Legal Update
Corporate and Tax, Mergers & Acquisitions

Problems Encountered in Connection with the Assessment of D&O Liability

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Introduction

The subject of claims against executive officers of public limited companies and managing directors of private limited companies has become increasingly topical in recent years. The problems involved pertain to claims against former executive officers of financial institutions (e.g., in the case of Bayerische Landesbank) as well as against executive personnel in other sectors.

General Allocation of Burden of Proof

In the case of D&O liability claims, a company (or an insolvency administrator) initiating an action benefits from the general burden of proof rule contained in the second sentence of section 93(2) of the Stock Corporation Act (*Aktiengesetz* – AktG), which also applies by analogy to private limited companies. As a result, the company must at first only provide evidence and proof of the existence of a possible breach of a fiduciary duty. The respective executive officer must then furnish exculpatory evidence, for example, by relying upon the business judgment rule (second sentence of section 93(1) of the Stock Corporation Act). In such cases, it will frequently be impossible to provide exculpatory evidence, in particular if a decision that subsequently proves to have been ill-advised is found to have been based upon inadequate information.

Assessment of Loss in the Case of Complex Business Decisions

On the other hand, a company initiating such an action must provide evidence and proof of the existence of a loss and the corresponding monetary amount, but it is often difficult to furnish such proof of a loss in the case of complex business decisions. Examples would include infelicitous corporate sales and acquisitions or legal transactions. The obligation to provide proof in the case of an infelicitous legal transaction can be problematic if, for example, it is not the transaction itself that is

ill-advised, but rather the conditions that are unfavorable (e.g., leases or financing agreements). If a company is dependent upon the execution of such agreements, executive officers who find themselves held liable will often argue that there was "no alternative" to agreements containing those conditions because no other possibilities were available.

Inadequate Documentation

The situation takes on a paradoxical twist in such cases since an executive officer who has not even gone to the trouble to investigate alternate possibilities more closely and made a decision regarding the matter at issue on the basis of no information at all will be the one with especially good possibilities for mounting a defense since any possibilities that may have existed will in such cases not have been examined and the company bringing the action would have to do so in retrospect and then also provide evidence and proof of the viability of such alternate courses of action in the proceedings. In such cases, deviation from the technical rules of evidence may be available pursuant to section 287 of the German Code of Civil Procedure (*Zivilprozessordnung* – ZPO) (assessment of loss by the court), which applies in the case of causality issues.

It can also be well imagined that the principle of good faith dictates that an executive officer or managing director may not rely upon any actual uncertainty resulting from misconduct on his part. It will be necessary to await the impact of these notions on the case law since no rulings on this issue have been forthcoming from the Federal Court of Justice or higher regional courts.

Assessment of the Implications of Poor Decisions

The question as to whether the implications of business-related decisions should be taken into account in the assessment of losses represents a further problem.

In such cases, the courts often point out that losses must be assessed from an overall perspective. Accordingly, not only the immediate implications of an ill-advised transaction are important in terms of assessing the amount of the loss; it is also necessary to examine the consequential results as compared with the projected hypothetical performance of the company's entire business operations based on the assumption of proper management.

This – substantively right – view of the issue involved can make litigation difficult since it to some extent negates the effect of the rule governing the allocation of burden pursuant to the second sentence of section 93(2) of the Stock Corporation Act, the reason being that it will inevitably prove very difficult to make hypothetical assumptions as regards a company's performance with absolute certainty if claims are brought years later (claims now become time-barred ten years after the tortious event in the case of publicly traded companies). Here too, judicial assessment of the loss pursuant to section 287 of the Code of Civil Procedure will regularly represent the only means of estimating the amount of the corresponding loss once a breach of duty is ascertained.

Special Treatment in the Case of Insolvency

D&O liability claims are often brought by insolvency administrators. A problem that frequently arises in the case of unsound transactions is that losses take the form of liabilities towards third parties. Such liabilities

represent insolvency claims that will regularly be settled only on the basis of the payout dividend from the insolvent estate.

Nevertheless, a company will still be entitled to collect payment of the full stated amount of the liability even if undergoing insolvency. For the purposes of recourse against debtors, the case law recognizes receivables as debts that are recoverable in the full nominal amount even if insolvency proceedings have been initiated against the creditor and only that portion of the corresponding liability will actually be satisfied that is based on the payout dividend. In the case of the insolvency of the creditor, its right of recourse is converted into a claim in the full amount of the claim of the third party. The fact that the creditor will receive only that share of the claims determined on the basis of the payout dividend is irrelevant.

Summary

In summary, it is to be noted that the assessment of losses in the case of D&O liability claims can result in significant problems at the level of legal disputes that should be addressed in advance. In many cases, a company bringing an action will have to react to the legal stance of the court in an ongoing action and retrospectively substantiate its loss. In addition, deviations from the technical rules of evidence pursuant to section 287 of the Code of Civil Procedure often also apply. Such deviations from the technical rules of evidence are especially likely in the case of uncertainty due to breach of fiduciary duty on the part of the officer against whom action is taken.

Note

This overview is solely intended for general information purposes and may not replace legal advice on individual cases. Please contact the respective person in charge with GÖRG or respectively the author himself: Dr. Klaus Felke on +49 221 33660-677 or by email to kfelke@goerg.de. For further information about the author visit our website www.goerg.com.

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