agreement on how the entity’s resources are to be administered. The opposite of loyal actions is thus illustrated by the mentality of the executive board of a failed bank in the United States where the executive board (comprised primarily of shareholders) noted that "since we own the bank, there is no reason why we should pay interest on the money we borrow from the bank". Nevertheless, the loyalty commitment has been defined in only a few member countries of the European Union.

1.1 Germany

1.1.1 Liability

In Germany, statutory rules on corporate governance can be found in various codes of law. The most significant ones are the German Civil Code (Bürgerliches Gesetzbuch- BGB\(^{14}\)), the German Commercial Code (Handelsgesetzbuch- HGB\(^{15}\)), the Private Limited Companies Act (Gesetz über die Gesellschaft mit beschränkter Haftung-GmbHG\(^{16}\)), and the Stock Corporation Act (Aktiengesetz- AktG\(^{17}\)).

Management board members are not strictly liable for any loss suffered by the company or by the creditors of the company. Unsuccessful management will eventually have a negative impact on the company but it will not automatically bring about personal liability for possible losses. Directors may become personally liable for any culpable violation of their duties. Such duties may originate from a contract (articles of association, contract with the director) or from law (civil, corporate, criminal or insolvency law). “The most frequent violation is the breach of loyalty obligations (non-compete covenants during and after employment or the collection

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14 German Civil Code (Bürgerliches Gesetzbuch) of 18 August 1896 (BGB).
15 German Commercial Code (Handelsgesetzbuch) of 10 May 1897 (HGB).
16 German Private Limited Companies Act (Gesetz über die Gesellschaft mit beschränkter Haftung), of 20 April 1992 (GmbHG).
17 German Stock Corporation Act (Aktiengesetz) of 06 September 1965 (AktG).
of kick-backs) and illicit disbursements from the company’s equity (indirect refundment to shareholders/partners, distribution of hidden dividends).”

German law on directors’ liability differentiates between liability towards the company (internal liability) and liability towards third parties (external liability). Additionally, directors may also have administrative and criminal liability, which are topics that fall outside the scope of this paper and are therefore not further discussed.

**Internal liability** is based on a breach of duties arising from the position of director in the company. The members of the management board are jointly and severally liable for damages caused if they fail to apply the care of a prudent and diligent manager. The term “jointly and severally” denotes that liability for the entire amount of damages falls on each managing director. Directors, shadow directors, and *de facto* directors are generally held liable as *de jure* directors. In many cases, directions or instructions of the majority shareholder, who is not legally a director and does not participate in the firm’s management, are routinely followed by the directors and employees. He/she may be held liable for damage to the company in the same way as *de jure* directors.

Members of the management or supervisory board who have breached their duties are jointly and severally liable together with any third party that influenced them to act against the interests of the company. This provision applies also to the shareholders and to the supervisory board members who influenced the directors. In an interesting decision in 1992 on the duties of a company vis-à-vis its bonus-shareholders, the Supreme Civil Court ruled that these shareholders will and may only expect first, that the company keeps within its objectives and secondly, that their capital investment will not be endangered by actions which “simply no honest businessman would undertake”. This standard would also apply to the liability of directors themselves.

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20 AktG § 117(2).
**External liability** is the liability towards all other persons except the company. The duties of the management board are primarily owed to the company and not to third parties; therefore, external liability is very rare. As a rule, any third party claims for damages can be filed against the company only, and the company may have recourse against the director.\(^{22}\) There are also many duties of a managing director that are aimed at protecting the interests of third parties such as the company’s creditors, contracting parties, purchasers of securities, shareholders and even the general public (for example, the tax and social security authorities).\(^ {23}\) In recent years, liability to third parties has become more and more important.\(^ {24}\)

Directors’ personal liability towards third parties requires a culpable violation of mandatory law for creditor protection, e.g. tax law, criminal law, insolvency law. For example, according to the German Tax Code\(^ {25}\) a managing director may become personally liable for payment of the relevant taxes. Third party claims may also be possible if payments to the shareholders are made in violation of the capital maintenance rules. They might be obligated to restore the full amount plus any ensuing damage.\(^ {26}\)

External liability is usually observed in case of the company’s insolvency.\(^ {27}\) If the company is in financial difficulties, there is a greater onus on the management board to act in the interests of creditors. The directors cannot conclude any transactions (enforce payments or transfer assets) which may lead to insolvency (causation of insolvency - *Insolvenzverursachungshaftung*\(^ {28}\)) or which may deepen the insolvency (deepening of insolvency - *Insolvenzvertiefungshaftung*\(^ {29}\)). There is greater liability and additional prohibitions if an insolvency situation appears e.g. no payments to the shareholders, to related parties, to the directors. The director is personally liable for payments effected after the company became insolvent (cash-
flow insolvency) or over-indebted (balance-sheet insolvency), and these sums must be repaid immediately regardless of any agreement to the contrary.\textsuperscript{30} Personal liability is excluded only if the payments were in line with the diligent conduct of a prudent businessperson, which means that every single payment must be justified as necessary or as preventing further and higher damage to the company. Violating the obligation to file an insolvency petition or prohibition of payments in an insolvency situation, the director is liable for damages not only to the company but also to third parties. Moreover, failure to file an insolvency application in time is a criminal offence. Creditors of the company may claim director’s liability for losses caused by unreasonable continuance (\textit{Erfüllungsbetrug}), and creditors who entered into a contract after the company became \textit{de facto} insolvent can claim liability for their losses in full - fraudulent pretence (\textit{Eingehungsbetrug}).

In very few and specific cases, shareholders are given the right to submit a direct claim against a member of the board. Shareholders would have personal claims against the company’s directors in cases of tort. The directors are not considered trustees or mandatories of the shareholders and they owe their contractual obligations and duties to the company itself. “This doctrine makes practical sense if, for instance, in case of a theft the missing amount is repaid to the company and by that the “reflex damage” suffered by the shareholders is levelled out. There remain, however, instances where the company as such is not affected and, at the same time, the breach of its director’s contractual obligations is not a tort.”\textsuperscript{31} These cases are, for example, wrong information about the current financial status of the company (shareholders invest further equity capital and lose it because the firm goes bankrupt), wrong information in the course of a takeover of the company, where directors have neglected to properly handle the collection of capital contributions. In such cases the shareholders may sue the directors personally on the grounds that they violated their duties to the shareholders. “Shareholders can make claims on their own account in the case of prospectus liability or where there has

\textsuperscript{30} GmbHG § 43a(1) and 64 (1).
\textsuperscript{31} Ibid, p. 15.
been a breach of information requirements, such as for the immediate release of *ad hoc* notices.”32

### 1.1.2 Duty of care and duty of loyalty

#### a) Duty of care

According to the duty of care principle, all members of the management board must manage the company in the **best interests of the company and with the diligence normally expected in a similar position.** The management board must act in the company’s best interests with the objective of increasing the sustainable value of the enterprise (‘interest of the company’ test).33 “The company interests are not limited to those of the owners. Company creditors, employees, consumers, and society are also affected.”34

The best interest of the company is not necessarily identical to the interests of the shareholders. The question whether the directors acted in the most economically purposeful manner for the company or for the shareholder often rise in situations where a subsidiary sells goods and services or lends money to the parent company. The managing directors must make sure that the terms and conditions of agreements made with shareholders are in line with normal market terms. A ruling by a German Federal Court of Justice35 nicely exemplifies what courts consider important when evaluating the responsibilities of directors36 in these situations. In this case, approximately €40 million was granted by way of unsecured upstream loans by the company to its main shareholder in a couple of years. The borrower became insolvent and as a consequence the lender also became insolvent. The court found that the members of the supervisory board had not violated their duties by failing to oppose the loans themselves if the borrower was in good financial standing at the time when the loan was given and the loan agreement was concluded on normal

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32 Sieg, O. *Directors’ Liability and Indemnification*, p. 126.
35 BGH, Judgment of 01 December 2008- II ZR 102/07.
36 Author comment: this case was against the supervisory board members, but is applicable also for directors.
market terms. The court stated that it was not possible to hold the directors and supervisory board liable if the shareholder's financial situation unforeseeably worsened at a later point. In this case, the court held that in the lending process, the interests of shareholders were not set ahead of the interests of the company, resulting in no breach of the law.

Despite that, it cannot be argued that the shareholders' interests need not be considered at all. This might be considered permissible in the case of multi-company entities. A director of a subsidiary cannot be held liable for actions taken in the interest of the whole group or its subsidiaries if it is determined that any other honest and conscientious director of an individual company would have acted in the same manner.\textsuperscript{37} Thus, if board members believe that there is more than one path to achieving the same goal, they are free to choose the way which they see as more favourable to the group.

A director must employ the diligence of a prudent businessman in all matters concerning the company.\textsuperscript{38} The managers must manage the company with such care as might be expected of an ordinary prudent businessman. Directors must take all possible care but more than the usual care that might be expected from an ordinary man. “The standard is objective in the sense that a director will not succeed with the defence that he has acted with such care as he would apply in his own affairs.”\textsuperscript{39} These rules apply not only to the care that a director is expected to take but also to the level of skill, knowledge and experience that will be expected from him. If a director is, as usual, appointed to run a particular division or field, he has to have the necessary skills and knowledge. If his own knowledge does not enable him to judge important questions, such as, for example the derivative business of the company on which the board as a whole has to reach a conclusion, he will have to acquire that knowledge or seek advice and judgement from outside experts. If a director has a special skill, he will be expected to use it fully and continuously in the service of the company.\textsuperscript{40} Special knowledge or competence of the director may increase the

\textsuperscript{37} AktG § 317.
\textsuperscript{38} GmbHG § 43(1) and AktG § 93(1).
\textsuperscript{39} Baums, T. Personal Liabilities of Company Directors in German Law, p. 10.
\textsuperscript{40} Ibid, p. 10.
standard of care. A director must exercise the care and skill of a diligent manager, which would be exercised by the management of a company of the same size and type. Thus, board members’ duty of care cannot be measured against a uniform standard, since liabilities that fall on these individuals depend on their positions and knowledge base, as well as on the peculiarities of companies. Consequently, it can be argued that the same violation may be dealt with differently from one company to another.

b) Duty of loyalty

The duty of loyalty (Treuepflicht) is a duty to safeguard the interests of the company. This is based on many concrete obligations such as the duty to exercise powers for the purposes for which they are conferred, the duty not to pursue personally business opportunities relating to the corporation’s existing or contemplated business, and the duty not to engage in any trade nor enter into any transaction in the company’s line of business on their own behalf or on behalf of others. “The loyalty duty towards the company interest implies that the company resources are considered entrusted, third party resources even if (1) a sole shareholder is involved, or even if (2) all shareholders agree to dispose otherwise. ‘Shareholders egotism’ reflecting the owner interest is not, however, to be ruled out with the small shareholders who may vote in favour of a high dividend out of short term interest even if this could be harmful to the company.”

In Germany “self-contracting” and “multiple representations” is prohibited. The Civil Code states that an agent cannot, unless otherwise authorized, enter into a transaction on behalf of his principal with himself in his own name or in his capacity as agent for a third party, unless the transaction exclusively involves the fulfilment of an obligation. Therefore a managing director cannot represent the company in dealings with himself or herself or with a third party represented by him or her (such as another ‘affiliated’ company for which he or she acts as representative). In a stock

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41 Sieg, O. Directors’ Liability and Indemnification, p. 119, 122.
42 Ibid, p. 46.
43 Author comment: a director is seen as an agent in the context of BGB § 181 and Company Law.
44 BGB § 181.
corporation the director cannot simultaneously represent both parties. The supervisory board must decide the representative of the company vis-à-vis its managing directors." This rule does not apply to contracts with companies which are closely connected to the director e.g. through shareholding, relatives etc. In that case, the board member is not a representative of the counterparty and the transaction does not need to be approved by the supervisory board. The situation is different in a private limited company, where in this case the company may be represented even by an employee with a power of representation.46 “The discussion centres only on the question of whether the shareholders must be informed as far as contracts with the directors themselves are concerned. Only recently, following an incident at Mannesmann, the Social Democrats have tabled a bill that would provide for a disclosure of certain personal business interests of directors to the public.”47 There is the obligation to disclose transactions with related parties (including managers) in annual reports. But the obligation takes effect post-transaction(s) only. Additionally, members of the board do not have to disclose their affiliate associations either prior to accepting a position or during the time they carry out their service to the company. Lack of this disclosure can be viewed as a weakness of the German legal system.

Nevertheless, in Germany managing directors are very often released from the prohibition of self-dealing and multiple representations. Managing directors can be released from these prohibitions by the shareholders’ resolution or the articles and such derogation must be registered.48

In addition to the above-mentioned restrictions, all transactions between the company and board members, persons and companies closely connected to these must be in line with industry standards. Loans and transactions which do not follow the arm’s length principle and which do not serve the company’s interest may trigger civil and criminal liability of the management board member.49 Such liability is joint

45 AktG § 112.
46 BGH, Judgment of 13 June 1984, BGHZ 91, 334 (336 f.).
47 Baums, T. Personal Liabilities of Company Directors in German Law, p. 8.
49 Cotta, P, Goetz, A, von Rumohr, Karl. Corporate Governance, Board structures and directors’ duties in 38 jurisdictions worldwide, p. 84.
and several with any shareholder/fellow director who has enjoyed the preferential terms.50 A director must always bear in mind the interests of the company. A director cannot take over the company’s business opportunities in order to use them for his own benefit or for those close to him. “This includes illicit synergies, like negotiating favourable business conditions for his own or for his family’s procurement, while the company enjoys less favourable terms with the same supplier. Though the amount of damage suffered may be doubtful, the benefit obtained by such illicit arrangements has to be refunded to the company, because judicial practice presumes that any such benefit was obtained at the expense of the company.”51

However, questions about conflict of interest arise in situations such as where a board member discovers a good business opportunity and has to decide whether he/she is obligated to make it known to the company before using it at his/her own discretion. In the opinion of the author, the board member is required to evaluate the potential benefits for the company as a first step, but only if the business opportunity falls within the scope of the company’s activities. If the board member considers the opportunity to be within the scope of the company’s activities but deems the opportunity to be unsuitable for the company (e.g., from the point of view of suitability, existence of sources, or the company’s strategies), he/she should confirm the decision with a superior body before using it for personal benefit. If the opportunity falls in a completely different business area from the one the company is involved in, the author is of the opinion that the board member does not have to inform the company or to realize it for the benefit of the company.

The duty of loyalty also includes the management board member’s duty of confidentiality.52 Management board members have essential information about the company’s business. The members are obligated to maintain confidentiality of business matters, trade secrets and other proprietary information belonging to the company. The duty of confidentiality does not end upon removal from office and lasts without a term.

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50 GmbHG § 43 and AktG § 93.
52 GmbHG § 85 and AktG § 93(1)(3).
A managing director is subject to a statutory covenant not to compete with the company’s business while holding his or her office regardless of whether the covenant is explicitly stipulated in the service contract, in the articles of association, or even by law. The managing director may not compete with the company, either in his/her own name or in the name of a third party.\textsuperscript{53} “Violation of the director’s non-compete obligation (be it post-contractual or not) does not require any competitive activity as such: it is sufficient that the director owns a controlling interest in a competitor, be it direct or indirect or through a close relative.”\textsuperscript{54} The non-compete obligation just described normally ends upon removal and termination of the service contract as managing director.\textsuperscript{55} Any non-competition obligation which goes beyond the statutory covenant must be regulated in the service agreement. “Respective judicial practice is vague and therefore any post-contractual non-compete covenant should not extend beyond two years and must entitle the former director to a compensation of no less than half of his former remuneration.”\textsuperscript{56} In order to work for a competitor (also for a group company), explicit exemption is needed. The shareholders may release the managing director from the covenant at any time by the articles of association or by a unanimous shareholder resolution.

1.2 Estonia

1.2.1 Liability

In Estonia, liability of board members is regulated in a very similar manner to Germany, and is categorized into internal liability and external liability. In addition to civil liability, criminal and administrative liability can be enforced against board members. These are, however, not discussed since they fall outside the scope of this paper.

In Estonia, the principal source of management board liability and obligations is the Commercial Code (Ärieadustik - ÄS\textsuperscript{57}) which entered into force in 1995. The

\textsuperscript{53} HGB § 112-113, AktG § 88.
\textsuperscript{55} BGH, Judgment of 9 February 2005 (OLG Celle) - 9 U 178/04.
Commercial Code has thereafter been amended on numerous occasions (81 times as of 01.05.2011). Some general corporate governance rules are also provided in the General Part of the Civil Code Act (Tsivilseadustiku üldosa seadus- TSÜS\(^{36}\)) and Law of Obligation Act (Võlaõigusseadus- VÕS\(^{39}\)).

The members of a directing body of a legal person who cause damage to the legal person by violation of their duties are solidarily liable for compensation for the damage caused to the legal person\(^{60}\) (so called internal liability). Estonian laws do not specifically define the terms shadow director and de facto director, and there is no relevant judicial practice. But similarly to Germany, since January 1\(^{\text{st}}\) 2006, liability of the influencing person came into effect and it can also be applied to a de facto director. A person who, by misusing his or her influence, influences a member of the management board or supervisory board to act contrary to the interests of a stock company is liable to compensate any damage incurred thereby to the stock company. A member of the management board or supervisory board who violated his or her obligations will be held liable solidarily with the person who influenced him or her, unless he or she proves that he or she has performed his or her obligations with due diligence.\(^{61}\)

Contrary to Germany, Estonian laws allow a creditor to also claim compensation for damages on behalf of the company. The law states that a claim for payment of compensation to a legal person for damage may also be submitted by a creditor of the legal person if the assets of the legal person are not sufficient to satisfy the claims of the creditor.\(^{62}\) This right of the creditor is limited in the case of declaration of bankruptcy of a company. In that case, only a trustee in bankruptcy may file a claim on behalf of the company.\(^{63}\) Since these norms handle compensation related to the company, they cannot be defined as external liability but should, instead, be considered as claiming right transfers to the creditor. The advantage of

\(^{60}\) Estonian General Part of the Civil Code Act § 37(1).
\(^{61}\) Estonian Commercial Code § 167\(^{1}\) and § 289\(^{2}\).
\(^{62}\) Estonian General Part of the Civil Code Act § 37(2) and Estonian Commercial Code § 187 and § 315.
\(^{63}\) Estonian Commercial Code § 187 and § 315.
this is questionable and the effectiveness of the procedure is yet to be proven in practice. Prior to the law of July 1st, 2002, a creditor could claim damages directly to him/herself. In that case, if the company’s assets were not worth enough to cover the damage, the members of the management board jointly shared the liability for the damage caused.

The Supreme Court has, beginning with its decision of 11.05.2005, explained that any violation of a board member’s obligations towards a company should be assessed in the light of principles of contractual liability and not the provisions related to tort or non-contractual unlawful damages. External liability of directors is based on the law of delict and not contractual liability as in the case of breach of law towards the company, as there is no contractual relationship between the creditor and the director.

**External liability** will apply when a management board member has by his/her actions damaged a creditor by violating a specific rule designed for the protection of creditors. In Estonia, as in most European countries, the main obligations of a director are intended for the protection of the company, and board members are usually liable to the company only. The court has reiterated in several decisions that the general rule of liability of a board member is designed to protect the company and not its creditors. However, there are a few provisions intended to protect the interests of creditors. The court has found that a creditor may claim damages caused to it directly from a director if the creditor has been damaged by actions that violated legal obligations that the representative should have personally fulfilled in order to avoid causing losses to the legal person’s creditor, where such obligations have been expressly provided for the protection of creditors’ rights. More specifically, the Supreme Court has so far considered the duty to file for bankruptcy on time to be such an obligation. The author suggests that direct claims are also allowed in the case of filing of false data in annual reports, failure to act in a situation of insufficient net assets, violation of the loan prohibition, violation of the prohibition of payments,

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64 Estonian Supreme Court decision no 3-2-1-41-05, 11.05.2005, RT III 2005,17,181, p. 18.
violation of the obligation to notify creditors, incorrect evaluation of non-monetary contributions used as payment for shares and violation of the conditions for the company’s acquisition of own stock or shares.

A member of a company’s management body may also be directly liable towards a creditor if he/she has damaged the creditor by intentional conduct contrary to good morals. The Supreme Court has ruled that intentional conduct contrary to good morals is present in cases where a director fails to notify a creditor of the initiation of compulsory dissolution procedures against the company or pays out an amount deposited with the company to secure the performance of a third person’s contract. In literature, examples of intentional behaviour contrary to good morals have also included the conduct of a director who lures investors to purchase company stock by concealing the company’s poor economic situation, thereby causing damage to the investors.

The court has also accepted a shareholder’s direct right of claim against a director as equal to a creditor’s right of claim. In its decision of 23.04.2008, the court found that if the management board provides false data to a shareholder, thereby damaging the shareholder, the director and the company may both be liable for damage caused to the shareholder.

A director’s direct liability to the state (public interest) has been separately established by tax laws. Under the Taxation Act, directors who intentionally, or by gross negligence, breached the obligation of the company to declare the tax obligations correctly are jointly and severally liable with the company.

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* Estonian Law of Obligations Act § 1045(1)8.
1.2.2 Duty of care and duty of loyalty

a) Duty of care

"Common care" is the foundation of the duty of care principle, where all essential executive board member obligations, liabilities, and duties are derived from. Directors are required to act in the most economically purposeful manner. Acting in the best interests of the company represents the board member’s subjective belief and the objective obligation to consider only the conditions that an intelligent and honest person would deem to be in the interests of the company. The author is of the opinion that some cases (e.g. insolvency) should nevertheless mandate the management board to prefer the interests of creditors, employees or shareholders (interests of protecting an investment). The requirement to act in the most economically purposeful manner was first touched upon in a Supreme Court decision of 31 October 1996. In the dispute, a manager breached the company’s sole distribution contract by organising sale of goods in a prohibited region through a separate company. The court found that a mandatary must take into account all facts in his/her knowledge and act in good faith and avoid any damage to the mandator, and thus the director was obligated to compensate for the damage caused to the company through his actions.

Members of a management body must perform their obligations arising from law or the articles of association with the diligence normally expected from a member of a management body. Therefore, a director must act on the level of generally accepted professional competence, which is by default a higher standard.

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72 Author comment: For some reason, this obligation is stated only for public limited companies and not for private limited companies. However, the court has acknowledged the same obligation also for private limited companies (Estonian Supreme Court decision no 3-2-1-45-03, 06.05.2003, RT III 2003,18,173, p. 21).
73 Estonian Law of Obligations Act 620(2).
74 Kalaus, T. Juhatuse liikmete hoolsuskohustus ja ärilise otsuse reegel üldise õiguse maades, p. 273.
75 Estonian Supreme Court decisions No 3-2-1-121-96, 31.10.1996. RT III 96,32,416.
76 Estonian Civil Code § 35 and Estonian Commercial Code § 187(1) and § 315(1).
than expected from a layman. He/she must be capable of exercising the necessary level of diligence commensurate with the nature of the mandate. A mandatary must perform the mandate to the maximum benefit of the mandator in the light of and according to the mandataray’s knowledge and abilities and must prevent any damage to the property of the mandator. In addition, a mandatary who is acting for the purposes of the mandatarey’s economic or professional activities must apply the generally recognised skills of the mandatary’s profession. According to law the situation, age, education, knowledge, abilities and other personal characteristics of a person are taken into consideration upon assessment of the culpability of the person. The author opines that the knowledge and abilities of a specific person cannot be taken into account where they fall below the generally recognised minimum skills of directors. But if an attorney performs duties as a director, he/she should certainly be subjected to higher standards of legal knowledge than other directors. The author’s opinion is supported by a decision of the Supreme Court, worded as follows: “A difference should be made between the general (human) duty of care expected from all persons, which is founded on generally recognised moral standards and practices, and the special duty of care required from a person/official active in a given field.”

The criteria for assessing the duty of care were first set out by the Supreme Court in 2003 in three separate decisions and the principles established therein have been followed ever since. The court noted that the duty of care means that a member of the board must be diligent, well-informed in order to take decisions and should not take unjustified risks. Failure by a member of the board to act with due diligence which a reasonable person in such office in similar circumstances would apply can be considered as breach of the duty of care. The Bankruptcy Act in force until 30.04.2004 enabled to derive some activities which would surely fall outside the

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77 Estonian Law of Obligations Act § 620.
78 Estonian Law of Obligations Act § 1050(2).
79 Estonian Supreme Court decision No 3-1-1-136-05, 08.03.2006, RT III 2006, 9,82, p. 15.
80 Estonian Supreme Court decision No 3-2-1-41-03, 30.04.2003, RT III 2003, 17, 164 and Estonian Supreme Court decision No 3-2-1-45-03, 06.05.2003, RT III 2003, 18, 173; Estonian Supreme Court decision no 3-2-1-67-03, 02.06.2003, RT III 2003, 18, 206.
81 Estonian Bankruptcy Act (02.05.1992, RT I 1992, 31, 403) § 60(2).
scope of the duty of care. Such grave management errors included (1) use of the property of the legal person in one’s own interests, (2) entry into transactions on behalf of the legal person in one’s own interests, (3) use of the property of or a loan taken by the legal person against the interests of the legal person in one’s own or any other person’s interests, (4) concealment of property of the legal person, (5) an unreasonable increase in the obligations of the legal person, (6) an incorrect indication of the value of property on the balance sheet of the legal person, (7) organisation of fictitious or inadequate accounting, including the recording of fictitious payments and debts, (8) procurement of capital on extremely unfavourable terms to the legal person, (9) taking or granting of a large loan if it is obvious that it is impossible to pay or receive repayment of the loan and (10) other acts in one’s own interests which damage the legal person causing the insolvency of the legal person. The list has since been removed from the Bankruptcy Act, but the author suggests it remains a suitable standard for establishing breaches of the duty of care in case of disputes. The current version of the Act contains no specific list of grave errors in management, simply defining them as actions of a certain level of gravity, i.e. gross negligence or intentional violation.82

The author concludes that instead of following German legislation in this field, Estonia has adopted US-style general rules by providing for the duty of care of directors. According to Article 8.30(a) of the so-called Model Business Corporation Act83, jointly drafted by the American Law Institute and the American Bar Association, each member of a board of directors, when discharging the duties of a director, must act:

a) in good faith;

b) with the care that a prudent person in a like position would reasonably believe appropriate under similar circumstances; and

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82 Estonian Bankruptcy Act (22.01.2003, RT I 2003,17,95), § 28(2).
83 The Model Business Corporation Act (MBCA), revised through 2005 Adopted by the Committee on Corporate Laws of the Section of Business Law with support of the American Bar Foundation. Available at Internet: http://apps.americanbar.org/buslaw/committees/CL270000pub/nosearch/mbca/assembled/20051201000001.pdf (last visited 15.05.2011) Article 8.30(a).
c) in a manner the director reasonably believes to be in the best interests of the corporation.

Meanwhile, Estonian law has so far made no progress in implementing the business judgement rule which is a fundamental principle in the USA (see section 2.1).

b) Duty of loyalty

The general duties of the members of a management body in Estonia include the requirement to be loyal to the legal person.84 The Law of Obligations Act also stresses that upon the performance of a mandate, the mandatary85 must act in a loyal manner with respect to the mandatory.86

The Supreme Court has reitered in several decisions that the duty to act in good faith also entails the duty to avoid conflicts of interest between oneself and the company.87 The law provides that conflicts of interest (transactions with oneself or persons represented by oneself) must, as in Germany, be avoided by obtaining the approval of a superior body.88 The approval requirement can be waived by law or authorisation.89 The superior approval requirement does not apply to transactions concluded in the course of ordinary business of the company or on the market price of a service.90 It may thus be concluded that transactions with a person bound by the duty of loyalty may, with the approval of a superior body, be non-compliant with market conditions – a practice generally not permitted in Europe. The author finds such an exception is justifiable only if applied with the requirement that any such transaction must be separately notified to the superior body.

The Estonian Commercial Code regulates that a transaction concluded between a company and a member of the management board is void if the shareholders or

84 Estonian General Part of the Civil Code Act § 35.
85 Author comment: a director is seen as a mandatary in the context of Estonian Law of Obligations Act.
86 Estonian Law of Obligations Act § 620.
87 Estonian Supreme Court decision No 3-2-1-41-03, 30.04.2003, RT III 2003,17,164 and Estonian Supreme Court decision No 3-2-1-41-05, 11.05.2005, RT III 2005,17,181.
88 Estonian Commercial Code § 168(1), § 181(3-4), § 307 (3-4) and § 317(8).
89 Estonian Civil Code § 95.
90 Estonian Commercial Code § 181(3) and § 307(3).
supervisory board do not agree to the transaction.\textsuperscript{91} In these relationships the management board member cannot argue that he or she is not obligated to ascertain whether a relevant internal decision exists and he or she must be treated like a third person. The management board member must know whether internal procedures have been complied with.

Similarly to Germany, in Estonia there is no obligation to disclose information about positions held in other companies before the nomination takes place or about other facts which may create a conflict of interest (loans given/taken, guarantees, other benefits, etc). There are also no regulations entitling shareholders to obtain such information. Similar to Germany is also permission to disclose transactions with oneself or persons connected with oneself only subsequently. The law requires that transactions with members of the management and the highest supervisory body and with other related parties must be indicated in the annual report (description of the parties, the volume and balances of the transactions as at the balance sheet date)\textsuperscript{92} The author’s recommendation is to amend those provisions.

Further, to avoid conflict of interest, Estonian law prohibits granting or guaranteeing a loan to a member of its management board or supervisory board or its procurator. This applies also to credit agreements and other economically equivalent transactions. A subsidiary may grant a loan to a member of its parent undertaking if this does not harm the financial status of the company or the interests of creditors. Nevertheless, a subsidiary may not grant a loan for acquiring a share of the company\textsuperscript{93} Transactions in violation of the prohibition to grant a loan are void. Transactions in violation of the prohibition to guarantee a loan do not result in the nullity of the transaction, but the person whose loan was secured must compensate for the damage caused to the company by providing security\textsuperscript{94}

The General Part of the Civil Code Act regulates that if a representative also acted as the representative of the other party or engaged in self-dealing, the representative is presumed to have violated the obligations arising from the legal

\textsuperscript{91} Estonian Commercial Code § 181(3) and § 307(3).
\textsuperscript{92} Estonian Accounting Act appendix 3 section 16 (20.11.2002, RT I 2002,102,600).
\textsuperscript{93} Estonian Commercial Code § 159 and § 281.
\textsuperscript{94} Estonian Commercial Code § 159(4) and § 281(4).
relationship on which the representation was based upon entry into the transaction and the principal may cancel the transaction.\textsuperscript{95} The court has also found, in its decision of 14.09.2006,\textsuperscript{96} that a transaction by a management board member in which he/she was simultaneously the representative of the other party may be cancelled because it should be assumed that the transaction breached the mandatary’s obligations under the representation relationship and was not in the interests of the mandator.

The duty of loyalty also entails a \textit{confidentiality obligation and prohibition of competition}. In Estonia, the members of the management board must maintain the business secrets of the company. “Production secrets usually relate to production processes and volumes, the composition of substances and ways of producing them, while business secrets may include an undertaking’s customers, price formation, contractual partners, business ideas and plans etc.”\textsuperscript{97} The court has explained the duty to maintain business secrets and its continuation very thoroughly in its decision of 09.12.2008.\textsuperscript{98} A director is obligated to maintain business secrets regardless of whether or in what form this obligation has been provided for in his/her contract of service. On the other hand, the court found that compliance with the duty of loyalty or duty of care should be assessed in the light of whether and to what extent the director was or should have been aware of what were the company’s actual business secrets, the disclosure of which might have caused damage to the company. The court also noted that a director’s obligation to maintain business secrets remains in force after the termination of his/her contract, insofar as this is necessary to protect the justified interests of the company. However, the court emphasized that this should not lead to a situation where the obligation to maintain business secrets would preclude the director from any further activity in the given field. Contracts may also provide a time limit for the obligation to maintain business secrets. To avoid disputes, it is therefore advisable for a company to have guidelines specifying

\textsuperscript{95} Estonian General Part of the Civil Code Act § 131(1).
\textsuperscript{96} Estonian Supreme Court decision 3-2-1-68-06, 14.09.2006, RT III 2006, 30, 266.
\textsuperscript{97} Varul, P. Juhtorgani liikme kohustused kui vastutuse alus. Law office Paul Varul Newsletter, 2009-11.
\textsuperscript{98} Estonian Supreme Court decision No 3-2-1-103-08, 09.12.2008, RT III 2008,51,353, p. 20.
the content and rules of disclosure of the company’s business secrets and the limit of business secrets.

In Estonia, a member of the management board may not, without the consent of the supervisory board (if there is no supervisory board, then without the consent of the general meeting):

- be a sole proprietor in the area of activity of the company;
- be a partner of a general partnership or a general partner of a limited partnership which operates in the same area of activity as the company;
- be a member of a directing body of a company which operates in the same area of activity as the company, except if the companies belong to one group.99

Art. 9 of the draft Fifth Directive goes even further by providing that such approvals must also be notified to the general meeting.100 In Estonia, if the activities of a member of the management board are in conflict with the prohibition on competition, the company may require that the member of the management board terminate the prohibited activity, transfer the income received from the prohibited activity to the company and compensate for damage to the extent exceeding the claimed income.101

Estonia’s regulation on the directors’ prohibition on competition after termination of service is similar to that of Germany. However, there is a lack of legal reasoning as to the time limits and compensation for a contractual prohibition of competition, and whether any such compensation could be paid in advance or should be paid monthly after termination. The author opines that both the prohibition and compensation for the restriction of choice of employment should be reasonable.

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99 Estonian Commercial Code § 185 and § 312.
101 Estonian Commercial Code § 185 (2), (3) and § 312 (2), (3).
2 LIMITATION OF LIABILITY

2.1 Business judgment rule

Conduct of business includes legally required decisions and also entrepreneurial decisions. Entrepreneurial decisions concern further developments and are based on predictions and assessments. This puts board members in a very difficult situation in which they must take decisions while threatened by liability for those decisions. Board members, similarly to legal guardians, are granted certain autonomy and flexibility in decision making but are legally liable and thus obligated to exercise care and loyalty when acting in the interests of the business entity. The question is how much freedom board members should be given. If shareholders have appointed the board members, they should trust their business abilities and experience and the law should not give the owners the opportunity to challenge any decision or transaction that the owners do not like. Whatever the result, if a decision is based on appropriate information and is fair-minded, it is always reasonable and should not be disputable. Meanwhile, fear of liability may create a situation where board members cannot act freely and take the appropriate risks that are essential for business. This could lead to an opposite effect, with the board trying to act too prudently and risk-free, inhibiting the development of the company. The management board should be the body which has the best knowledge of how to implement the company’s strategy and should therefore be free to apply discretion. Thus, in order to prevent slowing the development of companies down, board members should be granted a widened scope of business judgement and courts should only interfere in case of obvious diligence or loyalty failures.

The business judgement rule is an American case law-derived concept in corporate law. The business judgement rule specifies that a court will not review the business decisions of directors if the business judgement rule applies. The business judgement rule creates a strong presumption in favour of the director. The business judgement test was constructed in the opinion for Grobow v. Perot, (Del. 1988), as a

102 Sieg, O. Directors’ Liability and Indemnification, p. 121.
guideline for satisfaction of the business judgment rule. A director will not be considered liable if he/she:

- acted in good faith;
- acted in the honest belief that his/her actions were in the company's best interest;
- acted on an informed basis;
- was not wasteful;
- was not involved in self-interest or self-dealing (the duty of loyalty concept plays a role here).

The business judgement rule has now been modernized and in addition to what was stated above, it is assumed that the rule does not apply when a director fails to act or abdicates his responsibilities and if the directors' conduct was an abuse of discretion.104

So, if there is no evidence of fraud, bad faith or exercise of self-interest, and a decision of a board member has been taken with a rational commercial purpose, a court can not re-evaluate decisions adopted by directors. A court would make a decision in different circumstances, in the light of new information and with hindsight, knowing the end result. “The Business Judgement Rule is like “a sieve” through which claims against the board members must pass.”105 Thus, a decision subject to the business judgement rule is final and whether it will eventually be beneficial or harmful to the company is irrelevant. The main purpose of this rule is that courts should not evaluate the accuracy, feasibility and reasonableness of choices made by board members, as this would mean penetrating management board competence to an unacceptable depth.106

106 Kalaus, T. Juhatuse liikmete hoolsuskohustus ja ärilise otsuse reegel üldise õiguse maades, p. 275.
2.1.1 Germany

Since November 2005, Section 93(1) of the Stock Corporation Act includes the business judgement rule with regard to entrepreneurial decisions.107 “The business judgement rule complied with the prevailing case law at the time of implementation.”108 For example, in the November 22nd, 2005 Kinowelt decision, the Federal Court of Justice stated that by exceeding the scope of discretion in entrepreneurial decisions, directors would be guilty of an intentional breach of fiduciary duties.109 More specifically, the court pointed out that when assigning liabilities, distinct characteristics of business decisions should be considered. The law states that a breach of duty has not occurred if a director could reasonably believe that he/she acted on the basis of adequate information in the interest of the company.110 Therefore, the business judgement rule states that directors are not liable for mistakes made while staying within the scope of their discretion when making entrepreneurial decisions.

“The Business judgement rule in Germany means that the management must take measures that a prudent and reasonable manager would have taken. (...) the management board can be held liable for the poor performance of the company based on entrepreneurial business decisions taken with the due care of responsible managers, even if these decisions subsequently turn out to be failures.”111 “The business judgement rule encourages directors to take entrepreneurial risks, but at the same time prevents them from acting rashly or improvidently at the expense of investors and employees.”112 Usually courts should not set the “competent businessman” as a model to objectively assess the actions of management. Instead,

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107 Author comment: although this is stated only regarding stock corporations, the court has acknowledged that the same principle also applies regarding private limited companies.
108 Sieg, O. Directors’ Liability and Indemnification, p. 121.
109 BGH, Judgment of 22 November 2005 (Kinowelt) - 1 StR 571/04.
110 AktG § 93(1).
111 Cotta, P, Goetz, A, von Rumohr, Karl. Corporate Governance, Board structures and directors’ duties in 38 jurisdictions worldwide, p. 81.
112 Sieg, O. Directors’ Liability and Indemnification, p. 121.
they should construct and approve leadership duties for specific situations. That would leave room for court interference and judgments.\textsuperscript{113}

The business judgement rule requires directors to act in good faith. Acting in good faith includes both intentional and unintentional activities.\textsuperscript{114} The starting point for assessing the business judgement rule is the director’s perspective. It is implied that the director considers the best interests of the company when making decisions and his/her actions will be based on common sense. According to case law, a director has acted unreasonably if he or she has incorrectly assessed the risk connected with the entrepreneurial decision and has thereby acted irresponsibly. An action is not considered reasonable if a board member makes a decision without sufficient information, without consulting with specialists, and/or simply out of incompetence. The preamble to Section 93(1) expressly states that entrepreneurial decisions are often based on instinct, experience and intuition with regard to future developments, as well as a sense for the market and the reactions of customers and competitors. The appropriateness of information must be assessed on the basis of:

- the time available in which to make the decision;
- the importance and nature of the decision; and
- a consideration of general economic standards.\textsuperscript{115}

It could be said that the director is also justified to rely on information, opinions, and judgements of employees and experts, provided he or she has a reason to believe that these individuals merit confidence.\textsuperscript{116} The business judgement rule does not regulate situations and ways where involvement of experts is needed and leaves it up to the director to decide. External professional advice will not necessarily prevent directors’ liability and in Germany, such external professionals are not specified. According to the U.S. Model Business Corporation Act section 8.30(f)\textsuperscript{117}, a director is entitled to rely on:

\textsuperscript{113} Baums, T. \textit{Personal Liabilities of Company Directors in German Law}, pp. 8-9.
\textsuperscript{115} Sieg, O. \textit{Directors’ Liability and Indemnification}, p. 123.
\textsuperscript{116} Baums, T. \textit{Personal Liabilities of Company Directors in German Law}, p. 10.
\textsuperscript{117} MBCA section 8.30(f).
(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the functions performed or the information, opinions, reports or statements provided;

(2) legal counsel, public accountants, or other persons retained by the corporation as to matters involving skills or expertise the director reasonably believes are matters (i) within the particular person’s professional or expert competence or (ii) as to which the particular person merits confidence; or

(3) a committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

2.1.2 Estonia

Estonian company law does not recognize the business judgment rule as such. The question is whether this principle could be derived from the obligation of reasonable, economically purposeful conduct, and the obligation to maintain good faith in mutual relations. The author finds that certain elements of the business judgment rule are indeed present in Estonia but Estonian law does not present them as a set of conditions precluding liability.

The principle of good faith is deemed effectual throughout Europe via the Roman heritage, and has thus been also adopted in the Estonian General Part of the Civil Code Act. According to that, rights must be exercised and obligations must be performed in good faith and a right must not be exercised in an unlawful manner or with the objective to cause damage to another person.118 A specific provision is also created for the directing bodies of legal persons (principle of good faith in mutual relations). It says that the shareholders or members of a legal person and the members of the directing bodies of a legal person must act in accordance with the principle of good faith and consider each other’s legitimate interests in their mutual relations.119 The Supreme Court found in its decision of 31.03.2010120 that conduct contrary to good morals is well established in a case where a director, who also has a 50% holding in the company, takes control of the company and its economic

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118 Estonian General Part of the Civil Code Act § 138.
119 Estonian General Part of the Civil Code Act § 32.
120 Estonian Supreme Court decision no 3-2-1-7-10, 31.03.2010, RT III 2010,15,108.
activities (including transferring the assets of the stock company to another company controlled by himself) without the other shareholder’s knowledge. The court found that even if performed in accordance with the procedures provided by the law, such procedures may still be illegitimate if carried out at the expense of other shareholders, making the pursuit of such a purpose unlawful in itself.

Members of the management board are also required to follow the principle of reasonableness. Reasonableness is to be judged by what persons acting in good faith would ordinarily consider to be reasonable in a similar situation. In assessing what is reasonable, the nature of the obligation, the purpose of the transaction, the usages and practices in the fields of activity or professions involved and other circumstances must be taken into account.121 Therefore, the standard is not what care a particular director might believe appropriate in the circumstances but what a person— in a like position and acting under similar circumstances— would reasonably believe to be appropriate. According to Salomon, a person of average reasonableness is deemed to be progressive, which is crucial for carrying out profit-driven activities, also have common sense and practical wisdom and be capable of making decisions on an average level.122 The reasonable person will consider the foreseeable risk of harm of his actions, the extent of the risk so created, any alternatives of lesser risk, and the costs of those and the likelihood that such risk will actually cause harm. In its decision of 30.08.2007, the Tallinn Circuit Court123 deemed unreasonable the conduct of a director who concluded a below-the-cost personnel rent contract in such a manner that initial rent payments did not cover all labour costs (including taxes) but only payments to the workers. The court found that the contract was proven unreasonable and without any economic purpose by the mere fact that the plaintiff did not intend to pay taxes on a current basis and was planning to incur tax arrears.

In professional publications and case law, attempts have been made to introduce a notion that a director’s activities cannot be assessed on the basis of consequences. Professional publications have emphasized that management must not be required to act in a manner that profits the company at any cost or only

122 Salomon jt. 1993, p. 87.
123 Tallinn District Court decision no 2-05-2007, 30.08.2007.
protects the interests of shareholders, employees and creditors. Instead, the basis for assessment should be the quality of the management board’s actions that lead to a given decision, and whether the aim has been to secure the company’s sustainability and maximise its profits. There is currently no judicial decision in Estonia that would contain the express statement, but the Supreme Court noted in its decision of 11.05.2005: 124 “The plain fact that an asset was sold below the market price does not automatically mean that the duties of a management board member have been breached. The plaintiff must prove that the defendant when selling the asset did not exercise the care normally expected from a director in such a situation or breached the duty of loyalty or some other duty.” In decisions of 30.04.2003125 and 06.05.2003, 126 courts have also reviewed the requirement of sufficient information in the context of economical reasonableness. The courts stated that the management board member’s obligation to act in the most economically purposeful manner means, inter alia, that a management board member should be careful, sufficiently informed to adopt decisions and should not expose the stock company to unjustified risks.

Indeed, the duty of care is expressed in fairly general words in Estonian law, possibly leading to situations where a person held liable may have been acting in the best interests according to his/her conscience, yet a court as a bystander still finds that the duty of care was not exercised. If the law would be taken word for word, a great number of directors could be deemed to have breached the duty of care and subjected to compensation claims. Most so-called “stupid decisions” could be seen as breaches of the duty of care. However, such application of the law would be unreasonably burdensome for directors who have to adopt complex decisions in varying economic situations during a limited time and with limited information. Understanding the delicacy of the issues of directors’ liability, Estonian courts have interpreted the duty of care and duty of loyalty with great caution and have not applied the duty of care word for word, attempting to find reasons why directors should not be held liable. There is a need for a clearer duty of care standard, to provide peace of mind to directors whose actions are in compliance with the rules

124 Estonian Supreme Court decision No 3-2-1-41-05, 11.05.2005, RT III 2005,17,181.
125 Estonian Supreme Court decision No 3-2-1-41-03, 30.04.2003, RT III 2003,17,164.
126 Estonian Supreme Court decision No 3-2-1-45-03, 06.05.2003, RT III 2003,18,173.
and to allow claiming damages from directors who have breached their obligations. In view of the aforementioned, the author finds that Estonia has a clear need for a business judgement rule and the lack thereof is a major shortcoming in Estonian legislation concerning the liability of directors. The principles of good faith and reasonableness are in themselves insufficient for limiting or excluding liability. Also, courts have not set the priority of requirements for establishing liability in a way that acting in good faith would suffice to preclude further analysis of other obligations. Thus, acting in accordance with the principle of good faith or reasonableness does not preclude liability on other grounds.

2.2 Acting according to higher body instructions

2.2.1 Germany

In order to mitigate the liability of board members, it is important to involve superior decision-making bodies in the decision making process. Although it does not always give full protection and avoid liability, it is certainly an important argument if the liability issue arises.

The corporate bodies for German private limited companies are (a) the managing director(s) and (b) shareholders’ meeting. And for German stock corporations, they are (a) managing director(s), (b) supervisory board, and (c) shareholders’ meeting. The supervisory board is mandatory for stock corporations. For private limited companies, it is required only in very exceptional cases when one of the four co-determination acts apply\textsuperscript{127}. It applies to less than one per cent of all GmbHs.”\textsuperscript{128} German law requires that the management board acts autonomously, without the influence of other governance bodies.\textsuperscript{129} Under German law, management and supervision are strictly separated. A member of the supervisory board may not be a member of the management board and vice versa.\textsuperscript{130} However, a

\textsuperscript{127} Author comment: If a private limited company has more than 2,000 employees, half of the members of the supervisory board must be representatives of the employees and if a private limited company has more than 500 employees, one-third of the supervisory board members must be appointed by the employees.


\textsuperscript{129} AktG § 76(1).

\textsuperscript{130} GmbHG § 52(1) and AktG § 77(2), § 105(1), § 111(4).
shareholder of the company may well be appointed the managing director. The same is true for a director of a shareholder entity.

"Apart from their function to represent the GmbH (Vertretung) the managing directors are competent to manage its affairs, i.e. to decide on how to run its business (Geschäftsführung)."\textsuperscript{131} The articles of association, internal rules, or the service contract may contain a catalogue of transactions for which the managing directors require the prior written consent of the shareholders or supervisory board. “German law states that legally required decisions must comply with the statutory rules, bylaws and guidelines of the company, the directives of shareholders and instructions agreed in the employment contract.”\textsuperscript{132} Thus, board members have to look after and follow the interests of and instructions from different types of stakeholders. This immediately raises the question of whether there is an obligation to follow every single instruction and how to act if conflict of interest between different stakeholders exists or arises.

\textbf{a) Supervisory board instructions}

The supervisory board may not be entrusted with any management tasks and is not entitled to interfere in the management of the company.\textsuperscript{133} “The supervisory board’s exclusive competence in this regard is to monitor the management, not to exercise management functions itself. Management activities, for that matter, cannot be conferred upon it.”\textsuperscript{134} The main functions of the supervisory board are general supervision of the management board and approval of transactions as set forth by the articles. The law does not provide a list of transactions that require the supervisory board’s consent. The company’s articles of association or the supervisory board itself may decide on such a list of transactions.\textsuperscript{135} In Estonia, the law has outlined an illustrative list, which can be modified by the articles of association. It guarantees a minimum level of shareholder involvement in the case of absence of adequate attention for the subject by the shareholders or the supervisory board itself.

\textsuperscript{131} Müller K. The GmbH. A Guide to the German Limited Liability Company, p. 29.
\textsuperscript{132} AktG § 91(2).
\textsuperscript{133} AktG § 76(1).
\textsuperscript{134} Müller K. The GmbH. A Guide to the German Limited Liability Company, p. 52.
\textsuperscript{135} AktG § 105 and § 111.
The author finds that such a list is necessary in order to prevent large-scale abuses of power.

If the supervisory board refuses to give consent for certain transactions, the management board may submit the matter to the general meeting, who may decide to approve the transaction but only with a three-quarter majority of favourable votes. If the supervisory board’s decision is overruled by the shareholders, the managing director may carry out the respective transaction without consent from the supervisory board. The consent of the supervisory board does not release the managing directors from their liability.

If the managing director does not obtain approval from the supervisory board when approval is required for transactions that exceed a specific amount set forth by the company, the managing director may be liable for the full value of agreement (exclusive of any benefits that might have resulted for the company from the contract). E.g. there might be a case where a manager must obtain the prior approval of the shareholders for transactions which exceed Euro 100,000. But the manager enters into a contract worth Euro 150,000 without prior written approval. As a result, the manager may be held liable for the full amount (Euro 150,000). Therefore, the goods or services received by the company will not be taken into account when calculating the loss resulting from the transaction. In the case of KG Berlin, the German court reasoned their decision by stating that the company was, as a result, bound legally and economically by the agreement it had never wished to commit to.

b) Shareholders’ instructions

Shareholders’ instructions differ in the case of private limited companies and stock corporations. The ability of shareholders of a GmbH to guide and influence policy and management is considerably more influential and much more direct than that of shareholders of a stock corporation. The shareholders of a GmbH are more closely

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136 AktG § 82.
137 Baums, T. Personal Liabilities of Company Directors in German Law, p. 13.
138 BGH, Judgment of 17 December 2004 (KG Berlin) - 14 U 226/03.
involved in the operation of the company compared to the AG form of company. The shareholders of a GmbH may influence every single management issue by giving instructions to the managing director.\textsuperscript{140} In stock corporations, the management board is responsible for running the company and has wide discretion. Generally, the shareholders are not competent to resolve matters regarding management of the company and directors are not bound by shareholders’ instructions\textsuperscript{141}. “Consequently shareholders have less influence on the management and directors can protect themselves less often against personal liability by obtaining shareholders’ approval.”\textsuperscript{142}

In the case of limited liability companies, the excessive risk of liability that falls on the board members can be managed and reduced via involving the shareholders. Providing management directors with instructions falls within the competence of the shareholders’ meeting.\textsuperscript{143} The right to issue instructions (either in a general form or in a specific case) can be transferred to individual shareholders or to another body (optional supervisory board, advisory board, etc.) in the articles of association.\textsuperscript{144} “The board of management is obliged to provide the shareholders in due time with the information necessary to be able to form a correct decision and, in principle, cannot rely on its right to confidentiality vis-à-vis the shareholder’s meeting.”\textsuperscript{145} If the management board has passed the decision-making power over to the shareholders, then as a rule and unless the decision is deemed to be illegal, the management board should follow the shareholders’ instructions. Such instructions have to be obeyed even if their implementation is, in the judgement of the managing director, detrimental to the company.\textsuperscript{146}

The Limited Liability Company Act § 46 contains a catalogue of matters the shareholders’ meeting is competent to decide, and the management is obligated to

\begin{footnotesize}
\textsuperscript{140} Schepke, J. Duties and responsibilities of directors in Europe. CMS Legal Services EEIG 2008, p. 28.
\textsuperscript{141} AktG § 76(1) and § 119(2).
\textsuperscript{143} GmbHG § 37(1).
\textsuperscript{144} Müller K. The GmbH. A Guide to the German Limited Liability Company, p. 35.
\textsuperscript{146} Müller K. The GmbH. A Guide to the German Limited Liability Company, p. 36.
\end{footnotesize}
call a shareholders meeting for these decisions. However, this is an open list and the management board must be able to decide if and when they need the involvement of shareholders. Similarly to Estonia, the German Federal Court (Bundesgerichtshof) acknowledges the existence of implied powers of the shareholders’ meeting to pass resolutions concerning fundamental management decisions. One of the landmark decisions is Holzmüller and Gelatine.147 In this case, the management decided to transfer roughly 80% of the company’s assets to a solely owned subsidiary, where the rights of the shareholders’ meeting would be, understandably, exercised exclusively by the management board of the parent company. The court decided that such transaction (sale of an essential part of the enterprise) has to be approved by a three-quarter majority of the shareholders’ meeting. According to the court, measures of the management board that have a significant effect on the rights and assets of the shareholders require the consent of the shareholders’ meeting. Therefore, measures and/or transactions which affect a substantial part of the company’s assets, turnover, and earning capacity must be accepted by the shareholders. Whenever interpreting the law, it is crucial to also consider the overall implications, instead of relying solely on the wording of the law.

The immediate question that arises is whether compliance with instructions releases the board members from liability. Board members can be released from liability if a valid shareholders’ decision was made that gave them the instructions to act. Board members cannot be held liable for actions that were taken upon binding instruction by the shareholders’ meeting.148 If a director’s action has been approved or ratified by the shareholders, the company is, as a general rule, precluded from claiming damages in relation to the action.149 In the Ebert case150, the court dealt with the obligation of the management to accept and follow the shareholders’ instructions and resulting liabilities. The court stated that there is no autonomous field of management in which the sole competence of a director can exist. A member of a management board is obligated to enable and support shareholders in making sound

148 AktG § 93.
149 Schepke, J. Duties and responsibilities of directors in Europe. CMS Legal Services EEIG 2008, p. 31.
150 BGH, Judgment of 15 May 2003 (Ebert), LSK 2003, 230107.
decisions, as well as to bring attention to any judgements which would not serve the best interests of the company. However, a director cannot be held liable for following orders that turn out not to serve the best interests of the company, but that were put into effect by appropriate people or governing bodies of the company, because such damages will be incurred by the company itself.

Where directors are obligated to follow the instructions of the shareholders, their liability will be excluded accordingly provided that the instruction itself was lawful. The directors may not follow instructions which are clearly null and void, and they are bound, at any time, by the general duty of a diligent and prudent businessman and fiduciary duty to act in good faith. The instruction must not conflict with mandatory provisions of company law or the articles of association. A decision may be deemed illegal for several reasons such as: violation of the procedures for convening the meeting, misuse of representation rights, lack of crucial information, acting under conflict of interest, among others. This creates very difficult conditions for the board members to operate within, since on the one hand they must follow the instructions, yet on the other hand they are obligated to ignore them if the decision is illegal. If a board member complies with instructions which are illegal and/or harmful to the company, in addition to holding the board member liable, it is possible to also extend liability to those who influenced the board decision or the transaction (refer to section 1.1).

Examples of these are clearance of upstream loans and cash-pooling systems since 1 Nov 2008. Before that the German Federal High Court found that cash-pooling agreements which cause the pool-members to transfer their registered equity to the pool might give rise to unlimited personal liability of the directors, if the pool-leader becomes insolvent thereafter and therefore the directors have to refuse almost any instructions by the shareholders to grant upstream loans.\textsuperscript{151} The new rules mean that directors of German companies cannot simply refuse to grant upstream loans. If all shareholders instruct a director to grant a loan, he/she will now – as a general rule – be bound by such instruction. The new approach is the balance-sheet test, under which cash may be swapped for claims against the shareholder of the same value.

\textsuperscript{151} BGH, Judgment of 16 January 2006, II ZR 75/04.
Therefore, German companies can now grant upstream loans and participate in cash-pooling systems with all their available cash, provided that the receivables against their shareholders prove to be of full value. If (minority) shareholders oppose the loan, the director’s position becomes difficult. The director must act according to the instructions given by the shareholders’ meeting (i.e., the vote of the majority shareholder), but at the same time the majority shareholder may not misuse its voting power to achieve its own interests to the detriment of the objective interests of the company.\(^\text{152}\)

Therefore, the executive director of a stock corporation in Germany is normally not authorized to follow the directions and/or instructions of the shareholders’ meeting or of an individual shareholder or of a third party. But the situation is different in the case of private limited companies, where the director is required to follow the instructions of the shareholders’ meeting, which may include directions from a parent company if it is the controlling shareholder of the company. Nevertheless, any individual shareholder (i.e., outside a formal shareholders’ meeting) or third party is prohibited from giving directions or instructions to the managing director.

2.2.2 Estonia

The management structure of Estonian companies is similar to that of Germany and the overlapping principles will not be repeated in this chapter. A supervisory board is obligatory for all stock corporations (aktsiaselts). A private limited company (osaühing) must have a supervisory board if the share capital is greater than Euro 25,000 and the management board has less than three members, or if prescribed by the articles of association.\(^\text{153}\)

Under Estonian law, management and supervision are strictly separated. A member of the supervisory board may not be a member of the management board and \textit{vice versa}.\(^\text{154}\) The members of the management board are elected and removed by


\(^\text{153}\) Estonian Commercial Code § 189(1).

\(^\text{154}\) Estonian Commercial Code § 180(3) and § 308(3).
the supervisory board. Estonian laws do not provide an explicit definition of the independence of the boards or do not explicitly require that a board member must be independent, but he/she must act according to the best interests of the company and in good faith.

a) Supervisory board instructions

The supervisory board plans the activities of the company, organises the management and supervises the activities of the management board. As it stands currently in Estonia, regulation is unclear about the scope of how much the supervisory board can interfere in the management of the company. The articles of association may grant the supervisory board the right to decide on other issues which are not placed within the competence of the management board or the general meeting pursuant to law or the articles of association. As the competence of the management board is quite broad, it is likely to create lack of understanding between the supervisory and the management boards. For that reason, the author calls for specific and clearly defined regulations that would establish supervisory competence conclusively in either the articles of association or by legislative action.

At the same time, the law states that the competence of a body of a legal person may not be transferred to any other body or person and a member of a body of a legal person may not transfer his or her rights as a member of the body arising from law unless otherwise provided by law. Accordingly, the Supreme Court stated in a decision of 23.12.1997 that although the supervisory board has the right to restrict the management board’s right of representation, it remains the absolute right of the management board, and the supervisory board cannot thus assume the right to represent the company in certain transactions or disputes with third persons. The same principle may thus also apply to other daily management decisions.

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155 Estonian Commercial Code § 184(1) and § 309(1).
156 Estonian Commercial Code § 316.
158 Estonian General Part of the Civil Code Act § 31(3).
159 Estonian General Part of the Civil Code Act § 31(6).
The Estonian Supreme Court has in several decisions also referred to the existence of implied power. In a decision of 31.03.2004 the court found that although it may not be expressly provided by law, the management is obligated to inform the members of the supervisory board of events such as a merger. This allows the supervisory board to exercise its rights related to clarifying facts and going through documents and secures its right to call for a general meeting to decide upon the merger of a stock corporation. Directors cannot therefore proceed solely from the wording of the law and are obligated to involve the supervisory board and owners in important decisions.

The supervisory board gives orders to the management board regarding organisation of the management of the company. Consent of the supervisory board is required for conclusion of transactions which are beyond the scope of ordinary course of business and, above all, for conclusion of transactions which bring about:

1) acquisition or termination of holdings in other companies;
2) foundation or dissolution of subsidiaries, or
3) acquisition or transfer of an enterprise, or the termination of its activities;
4) transfer or encumbrance of immovables or registered movables;
5) foundation or closure of foreign branches;
6) investments exceeding a prescribed sum of expenditure for the current financial year;
7) assumption of loans or debt obligations exceeding a prescribed sum for the current financial year; or
8) grant of loans or guarantee of debt obligations if this is beyond the scope of the ordinary course of business of the company.

The articles of association may prescribe that the consent of the supervisory board is not required, or is only required in the cases specified in the articles of association, and may prescribe other transactions for the conclusion of which the consent of the supervisory board is necessary. Thus, the supervisory board has authority over management; and consequently, the management board is restricted from finalizing

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161 Estonian Supreme Court decision No 3-2-1-7-10, 31.03.2010, RT III 2010,15,108 p. 29.
162 Estonian Commercial Code 317(1).
transactions which are beyond the scope of ordinary course of business without the supervisory board’s approval. What defines “ordinary course of business” is clearly debatable; and it is the author’s opinion that interpretation of the term must be left to the shareholders to decide rather than be defined by Estonian legislation, since shareholders have invested in the company directly and as a consequence are in the position to potentially suffer the most significant losses. The author recommends including acquisition of immovables and encumbrance of the enterprise or shares in the list of issues requiring the supervisory board’s consent because these are fundamental and often crucial issues.

Consent is not required for conclusion of a transaction if a delay in conclusion of the transaction would bring about significant damage to the company.\(^{163}\) This provision is necessary in order to react quickly in accordance with the company’s best interests. Nevertheless, the author is of the opinion that this provision should be interpreted carefully because calling a supervisory board meeting is quite easy and fast under the law. It is also problematic that the law does not obligate the management board to notify the supervisory board of such a transaction as soon as possible after it has been made.

Furthermore, appointing a board member to the management board automatically creates an authorisation agreement with the company. The agreement exists whether it is concluded in writing or not.\(^{164}\) The Law of Obligations Act requires that a mandatary must adhere to the instructions provided by the mandator upon performance of the mandate. A mandator may not provide specific instructions concerning the manner or conditions of performance of the mandate in the case where the mandatary is expected to perform the mandate based on the mandatary’s professional skills or abilities.\(^{165}\) Therefore, the instructions of the company cannot be too specific. Nevertheless, the law provides that if a mandatary wishes to deviate from the instructions of the mandator, the mandatary shall inform the mandator thereof and wait for the decision of the mandator, except in the case where a delay would be likely to cause unfavourable consequences for the mandator and if it may

\(^{163}\) Estonian Commercial Code § 180 and § 317.

\(^{164}\) Estonian Law of Obligations Act § 619.

\(^{165}\) Estonian Law of Obligations Act § 621(1).
be presumed under the circumstances that the mandator will approve of the deviation. In the case where adherence to the instructions of a mandator would be likely to cause unfavourable consequences for the mandator, the mandatary must comply with the instructions only after the mandatary has called the mandator’s attention to such consequences and if the mandator fails to modify the instructions.\textsuperscript{166} Therefore, the management board cannot merely ask for the opinion of the supervisory board and/or shareholders without sharing their own opinions and insights, and fully disclosing all possible consequences and outcomes.

Estonian law does not regulate situations where the supervisory board refuses to approve the management board’s transaction. If the management board considers a transaction to serve the best interests of the company, then they have to have the possibility to ask a second opinion from the owners. However, Estonian law does not address situations where the opinion of the shareholder(s) and supervisory board differs. Whose opinion will prevail? That might be considered as a weakness of Estonian law.

The management board must, in directing, adhere to the lawful orders of the supervisory board.\textsuperscript{167} The meaning of the term “lawful” is ambiguous and burdens the directors with an extra obligation to assess whether the higher body’s decision is legitimate. The supervisory board’s approval of a particular action by the director does not release the director from liability before the company. The aforementioned is also supported by a provision of the draft Fifth Directive,\textsuperscript{168} according to which authorization given by the supervisory organ does not have the effect of exempting the members of the management organ from civil liability.

Absence of the supervisory board’s approval does not make a given transaction void because such approval is not valid with respect to third persons.\textsuperscript{169} On the other hand, the Supreme Court has emphasized in its decision of 04.03.2002\textsuperscript{170} that a transaction concluded without approval may result in liability for the director and

\begin{itemize}
\item \textsuperscript{166} Estonian Law of Obligations Act § 621(2-3).
\item \textsuperscript{167} Estonian Commercial Code § 180(4) and § 306(2).
\item \textsuperscript{168} Amended proposal for a fifth directive, Art 14(4).
\item \textsuperscript{169} Estonian Commercial Code § 317(4).
\item \textsuperscript{170} Estonian Supreme Court decision No 3-2-1-26-02, 04.03.2002, RT III 2002,9,94, p. 8.
\end{itemize}
has, for example, accepted in a decision of 11.05.2005\textsuperscript{171} that the sale of assets without the supervisory board’s approval constitutes a breach of the duty of care.

b) Shareholders’ instructions

Estonian law provides for issues that remain in the competence of owners of stock corporations or private limited companies. Those lists include none of the transactions or operations falling within the ordinary course of business. However, shareholders of private limited companies may also adopt resolutions on matters which are within the competence of the management board or supervisory board\textsuperscript{172} without their consent. The shareholders may establish the range of such issues in the articles of association or adopt an ad hoc decision with regard to an issue. Therefore, the shareholders of a private limited company may interfere in the company’s ordinary course of business to quite a large extent. In a stock corporation, the possibility to give instructions by shareholders to the management board is much more limited. According to law, the general meeting may adopt resolutions on other matters which are not expressly stated in law only on the demand of the management board or supervisory board.\textsuperscript{173} Therefore, the general extent to which the owners are allowed to interfere in daily management is similar to that of Germany.

If an Estonian company does not have a supervisory board, the management board may decide on all issues related to the business of the company without involving other corporate bodies (e.g. shareholders), unless the articles of association prescribe otherwise. This may ignite a series of court disputes since the management board is able to transfer all the assets of the company without notifying the shareholders or other board members. In such a case, the shareholders and company are left with only one option, and that is to claim damages: a plea that is hard to prove and even if successful, rarely sufficiently covers full losses (e.g. future profits). The Estonian Supreme Court has in several decisions also referred to the existence of implied power, offering a new interpretation of the question of when the

\textsuperscript{171} Estonian Supreme Court decision No 3-2-1-41-05, 11.05.2005, RT III 2005,17,181, p. 18.
\textsuperscript{172} Estonian Commercial Code § 168(2).
\textsuperscript{173} Estonian Commercial Code § 289(2).
involvement of shareholders is needed. In this respect the court found in its decision of 03.12.2004 that regardless of whether a decision to establish a subsidiary requires the supervisory board’s approval or not, it also requires the approval of a general meeting of shareholders if the economic effect of establishing the subsidiary might be equivalent to division through separation because a part of the parent company’s assets will be transferred to the subsidiary (in the current case, the parent company contributed significant funds to the share capital of the subsidiary, but the shareholders of the parent company, and not the parent company itself, would have become shareholders of the subsidiary). The court found that this statutory requirement is appropriate since all of the above-mentioned transactions have a significant implication for the interests of shareholders. According to the court decision, corporate bodies must first evaluate the results of a transaction and then, on the basis of these outcomes, decide to whose competence the issue falls. Thus, the inferior bodies (the management board and supervisory board) are obligated to exercise caution and involve the shareholders in fundamental decisions even if the law does not expressly provide for such an obligation. It is recommended by the author that the same interpretation is to be followed in cases where the company does not have a supervisory board; as well as to ensure that this practice is to be stated into law. The shareholders must be involved in the decision making process regarding transactions which have a significant influence over their interest. It is the author’s opinion that regulation is needed regarding companies without a supervisory board to guarantee shareholder involvement in transactions that go beyond the ordinary course of business similarly to the competence of the supervisory board.

The management board is also obligated to follow decisions that yield economically most efficient outcomes; yet, the same obligation does not apply to the shareholders when giving instructions to the management board. A director should also remember that his/her actions must be driven by loyalty to the interests of the company and not the persons related to the company, such as shareholders, the state or other stakeholders. He/she should resist any influence to conclude transactions

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against the good of the company, even if so required by a decision of shareholders or the supervisory board. Similarly to Germany, liability of the influencing person is accepted in Estonia from 1 January 2006 (see section 1.2.1). As a result, liability of a director may arise in a situation where a parent company influences the management board of a subsidiary to adopt a decision beneficial for the parent company but harmful to the subsidiary. Estonia’s highest court is yet to make a decision ordering damages from an influenced person.

The Supreme Court has, however, referred to this possibility in some of its other decisions. For example, a decision of 31.03.2010\textsuperscript{175} states that the basic case of liability of directors does not allow shareholders to file direct claims against directors as this right belongs exclusively to the company. Such claims are, however, possible by invoking the liability of an influencing person or beneficiary. It matters not which specific decisions the person made as a shareholder or director or whether he/she influenced the members of management bodies to make such decisions or used third companies or persons for the purpose. For example, a Finnish court passed a judgment on 12.09.1991\textsuperscript{176} whereby directors were ordered to pay damages caused to a company by a joint decision of the management boards of the parent and subsidiary to purchase goods from the parent company’s shareholders at prices that were significantly higher than usual. Thus, a transaction being beneficial to shareholders cannot supersede the interests of the company. That might, in some instances, create a contradiction and raise the question whether a decision which is not the most economically purposeful for the company is lawful or whether an unlawful instruction is only such instruction which is objectively unlawful or whether the director must analyze subjective criteria. If the shareholders adopt a resolution which normally falls within the competence of the supervisory board or management board, they will be solidarily liable in the same manner as members of the management board or supervisory board for damage caused by such

\textsuperscript{175} Estonian Supreme Court decision No 3-2-1-7-10, 31.03.2010, RT III 2010,15,108 p. 29.
resolution.\textsuperscript{177} Management board members are not liable if they act pursuant to a lawful resolution of the general meeting.\textsuperscript{178}

Therefore, the directors are not liable for losses caused to the company if they were acting \textit{bona fide} within a framework of a legitimate decision of the meeting of shareholders of the company. This principle is contrary to the draft Fifth Directive,\textsuperscript{179} according to which the authorization given by the supervisory organ does not have the effect of exempting the members of the management organ from civil liability. However, as the draft is no longer in the works and will probably not be adopted in the given form, Estonian law cannot be deemed to be in contravention thereof.

### 2.3 Division of obligations and liability

Directors share their managerial responsibilities collectively, regardless of how areas of competence are allocated among them. It is obvious that each manager cannot run the entire business alone. There will always be division of tasks regardless of whether the division is agreed orally or in writing or has simply developed over time. Management board members can be entrusted with different responsibilities, such as finance, marketing, personnel etc. These are often based on the specific training, knowledge or expertise of the person. “There is no requirement as yet in Community law that the company sets up rules of procedure to regulate the mode of activities for the management and supervisory bodies of the company.” \textsuperscript{180} For example, the draft EU fifth directive required that if the management organ has more than one member, the supervisory organ must specify which member of the management organ is responsible for questions of personnel and worker relations.\textsuperscript{181}

Specific areas of responsibility can be divided in Germany and also in Estonia by the articles, by shareholders’ resolution, by a resolution of the supervisory board, by the internal work procedure rules or by agreement with the company or between the directors. All these possibilities do not limit shareholders or third party rights, but they might limit company rights to claim. Also, these possibilities may give the

\textsuperscript{177} Estonian Commercial Code § 168(2) and § 298(2).
\textsuperscript{178} Estonian General Part of the Civil Code Act § 37(1).
\textsuperscript{179} Amended proposal for a fifth directive, Art 14(5).
\textsuperscript{181} Amended proposal for a fifth directive, Art 3(2).
management board the right to exercise regression against a board member whose failure to fulfill his/her obligation resulted in liability. If the division is executed by the articles or by higher body resolution, some of the jointly liable directors may be entitled to full indemnification by the company. The principle of division of liability is established also in the EU draft fifth directive\textsuperscript{182} whereunder each member is jointly and severally liable without limit but may exonerate himself/herself from liability if he/she proves that no fault is attributable to him/her personally. The directive stresses that release from liability applies even where the powers vested in the organ have been allocated among its members.

2.3.1 Germany

The management board conducts the company’s business jointly and unanimously, unless otherwise provided by the company bylaws.\textsuperscript{183} Even if managing directors have been assigned a distinct area or field of primary responsibility, such division of competencies has internal effect. External liability is a joint and several one.\textsuperscript{184} If several managing directors have been appointed, each of them is obligated to comply with the statutory duty to file for insolvency, irrespective of his internal field of responsibility and of his general signing authority.\textsuperscript{185}

As a general rule, a GmbH cannot invoke a violation of such an internal limitation vis-à-vis third parties in order to nullify a commitment made by the managing director on behalf of the company that was not in line with the managing director’s internal competencies. This may be different only if the third party in question was well aware of the managing director going beyond his internal authority and violating the internal limitation, or if the third party should have been aware that the situation was such that any reasonable person would have immediately detected a violation of the internal limitation of the managing director’s authority. Violation of such an internal limitation constitutes a breach of a board member’s service contract with the company and gives rise to a claim by the

\textsuperscript{182} Amended proposal for a fifth directive, Art 14(2-3).
\textsuperscript{183} AktG § 77(1).
\textsuperscript{185} GmbHG § 64(1) and AktG § 92(2).
company against the managing director for damages and may justify his dismissal for cause.\textsuperscript{186}

Generally, board members typically have joint and several liability. However, if the functions are divided among the members by the supervisory board or by the shareholders’ meeting, then a board member does not have the right to trespass on another board member’s "playground". In this case, liability for the results of a board member’s actions or omissions in his/her field cannot pass to other board members. So there can only be liability towards third persons, and a board member whose sphere of competence was interfered with should have the right to demand indemnification from the company or right of recourse against the board member in breach.

Division of obligations and liability may also be determined by agreement between the directors or by work procedure rules. Specific work procedure rules can be established by the board itself, unless otherwise provided for in the company’s statutes.\textsuperscript{187} The CGC recommend that rules of procedure for the management board be established, describing the quorum applying to management board resolutions, the operational responsibilities of each director and the matters that are under the operational responsibility of the management board as a whole. Such division does not limit the company’s or third parties’ rights to claim damages from all directors, but gives the directors the right of recourse against the member in breach.

Division of obligations and liability can sometimes be interpreted also by analyzing the directors’ representation rights. It is up to the company’s statutes whether the management is given the power to represent the company alone or whether two or more board members must act together. If nothing is prescribed, the members of the management board must, as a general rule, act jointly.\textsuperscript{188} It is common in Germany to stipulate that a company is represented by two managing directors acting jointly.\textsuperscript{189}

\textsuperscript{187} AktG § 77.
\textsuperscript{188} GmbHG § 35(2) and AktG § 77.
\textsuperscript{189} Müller K. The GmbH. A Guide to the German Limited Liability Company, p. 27.
Where joint decisions are taken by the whole board, each member who has taken part in adopting the decision will be responsible accordingly. Joint and several liability does not apply if the responsibilities are attributed to one director; in such case, only the director in charge of the respective department can be held liable.

“There is also, at least in principle, no duty to supervise one’s colleagues in fulfilling their duties. The court decisions as well as commentators, however, take a comparatively rigorous stance here. The importance of certain transactions may require that a board and its members ask for (prior) information on those issues, and adopt a policy that they be informed and asked for their consent in advance. And as soon as there are grounds for suspicion a co-director will have to act by himself asking for information etc.”\(^{190}\) Liability of the other directors may arise if it can be shown that they neglected their organizational duties and ignored apparent indications that their co-director had breached his duties.\(^{191}\) German law\(^{192}\) points out specifically and exclusively the cases where damage must be compensated by the board member who caused the damage. In these cases, liability is not shared by board members. Examples of these cases would be where a board member has paid dividends to shareholders in violation of the law, guaranteed loans, signed away company’s assets, acquired company’s own shares, etc.

In order to avoid unexpected liability, it is important to establish internal division of tasks. Division of duties does not affect third parties’ right of claim; however, the central issues here are internal liability as well as the right of recourse in respect of the defaulting member of the board.

### 2.3.2 Estonia

Estonian directors do not have to operate jointly and they usually hold the right of sole representation. Joint operation or coordination with other directors is not expressly required by law. Estonia has established very detailed rules of procedure for the supervisory board and general meeting, but not for the management board. On the other hand, the management board has power over very substantial

\(^{190}\) Baums, T. *Personal Liabilities of Company Directors in German Law*, pp. 9-10.

\(^{191}\) Sieg, O. *Directors’ Liability and Indemnification*, p. 124.

\(^{192}\) AktG § 93(3).
decisions, and failure to regulate their adoption may cause much dispute and damage to the company. The need for coordinated action within such a collective body should be self-evident, but is not inherent in Estonian companies.

Division of liability is also possible in Estonia and regulated basically in the same way as in Germany. The relevant options will not be repeated at this point. As a brief reminder, it is possible to conclude an agreement among the directors or establish detailed rules of procedure or divide tasks between the supervisory board and shareholders by a shareholders’ decision or by the articles of association.

In Estonia, the specific rules of procedure of the management board may be prescribed by the articles of association or by a decision of the management board or supervisory board.\(^{193}\) Regrettfully, the work procedure rules are not actively used in Estonia, and the reality that each individual director has autonomous representation rights is bound to create misunderstandings and conflicts. As it stands currently, a company without a supervisory board is not obligated to discuss even the most basic decisions in management board meetings, fostering an environment in which each director is likely to develop a different view of what is best for the company and as a result, lead to conflicting actions. There is a wide range of serious issues and difficult situations that the above explained problematic practices have and will continue to allow. A recent court dispute of 29.10.2008\(^{194}\) in which almost the entire asset pool of a company was sold to a foreign entity by one director without consulting the other board member illustrates just one of those cases. As can be expected, the question under heated discussion was whether the transaction indeed served the best interest of the company and whether it caused irreparable damage. Also notable is a decision of 04.05.2010\(^{195}\) in a case where one of three directors concluded an agreement whereby the company guaranteed the obligations of an insolvent third person of whose management board he was also a member. As a reaction, the other two directors sold the company’s immovable for about a quarter of the market price and thereafter concluded a rental agreement allowing the company to remain the user of the immovable. The sale of immovable was justified by the need to eliminate the risk

\(^{193}\) Estonian Commercial Code § 306(5).

\(^{194}\) Estonian Supreme Court decision No 3-2-1-74-08, 29.10.2008; RT III 2008,43,294.

\(^{195}\) Estonian Supreme Court decision No 3-2-1-33-10, 04.05.2010, RT III 2010,22,154, p. 10.
of claims for payment against the company’s immovable property arising from the guarantee. The author finds that such a controversial sequence of transactions could have been avoided if a requirement of majority approval or joint representation had been in force for the management board.

In Estonia, directors usually hold the right of sole representation, which may be restricted by articles of association or a shareholders’ decision. The only aspect that the law does not allow restrictions in is the obligation to submit an insolvency application, which may thus be considered a mandatory provision similar to German law. Restrictions on the right of representation will apply to third persons only if entered into the commercial register, not by virtue of the articles of association. An analysis of the right of representation will therefore reveal some information on the division of tasks between directors. However, it is not possible to have the right of representation registered by fields of activity. Under applicable law, directors acting on behalf of the company must follow the restrictions established by the articles of association or the decisions of shareholders, supervisory board or management board, but such restrictions are not valid with respect to third persons. If a director violates a restriction on the right of representation, he/she may be deemed in breach of his/her obligations. Conduct against the will of other directors is considered a company’s own problem as it can be avoided by establishing appropriate rules against such conduct.

Estonia has adopted most of the principles of the German commercial code, with the exception of joint representation. Furthermore, it has failed to regulate the risks and problems arising from the exception. The author opines that it would be unfeasible for Estonia to introduce joint representation of board members so as to prevent conduct against a company’s interests by requiring involvement. Nevertheless, the author recommends introducing basic regulation that would make the management board meeting mandatory, provide the outline for the meeting’s structure and execution, define significant matters to be addressed, and specify what is to be accomplished by the assembly. The director may undertake measures that are

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196 Estonian Commercial Code § 181(1) and § 307(1).
197 Estonian Commercial Code § 181(2) and § 307(2).
unusual or extensive in view of the scope and nature of the activities of the company only if so authorised by the meeting of the management board, and in the latter case the board must be notified of the measures as soon as possible.

In case of a multi-member management board, situations may arise where damage has been caused by a single member of the board while the others have breached their obligations by taking no action to prevent such conduct. Examples: (a) a management board member concluded a harmful contract, the other members were aware of this but did not stop it; (b) responsibilities have been divided between management board members. One fails to perform an obligation in its area of responsibility. The others are aware of this, but take no action.198.

If a director’s failure to act (e.g. complete disregard for the company’s affairs) allows another member to act unlawfully, both members will have failed to duly fulfil their obligations. Thus, dividing responsibilities so that some members have no responsibilities whatsoever cannot be lawful. On the other hand, a director’s possibilities to stop another member should be assessed. “But in a situation where one management board member is, for example, away on vacation while the other one unlawfully disposes of the assets of a stock corporation, the member on holiday cannot be held liable if the management board member who caused the actual damage had not disclosed the unlawful intentions and such intentions could not have been reasonably suspected.”199

Similarly to Germany, Estonian law provides the cases where damage must be compensated by the board member who caused the damage and not jointly by all the members. Such cases include: a) submission of incorrect information to the commercial register;200 b) incorrect valuation of a non-monetary contribution;201 c) illegal dividend payment etc. As a result, those actions may be subjected to different liability agreements but no such agreement can be valid in respect of persons who are not parties thereto.

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200 Estonian Commercial Code § 33(8) and § 146 and § 252.
201 Estonian Commercial Code § 143(4) and § 249(4).
202 Estonian Commercial Code § 158(3) and § 280(3).
Agreement on division of responsibilities and respective liability between directors does not in any way limit the right of claim of persons who are not parties to the agreement. For example, a company’s right of claim cannot be limited by an agreement between directors, nor will an indemnification agreement within the company limit the right of claim of a third person or a trustee in bankruptcy. A creditor or trustee in bankruptcy has the right to file a claim also if the company has entered into a contract with the member of the management board upon which the company has limited its claims against the director.\footnote{Estonian Commercial Code § 187 (3,5) and § 315 (3,5).} A creditor has the right to submit a claim also if a legal person has waived a claim against a member of the management board or has entered into a contract of compromise with such member. A creditor has the right to submit a claim also if the liability of a member of a directing body is restricted in comparison with the provisions of law.\footnote{Estonian General Part of the Civil Code Act § 37.} Similarly to Germany, Estonian law provides a possibility for the liable director to file a recourse action against another director insofar as he/she has fulfilled a claim for the other director,\footnote{Estonian Law of Obligations Act § 69(2).} or against the company, if he/she is liable to third parties for damage caused by actions that were outside his/her contractual area of responsibility.

The above indicates that Estonian provisions and interpretations regarding the division of responsibilities are similar to those of Germany. However, the Estonian Commercial Code requires updating in respect of management boards’ rules of procedure, the involvement of directors and their right of representation, because an unlimited right of representation offers too many opportunities for disputes and problems.

### 2.4 Indemnification and waiver

Indemnification means that the company must compensate a director for damages and expenses relating to a claim that arises from performance of his/her duty to the company. Limitation of liability means that the liability is limited by amount, time, gravity of the offence, or some other factor. Indemnification or limitation of liability by the company or by the shareholder is one way to achieve clearance of liability.
The possibility of discharge depends on whether the company itself and/or a third party have a claim against the director, and on whether it is given for specific claims or in a more general form as an advance. By including superior bodies in high-risk decision making processes (refer to section 2.2), the board members are able to mitigate personal liabilities and also might request or demand exemptions from liabilities.

### 2.4.1 Germany

It is disputable under German law whether managing board member liability to the company can be validly limited in advance by some kind of general agreement. Most scholars are of the opinion that prior commitment to indemnification or waiver is not possible in stock corporations and the rule under § 93 AktG is mandatory. As regards private limited companies, the situation is much more complicated. Some scholars are of the opinion that liability in relation to a private limited company cannot be precluded or limited, either in the articles of association or in a private agreement, but some scholars consider it possible in limited liability companies. This has not been decided by the Federal Court yet, therefore the ambiguity remains.

Nevertheless, the majority of commentators hold that the standard to act with the diligence of a prudent businessman is compulsory and cannot be moderated by the articles of association of the company or contract with the director as prior commitment to indemnification is excluded by general civil law. The management board may seek precautionary indemnification from the shareholders’ meeting and/or from the supervisory board regarding internal liability. Indemnification is not allowed in the case of intentional breaches of duty, and also the question of whether prior indemnification is possible in the event of gross negligence is a subject of legal dispute. There is no court practice expressly dealing with these issues. Some

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206 E.g. Cotta, P, Goetz, A, von Rumohr, Karl. Corporate Governance, Board structures and directors’ duties in 38 jurisdictions worldwide, p. 84.
207 E.g. Sieg, O. Directors’ Liability and Indemnification, p. 129.
208 BGB § 276.
decisions of the Federal Court of Justice suggest that prior indemnification for gross negligence is possible, but these have been criticized by legal commentators.  

The company may waive specific claims against a director. In limited liability companies settlement must be decided by the shareholders’ simple majority vote, unless the articles provide otherwise. A stock corporation can waive or reach a settlement of the company’s damage claims only after a term of three years, upon shareholders’ resolution and if there is no objection by 10 per cent of the shareholders’ meeting to the resolution. A limited liability company cannot waive claims against directors based on breach of certain duties if compensation is needed to satisfy the creditors of the company (breaches of duties concerning maintenance of capital, delay in filing an insolvency petition, breach in connection with an increase in the nominal capital.).

In stock corporations, shareholder claims against directors have been made particularly difficult. A single shareholder does not have the right to bring an action against the management on behalf of the company. A minority with at least a 10 % share of the company’s capital can demand that the supervisory board or a special representative take action against managing directors. The problem here is, however, the high threshold of 10 % of the equity capital. In the case of Daimler Benz, for example, with an equity capital of about DM 2.3 bn this means that one would have to hold shares with a nominal value of DM 230 million or gather and convince other shareholders with equivalent shareholdings. The second problem is that the shareholder(s) who bring this action will have to bear all costs and expenses of the other party and the company should the action be dismissed. The Federal Government is currently considering an amendment of the rules concerning actions against directors by shareholders.

As a director’s liability towards third persons is very rare, the indemnification of directors is not very often raised. Indemnification does not limit the rights of creditors or bankruptcy administrator in case of bankruptcy. “A company may

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211 Sieg, O. Directors’ Liability and Indemnification, p. 129.
212 AktG § 93(4)
213 Sieg, O. Directors’ Liability and Indemnification, pp. 129-130.
214 Baums, T. Personal Liabilities of Company Directors in German Law, p. 12.
indemnify a director against liability to third parties so long as his action does not constitute a breach of his duties to the company at the same time, as well as against liability incurred in any civil or criminal proceedings where judgement is given in his favour.”215 The question of whether the director also breached duties in relation to the company and thereby established internal liability can usually be determined only after a final decision of the proceeding.216

External liability cannot be limited or avoided by a decision of the company organs, but indemnification with regard to third-party claims is possible and even obligatory if a director did not violate the duty of care owed to the company. However, if a respective shareholders’ resolution exists, this may obligate the company to hold the director harmless against the claims of third parties.217 Nevertheless, if there is a violation of the duty of care, the company may, in exceptional cases, indemnify the board member if the general meeting resolves on such indemnification (in the case of a stock corporation, the waiting period of three years must elapse).218 “The director is entitled to indemnification of defence costs in advance, as long as the company can recoup this if the director loses in the civil or criminal proceeding. This director’s claim is based on rights arising from his employment contract (Section 670 of the Civil Code). (...) In principle, if the director loses in a civil or criminal proceeding, defence costs cannot be indemnified. Claims based on Section 670 of the Civil Code are limited in case of contributory negligence on the part of the claimant.”219

Indemnification can also be granted by the parent company or shareholder, but in this case this does not limit the company’s, other shareholders’, third parties’ or creditors’ claiming rights. This is usually done by agreement which can consist of provisions permitted for the company by law. Indemnification by shareholders automatically raises the question whether this is needed to induce the director to act according to the shareholders’ instructions and in the interests of shareholders,

215 Baums, T. Personal Liabilities of Company Directors in German Law, p. 13.
216 Sieg, O. Directors’ Liability and Indemnification, pp. 128-129.
218 Cotta, P, Goetz, A, von Rumohr, Karl. Corporate Governance, Board structures and directors’ duties in 38 jurisdictions worldwide, p. 84.
219 Sieg, O. Directors’ Liability and Indemnification, pp. 128-129.
which might be against the interest of the company and would thus be unlawful. This raises the question whether the agreement was signed in good faith and whether it is valid.

A shareholder, who is at the same time a board member, is not entitled to vote on matters regarding exemption of him/her from a liability or granting of approval to his/her actions as managing director.\textsuperscript{220} It is acknowledged almost a general rule that provisions deviating from such rules in the articles of association are void to the extent the prohibition of voting is founded on the principle that no one is permitted to judge his or her own actions.\textsuperscript{221}

Every year, at the annual meeting, the shareholders decide whether or not to approve the management board’s activity during the previous year. This formal approval does not waive liability claims of a stock corporation, whereas in limited liability companies the formal approval has a (limited) precluding effect.\textsuperscript{222}

As a rule, a director is never contractually exempted from all liability. Usually, under contract, a board member is deemed to be responsible only in the case of an intentional act, gross negligence, if acting without receiving consent from other members and higher bodies and/or without notifying them. The author finds that clearer rules regarding exemptions from liability are needed in Germany to provide companies and board members with more clarity and security.

2.4.2 Estonia

Estonian law does not prohibit the waiver of claims against directors or the limitation of their liability. Similarly to German law, the possibility of discharge depends on whether the company itself and/or a third party has a claim against the director. Unlike Germany, Estonia does not differentiate between private limited companies and stock corporations. As in Germany, shareholders may grant indemnification.

\textsuperscript{220} GmbHG § 47(4).
\textsuperscript{221} Müller K. The GmbH. A Guide to the German Limited Liability Company, p. 44.
\textsuperscript{222} Baums, T. Personal Liabilities of Company Directors in German Law, p. 13.
According to law, the company and director may agree in advance to preclude or restrict liability in the case of non-performance of an obligation.\textsuperscript{223} The law additionally states that agreements under which liability is precluded or restricted in the case of intentional non-performance or which allow the director to perform an obligation in a manner materially different from that which could be reasonably expected by the company or which unreasonably exclude or restrict liability in some other manner are void.\textsuperscript{224} However, the law specifies that if, pursuant to law or a contract, a person is required only to exercise such care as the person would exercise in the person’s own affairs, the person shall nevertheless also be liable in the case of intent and gross negligence.\textsuperscript{225} In a decision of 04.05.2010,\textsuperscript{226} the Supreme Court noted that a director’s liability to the company may be modified by agreement or articles of association, including limiting the liability to intentional or grossly negligent conduct. Thus, Estonian law establishes limitations on indemnity agreements and does not allow such agreements in the case of intent and gross negligence. The author opines that indemnification of directors should also be banned in the case of breaches of the duty of loyalty because operating under a conflict of interest or in violation of the obligation to maintain business secrets or prohibition of competition rules should not be justifiable by carelessness.

Estonian law does not provide a possibility for a director to claim indemnity within a company. The author finds that this might nevertheless be possible in cases where a director has voted against a decision at a meeting and the dissenting opinion has been recorded in the minutes. If a decision of the management board was not adopted unanimously, the members of the management board who voted against the decision might be released from liability to compensate damages to the company caused by such decision. If the dissenting opinion or vote against has been proven, the director may be deemed to have fulfilled his/her obligations with due diligence and will not be liable for violation. Directors should thus have a possibility to claim indemnification from the company or at least file a recourse claim against other

\textsuperscript{223} Estonian Law of Obligations Act § 106(1).
\textsuperscript{224} Estonian Law of Obligations Act § 106(2).
\textsuperscript{225} Estonian Law of Obligations Act § 104(6).
\textsuperscript{226} Estonian Supreme Court decision no 3-2-1-33-10, 04.05.2010, RT III 2010,22,154, p 10.
members who executed the board decision. The importance of taking minutes should be stressed in this context. If minutes fail to show the names of participants, precise voting results, decisions adopted and deliberations held, all directors may still be liable if they are unable to submit proof to the contrary. A management board member of a private limited company might also be entitled to claim indemnification if an issue has been decided by the shareholders’ meeting and the director has later followed the decision (see section 2.2.2), or in cases where a supervisory board has the legal right to permit a director to act contrary to general provisions of the law (e.g. by release from the confidentiality obligation or prohibition on competition).227

Approval of annual reports or disclosing information to a higher body does not mean that the company has waived liability claims against its directors and will not constitute grounds for indemnity. However, if a superior body can be deemed to have approved or tolerated the management board’s conduct, this might have a precluding effect and serve as an argument in court for indemnification or limitation of liability. In Finland, for example, the decision to indemnify a director must be taken at the time of approval of the annual report. According to the Finnish Companies Act228, indemnification will not affect the shareholders’ right to propose a claim for damages against a board member at a general meeting if incorrect or incomplete information had been provided in the annual report, auditor’s report or otherwise with regard to the transactions for which damages are claimed. Where indemnification is refused, the company must immediately file its claim for damages: the action must be filed with a court within one year from submitting the annual report to the company’s general meeting.

Concluding an agreement (including a compromise) and waiving or filing a claim against a director must be decided by a superior body. Therefore, the general meeting (in the case of a limited liability company) or the supervisory board (in the case of a stock corporation) can adopt a decision on the release of directors from liability towards the company.229 A waiver decision can only be made with respect to certain actions that have caused damage to the company and have been specifically

227 Estonian Commercial Code § 186(2) and § 313(2).
228 Finnish Companies Act (Osakeyhtiöaki- OYL) 21.7.2006/624 15:5.
229 Estonian Commercial Code § 168(1) and § 317(8).
disclosed by the director. Upon indemnification, the decision-makers will also have to strictly observe the duty of care inherent in their position.

Shareholders’ right to vote in a conflict of interest situation is restricted. A shareholder may not vote if release of the shareholder from obligations or liabilities, conclusion of a transaction between the shareholder and the company, or conduct of a legal dispute with the shareholder or appointment of a representative of the company in such legal dispute or transaction, is being decided. The votes of such shareholder will not be taken into account in the determination of representation. Estonia has not seen enough debate on whether derogations from this principle should be allowed by mutual agreement. The author finds this to be an imperative provision which cannot be changed by agreement or articles of association without violating the principle of good faith.

The author opines that any waiver of claims for damages should be approved by the shareholders and the supervisory board’s decision alone is insufficient. Damage to the company usually means damage to shareholders through share price losses, which explains why the shareholders’ involvement in decision-making should be guaranteed. An additional problem is that if release from liability has been decided on the basis of false information, the decision needs to be disputed whereas the common term for disputing a decision is three months from adoption. Estonian laws should therefore provide, as the Finnish Companies Act does, that a decision of the general meeting on the discharge of a member of the board of directors or the managing director from liability is not binding if the general meeting has not been given essentially correct and adequate information about the decision or measure underlying the liability in damages.

As a director’s liability towards third persons is very rare, indemnification against creditors is not very often raised. It must be noted that such release from liability does not limit the rights of shareholders as well as creditors to pursue claims against the director, as the case may be. A director’s liability in the case of insolvency is not subject to limitation or waiver by the company either. The law states that a

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230 Estonian Commercial Code § 177(1) and § 303(1).
231 Finnish Companies Act 22:6(1).
creditor or trustee in bankruptcy has the right to file a claim also if the company has waived the claim or has entered into a contract of compromise with such member or resulting from an agreement, has limited the claim or filing thereof in another manner or has reduced the limitation period.\textsuperscript{232}

The author finds that Estonian law provides sufficiently clear boundaries for releasing directors from liability and changes are not needed in this area. Without prejudice to the aforementioned, shareholders should be involved in the process of discharging directors from liability.

2.5 Limitation period

Expiry of liability is one more option that enables avoidance of liability. If the limitation period has expired, no claims can be filed against a board member who caused damage to the company or acted illegally. A time-barred claim may be submitted to the court and a member of the board may even satisfy it, but if the board member challenges it because the limitation period has expired, there is no possibility to enforce it. The purpose of the limitation period is to ensure the security of business and legal peace; expiry of a claim does not relieve the debtor from performance of the obligation due but offers the opportunity to object to the claim upon the expiry of a certain time.\textsuperscript{233}

2.5.1 Germany

In Germany, the limitation period when a claim becomes statute-barred is generally five years.\textsuperscript{234} However, we can find a variety of situations when there are shorter and even longer periods. “The German legislator has learned its lessons from the financial crisis where some German banks and companies got themselves into serious financial difficulties and the German government had to provide facilities and/or grant securities at the expense of the German taxpayer, whereas the management of banks and companies – more or less – have not yet been charged for

\textsuperscript{232} Estonian Commercial Code § 187(5) and § 315 (5).
\textsuperscript{233} Vutt, M. Aegumine tsiviilõiguses. Kohtupraktika analüüs, p. 28.
\textsuperscript{234} GmbHG § 43(4).
their failure." An example of this would be the Restructuring Law (Restrukturierungsgesetz), which came into force on 31.12.2010. According to law, the limitation period was extended from five to ten years for claims of a listed joint stock corporation or a financial institution against its members of the board and/or the supervisory board who had infringed their obligation to exercise diligence.

The five-year period starts when a claim comes into existence, i.e. when the claimed damage is caused by the managing director’s action or failure to act. The court stated that whether or not the shareholder’s meeting is informed or has otherwise obtained knowledge of the respective facts giving rise to a claim for damages is irrelevant for tolling purposes. The problem is, however, that such acts may not necessarily become known before the five-year deadline has passed. The new Finnish Company Law provides good solutions to this issue by giving different expiration dates and by setting the limitation period to begin at the disclosure of the offence or at the end of the financial year in which the offence is committed. Finland’s legislation also mandates that the limitation period be suspended when the general meeting has decided to file a claim against a member rather than when the claim has been filed with the court. The claim must be submitted to the court within a reasonable period of time after the decision.

It is possible to extend the limitation period by agreement but it is questionable whether it is possible to shorten by agreement the minimum limitation period set by law.

### 2.5.2 Estonia

In Estonia, the limitation period for assertion of a claim against a member of the management board is also normally five years. The draft Fifth Directive provides that the period in which an action to enforce liability may be brought may not be less than three years. Thus, German and Estonian law currently provide a longer term

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236 BGH, Judgment of 21 February 2005,– II ZR 112/03.
238 Estonian Commercial Code § 187(3) and § 315 (3).
239 Amended proposal for a fifth directive, Art 21.
than would have been foreseen for the European Union as a whole. However, also in Estonia we can find a variety of situations when the law states shorter limitation periods. For example, the limitation period for a claim to terminate an activity which is not in compliance with the prohibition on competition rules and to transfer the income received from the prohibited activity is three months from the date the company becomes aware of the violation of the prohibition on competition but not longer than three years after the violation of the prohibition on competition (the general limitation period applies to a claim for compensation of damages). The Estonian regulation concerning expiry periods has not been amended due to the period of economic turmoil.

The author finds that the running of the limitation period in the case of intentional violations requires further analysis. The General Part of the Civil Code Act provides a three-year general limitation period for all transactional relationships. The Commercial Code extends this to five years in the case of directors’ liability. However, the General Part of the Civil Code Act provides a 10-year limitation period for claims arising from intentional violation of obligations. This longer limitation period is not included in the Commercial Code, although the relationship is of the same transactional nature. For example, the Supreme Court has found in its decision of 24.10.2008 that the five-year limitation period provided in the Law of Obligations Act for intentional violations of transfer of enterprise regulations should be viewed in conjunction with the longer limitation period of the General Part of the Civil Code Act. The Supreme Court thus concluded that transactional relationships should be subjected not only to the provisions of special laws but also the General Part of the Civil Code Act, regardless of whether the special laws include an express reference to the latter. “However, circuit courts have generally adopted a principle that the longer limitation period should be assessed restrictively with regard to intentional violations and should only be taken into account in the case of an obligated person’s bad faith or dishonesty. Circuit courts

240 Estonian Commercial Code § 185(3) and § 312(3).
241 Estonian General Part of the Civil Code Act § 146(1).
242 Estonian General Part of the Civil Code Act § 146(4).
have found, for example, that as the limitation period is among other things intended to force the creditor to pursue its right of claim within a reasonable period, a restrictive interpretation of intent is justified in the case of limitation periods.”244 The author also finds that the application of directors’ liability should be subject to analysis of whether the limitation period has been extended to 10 years as a result of intent. Similarly to German law, the limitation period of a claim begins when the claim falls due. A claim will be considered falling due at the moment when the entitled person obtains the right to claim performance of the obligation corresponding to the claim.245 In some cases, the law also provides a different starting point for limitation periods. For example, the limitation period will be five years if during a merger process any damage is wrongfully caused to the company, the partners or shareholders, or the creditors by entry of the merger in the commercial register.246 But as expiry begins with the commission of the act, it may sometimes be very hard to establish the moment of beginning. For example, the Supreme Court has found in a decision of 09.06.2009247 that expiry should not be counted from the moment of taking money from a company’s cash register but the moment when the money was used against the company’s interest, e.g. the moment when a director put it to use in its own interest or the interest of a third person. The draft Fifth Directive provides that a period of limitation commences from the date of the act giving rise to damage or, if the act has been disbursed, from the time when it has become known.248 Such derogation is not provided in Estonia. Meanwhile, commencement of the limitation period of tort claims has been tied to the moment when the entitled person became aware or should have become aware of the damage and the person liable for the damage.249 Yet the same has not been provided for a contractual relation between a director and a company - a problem common to both Estonia and Germany. In a decision of 09.04.2008,250 the Supreme Court explained that claims will

244 Vutt, M. Aegumine tsivilõiguses. Kohtupraktika analüüs, p. 46.
245 Estonian General Part of the Civil Code Act §147.
246 Estonian Commercial Code § 403(7).
248 Amended proposal for a fifth directive, Art 21.
249 Estonian General Part of the Civil Code Act § 150 lg 1.
expire in the same manner in cases where a company has later become insolvent. Therefore, a five-year period of limitation on claims for damages also applies in the case of bankruptcy and commences from the commission of the act, not the moment when the trustee in bankruptcy found out about it. The author recommends introducing regulation that would, in addition to existing grounds, allow for the extension or suspension of a limitation period under extenuating circumstances. A company’s bankruptcy or an intentional breach by the director or provision of misleading information to the shareholders are some examples of situations where these conditions could be met.

Estonia has not established the period during which a claim against a board member must be filed following a respective decision. In this context, another good example can be brought from the Finnish Companies Act which limits the period during which a claim against a board member must be filed once this has been decided at a meeting. If the filing of a claim has been decided, the action must be brought within three months of the decision. The author finds such regulation well justified as it should not be permissible to wait for years before filing a claim. Otherwise a situation could arise when the decision to file claims against a director has been adopted but the claims will not be filed with a court until shortly before the expiry of the five-year limitation period. This would be very stressful for the director and might give rise to manipulations.

According to the Commercial Code, a period of limitation differing from that set out by law can be established by agreement or changed by the articles of association of the company. The Commercial Code fails to specify whether the period can also be extended or only shortened. Such agreements will nevertheless be subject to provisions of the GPCCA according to which the parties may agree to extend a limitation period of less than ten years, but not more than up to ten years. Certain limitations also apply to agreements shortening the period of limitation. The alleviated conditions for expiry are not applied if the obligated person intentionally

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251 Finnish Companies Act 23:7(3).
252 Estonian Commercial Code § 187(3) and § 315 (3).
253 Estonian General Part of the Civil Code Act 145(2).
violated the person’s obligations.\textsuperscript{254} Anyhow, if the limitation period is reduced by agreement with the director, then it does not limit the right of the creditor or trustee in bankruptcy to file the claim against the board member.\textsuperscript{255} Waiver of the right to demand application of limitation is void.\textsuperscript{256}

The courts or other dispute resolution bodies do not automatically observe periods of limitation; expiry of a claim will only be taken into consideration at the request of the obligated person.\textsuperscript{257} “Preclusion terms (Ausschlussfrist) apply automatically, the obligated person need not invoke them separately, they will be checked by the court.”\textsuperscript{258} However, an expiry claim cannot be submitted against claims for recognition, for example. Accordingly, the Supreme Court has explained in its decision of 21.05.2009\textsuperscript{259} that the expiry of a claim for breach of obligation does not mean that the very fact of breach would cease to exist. Unless remedied, a contractual obligation will remain breached even if the claim for performance has expired, insofar as the obligation set out in the contract remains unfulfilled. On the other hand, cancellation of a contract is void if the claim for performance has expired and a management board member relies on such a claim.

\textsuperscript{254} Estonian General Part of the Civil Code Act 145(1).
\textsuperscript{255} Estonian Commercial Code § 187(5) and § 315 (5).
\textsuperscript{256} Estonian General Part of the Civil Code Act 145(3).
\textsuperscript{257} Estonian General Part of the Civil Code Act § 143.
\textsuperscript{258} Vutt, M. Aegumine tsivilõiguses. Kohtupraktika analüüs, p. 6.
\textsuperscript{259} Estonian Supreme Court decision No 3-2-1-53-09, 21.05.2009 RT III 2009, 29, 217, p. 11.
2.6 D&O liability insurance

Liability insurance is one possible way to limit endangerment of personal assets of board members. “The first ever Director & Officer Insurance (D&O insurance) policy came out of Lloyd’s of London in the late 1930s.”260 D&O insurance covers liability of the managing director vis-à-vis both the company and third parties.

2.6.1 Germany

Directors’ and officers’ liability insurance (D&O insurance) is very popular in Germany. “The first D&O insurance was offered in 1986.”261 “German insurers offer D&O policies since 1995.”262 Most listed stock corporations and increasing numbers of small and medium-sized companies carry D&O insurance for their directors.263 “It is, as a practical matter, certainly easier for a company to retain experienced management personnel if D&O insurance is offered as part of the remuneration package. (...) Further, it may enhance the company’s creditworthiness if it can show to its banks that D&O insurance policies are in place. Potential claims of the company against its management would then – at least to a certain extent – be covered by an institution whose ability to pay is not in doubt.”264

The insurance policy usually contains a clause pursuant to which the insurance company only pays for damages exceeding a certain minimum amount. Insurance coverage is excluded in the event the director “knowingly” violated his duties. This is the case if the director was, when causing the damage, aware of the existence of the duty, and if his action or failure to act was not consistent with what such duty demanded.265 “The insurance cover does not extend, however, to cases involving wilful breaches of duties, fraud, dishonesty, criminal behaviour and the like.”266 “Claims under the policy for insurance coverage against costs and fees for defending

261 Baums, T. Personal Liabilities of Company Directors in German Law, p. 15.
263 Sieg, O. Directors’ Liability and Indemnification, p. 130.
265 Ibid. p. 37
266 Baums, T. Personal Liabilities of Company Directors in German Law, p. 15.
against claims (Abwehrdeckung) and/or for compensating any damage (Schadensdeckung) can be brought forward by the director only as an insured individual not by the company.”

D&O insurance is taken out by the company and the company will normally pay the premiums. “The Act on Adequate Director’s Compensation (VorstAG) introduced a requirement for a minimum excess to be retained by the director into the AktG: the D&O liability insurance must provide for an excess of at least 10 per cent of the individual damage up to at least 150 per cent of the fixed annual remuneration of the director. Directors may take out additional insurance that covers the excess, as long as the company does not pay the premium.”

“One insurance company reported recently that liability disputes between directors and their companies are settled outside the courtroom in 90 % of cases.”

“Insurers typically try to force claimants into a two-step sequence: State court litigation against the director and, in a second step, arbitration for the director’s recourse against the insurer. Cases where insurers have provided voluntary cover for compensation of damage are rare (…).” Therefore the existence of liability insurance may become a major factor why compromise agreement with a non-compliant board member is not reached, since the company may be motivated to offset losses by filing for an insurance claim.

The use of liability insurance is well thought out and quite common in Germany. But even in Germany, clearer rules indicating conditions for exclusion of cover should be in place in order to prevent insurance fraud via intentional violations. For example, insurance should not cover board members’ breaches of obligations due to intentional acts or gross negligence.

2.6.2 Estonia

Estonia lacks substantial D&O practice or experience. There is no regulation either. This type of insurance was first introduced around 1995. According to AON

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268 Cotta, P, Goetz, A, von Rumohr, Karl. Corporate Governance, Board structures and directors’ duties in 38 jurisdictions worldwide, p. 84.
269 Baums, T. Personal Liabilities of Company Directors in German Law, p. 4.
Insurance Estonian branch, there might be only about 30 contracts of this kind in Estonia. The reasons why this opportunity is used so little could be rooted in its expensiveness and limited coverage (at least as far as Estonian insurers are concerned).

Regretfully, members of management bodies have limited access to liability insurance. Insurance companies offer director’s liability insurance to selected clients only, but such insurance products are, however, more widely available through insurance brokers. Brokers in Estonia offer the products of foreign insurers (e.g. Chartis Europe S.A., CNA Insurance Company Limited) who provide broader coverage and attach special conditions for each insured person to their general conditions. For example, according to the conditions of CNA Insurance Company Limited, the insurance covers the loss and also the normal defence costs and any punitive or exemplary damages. Loss means the total amount which any insured person becomes legally obligated to pay, including but not limited to damages, judgments, settlements, and the award of claimant’s costs. Loss will not include criminal fines or penalties imposed by law; civil fines and penalties in excess of a certain limit; taxes; matters uninsurable under the law; the multiplied portion of any multiplied damage award; or criminal or bail bonds.

It should also be noted that the premiums for such insurance policies constitute non-monetary remuneration of the management because the management board member is the beneficiary. As a result, such contracts should be approved within the company. Furthermore, there is no clear understanding in Estonia whether the premiums should be considered fringe benefits and taxed accordingly. Because of its high cost and complexity, the author does not expect a wider market for D&O insurance to develop in Estonia.

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272 CNA D&O liability general conditions Estonia D&O 2009, in possession of author.
CONCLUSION

The liabilities of management board members are provided in different laws and have not been combined into a single catalogue. Thus, the board members must keep themselves informed of all the laws and ensure that the company’s activity complies with all requirements. A management board member cannot be expected to be aware of all legal provisions that may influence a company’s operations (such as accounting provisions, tax laws etc), but he/she must be aware to the sufficient extent required for due diligence or involve experts in required fields if necessary.

The purpose of this paper was to examine the liability of management board members and limits of management board members’ liability and the possibilities of changing those limits. The issues were explored through an analysis of Estonian and German legislation and case law. The laws of Estonia and Germany are very similar in respect of the obligations of management board members but relatively different when it comes to exclusion or limitation of liability. Differences can also be observed in legal terms, although such differences are not too substantial (e.g. best interest of the company or acting in the most economically purposeful manner). More important problems are related to issues such as avoidance of conflict of interest. The author finds that the concept of conflict of interest has not been established in sufficient detail and the law does not treat transactions with companies closely connected to the director e.g. through shareholding, relatives etc as conflicts of interest. Also not covered are issues concerning the obligation to disclose, before a management board member’s nomination, information about his/her position in other companies or other facts that may lead to a conflict of interest (given/taken loans, guarantees, other benefits etc.). The right of persons under the duty of loyalty to conduct transactions on non-market conditions if so approved by a superior body – a practice usually not permitted in Europe – is also considered problematic, as is the fact that such transactions, if conducted on market conditions, need not be notified to a superior body at all. The lack of relevant disclosure is apparently a weakness in both legal systems.
The main problem with limiting the liability of a management board member is caused by absence of a business judgement rule. Unlike Germany, Estonia has virtually no regulation, case law or practice in the field. Persons under the duty of loyalty must not only refrain from (negatively) damaging the company managed by them but should also (positively) act to promote the company’s interests. For management board members to be able to take justified risks in the course of business management they should enjoy sufficient freedom and any unreasonable liability associated with risk-taking should be eliminated. It goes without saying that risk-taking is a central aspect of a director’s role. The business judgement rule is intended to limit the liability of board members in order to enable them to take reasonable risks to promote business growth without the fear of losing their personal assets in the case of failure. Without the business judgment rule, courts will have to dig into the reasons of management board members’ decisions, assessing their conduct from the point of view of a hypothetical reasonable person and with hindsight. This leads to application of personal beliefs, which should not be the case. Compared to the United States, the home of the business judgement rule, German law is also underdeveloped in this area. For example, the US recognizes the director’s authority to delegate and the director’s right to rely on others. The author finds that Estonia is in clear need of the business judgement rule.

Superior bodies should be involved in the limitation of management board members’ liability. An apparent deficiency of Estonian law is the lack of regulation dealing with situations where the supervisory board refuses to approve the management board’s transaction. The author recommends implementing a regulation comparable to that used in German law, by which the management board may then bring the matter to a shareholders’ meeting. Estonia’s problem is that while companies with a supervisory board have at least that superior body involved in important decisions, companies without a supervisory board are not subjected to any rules on shareholder involvement. The courts have attempted to fill this legal gap by acknowledging the implied power of shareholders’ meetings. The author finds that regulation concerning this issue is vital for both the management, who should be
well aware of when the owners must be involved, as well as the owners themselves in order to protect their interests.

Estonian legislation is also insufficient in respect of the management board’s rules of procedure and the involvement and right of representation of management board members. Estonian management board members usually have a right of sole representation that differs from the joint representation principle used in Germany. The unlimited right of representation and lack of rules of procedure have created too many opportunities for disputes and problems. Joint decisions and involvement of other management board members should be legally required for all important decisions of a company so as to avoid abuse of the company’s interests and management board members’ differing views on the company’s management.

Differences were also identified and proposals made in relation to other issues such as liability and limitations thereof when acting under the instructions of a superior body, reduction of limitation periods in case the general meeting decides to file a claim against a management board member, as well as extension, suspension or interruption of limitation periods in certain cases.

In conclusion, there are numerous ways of excluding or limiting the liability of management board members. Some can be derived from the behaviour of the management board members themselves (e.g. organisation of work among the directors), some are created by law (e.g. expiry of limitation period) and some through transactions (e.g. D&O liability insurance, indemnification, division of tasks) while some result from the decisions of management bodies (e.g. approval of a superior body, waiver from liability). It should also be noted that liability of management board members offers infinite possibilities for research because the plenitude of different companies, management board members and situations translates into an abundance of issues to be analysed.