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SMP Transactions Briefing: The German Federal Court elaborates on the liability regime applying to board members of a German stock corporation

I. Background

The Federal German Court in civil matters (Bundesgerichtshof, "BGH") has in two recent decisions confirmed and further specified the obligations of, and the liability regime applying to, the members of the executive board and the supervisory board of a German stock corporation (Aktiengesellschaft). The decisions illustrate the interplay of checks and balances between the corporate bodies of a German stock corporation. In particular, they are instructive to understand the role of the supervisory board: Its members independently fulfill a key function within the company's governance but, correspondingly, bear significant responsibilities vis-à-vis the company.

II. BGH NZG 2018, 1189

In a decision dated 10 July 2018, the BGH elaborated on the liability regime applying to the company's executive board members as well as on the competences of the executive board and its relationship to the supervisory board and the company's shareholders.

The company had sued the former members of its executive board for damages from a breach of their duties. The articles of association of the company specified a catalogue of measures which required the approval of the supervisory board. The company's sole shareholder was a German municipality. The executive board members had entered into a transaction without first obtaining the supervisory board's approval even though this would have been required, presumably to avoid a public discussion on the politically controversial transaction. However, both the chairman of the supervisory board and the legal representative of the company's sole shareholder had in advance approved of the transaction.

a) The BGH held that if either the articles of association of a stock corporation or the company's supervisory board (which acts through resolutions) specify certain measures that the executive board members may only take with the supervisory board's approval, the executive board members are internally, i.e. vis-à-vis the company, obliged to obtain such approval **before** taking the relevant measure. This is because the approval requirement provides an instrument to allow the supervisory board to preemptively control important measures that are to be taken on behalf of the company. Accordingly, an *ex post* approval of the relevant measure by the supervisory board does generally not suffice to fulfill this purpose.

   The supervisory board – or the relevant supervisory board committee to which the board may have delegated such decision items – then has to take a formal resolution as a corporate body; the approval of the chairman of the board does not suffice.

   Legal actions (such as entering into a contract) taken by the executive board members vis-à-vis third parties without first procuring the required supervisory board approval are effective and legally binding. In such case, however, the acting executive board members breach their internal duties vis-à-vis the company and, accordingly, may be held liable by the company for damages arising from such breach.

b) According to the BGH, even the prior approval of all shareholders of the company does not preclude the executive board members' liability vis-à-vis the company unless it is granted in a formal resolution of the general meeting.

The stock corporations act stipulates that the company cannot hold the executive board members liable for measures taken to implement a duly taken resolution of the company's general meeting. Commentators disagree, however, as to whether the prior approval of the company's sole shareholder (or all of its shareholders) should also preclude the company from asserting claims against the executive board members. The BGH has now rejected this view, arguing that only formal and legal resolutions taken in the company's general meeting are binding on the executive board members and that, therefore, only such resolutions may protect the executive board members against liability.

c) According to the BGH, the executive board members may, however, invoke as a defense the argument that had they submitted the relevant decision item to the supervisory board first, the supervisory board would have approved of the relevant matter. The executive board members bear the burden of proof to establish this defense. Since the supervisory board members enjoy entrepreneurial discretion in deciding on whether or not to grant such approval, the (hypothetical) answer to this question is legally pre-determined only where either the supervisory board members were obliged to take a specific decision or where they were prohibited from taking a specific decision. Accordingly, the executive board member will usually face substantial difficulties in establishing that the (independent) supervisory board members would have approved of the relevant measure. From a practical perspective, however, the subsequent approval by the supervisory board – even if it does not remedy the breach – could indicate the outcome of such (hypothetical) decision and, thus, be nevertheless helpful.

What remains unclear is whether the executive board members should be able to invoke a similar argument with respect to the general meeting. In theory they could argue that the (sole) shareholder would have formally instructed the executive board members to pursue a certain course of action had a shareholders meeting been called. In closely held corporations with one single shareholder such hypothetical decision of the general meeting could be easier to establish than the majority decision of a supervisory board, which has at least three members. However, the BGH's concern with a "circumvention" of the formal decision-making processes seems to indicate that the BGH would not follow such argument.

III. BGH NZG 2018, 1301

In a decision dated 18 September 2018, the BGH elaborated on the liability regime applying to the members of the company's supervisory board in connection with its role vis-a-vis the executive board.

The members of the supervisory board of a German stock corporation are obliged to independently supervise the conduct of business of the company's managing directors. In addition, the supervisory board represents the company vis-à-vis its executive directors. In this role, the supervisory board members are obliged to analyze proactively whether the company has damage claims against its executive directors from (potential) breaches of their duties against the company. If the executive directors indeed are in breach of such duties and the company suffers damages from such breach, the supervisory board members have to enforce the resulting damages claims.

Where the members of the supervisory board fail to enforce such claims against the company's executive board members, the members of the supervisory board themselves breach their respective duties vis-à-vis the company.

And if the company suffers damages from such breach, the company has damages claims against the relevant supervisory board members.

In its decision, the BGH further clarified this (rather strict) liability regime. The company had sued the members of the supervisory board for damages, arguing that they had breached their duty to enforce damages claims against the company's executive board members. The executive board members had in turn made illegal payments to one of the company's shareholders, who was at the same time a member of the supervisory board. However, the limitation period for the company's damages claims against its executive board members had expired.

a) This was not the case for the company's damages claims against the supervisory board members. The limitation period for claims against the supervisory board members begins to expire only when the company's claim for damages has come into existence. In addition to a breach of duty by the supervisory board member, this requires that the company has actually suffered damages from such breach. While the damage does not necessarily have to be quantifiable, the mere risk that damages may materialize at a later point in time does not suffice.

   If a supervisory board member has breached his duties by failing to take a certain course of action, the BGH distinguishes cases where a specific course of action would have to be taken at a specific point in time from cases where the required action could have been taken over a longer period of time. In the latter cases the limitation period for claims based on such (continuous) breach only starts to expire once the required action can no longer be taken.

   Where – as in the case at hand – the breach consists of a failure to timely enforce claims against the executive board members, this may be the case once the company's damage claims against its executive board members are no longer enforceable due to the expiry of the relevant statute of limitation. Consequently, in such cases, the limitation period of the company's claims against its supervisory board members should only *begin* to expire with the expiry of the company's claims against the executive board members. The defendants, however, argued that the limitation period for claims against the supervisory board member should already have started when the company's claim against the breaching executive board members materialized. The BGH rejected this latter proposal, arguing that the legal principles on which the supervisory board members' liability is based are meant to enforce their obligation to supervise and assert the company's rights against the executive board. It is the breach of this duty that establishes the supervisory board member's liability.

   As a consequence, the limitation period for claims of the company against its supervisory board members may expire a substantial period of time after the initial event from which the company suffered damages (namely the breach of duty of the executive board members). This *de facto* increases the exposure of supervisory board members from complex and non-transparent dealings that may only be fully understood after the limitation period for claims against the executive board members has expired. Since the relevant limitation period for claims against executive board members and supervisory board members of listed companies amounts to ten years each, this implies that claims against a supervisory board member for having failed to assert claims against an executive board member could in theory only expire 20 years after the initial breach. A consequence that is unfortunate and has been widely criticized but is dictated by the letter of the law.

b) The BGH further discussed whether the obligation of the supervisory board members to enforce claims of the company against its executive board members may apply even if this implied disclosing a previous

breach of duty of the supervisory board members themselves, thus potentially exposing them to liability vis-à-vis the company. Many commentators have argued that the supervisory board members should in such case be released from the obligation to expose misconduct of the executive board members.

The BGH, however, disagreed. The court emphasized that the supervisory board members are in principle obliged to enforce damages claims against the company's executive board members. They are required to strictly act in the best interest of the company that generally requires seeking compensation for damages suffered and does not allow any entrepreneurial discretion in this respect. Only under extraordinary circumstances may the company's best interest dictate to not enforce such claims, for example if the enforcement will likely be expensive but the relevant amounts unlikely to be recoverable.

Against this background, the BGH argues that the supervisory board's function, which requires its members to supervise the executive board and to protect the company's best interest, generally requires the supervisory board member to also enforce claims against the executive board members if this implies bringing to light prior breaches by the supervisory board members themselves. Although the court recognizes that such situations need to be assessed on a case-by-case basis, weighing the interests of the company on the one hand against the interests of the supervisory board members on the other, the decision clearly suggests that only under very exceptional circumstances (if at all) the supervisory board members' right to not "self-indict" oneself might prevail.

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IV. Conclusion

The BGH has clarified important aspects of the obligations of, and the liability regime applying to, the members of the executive board and the supervisory board of a German stock corporation. Where the executive board members require the approval of the supervisory board to certain measures, such approval has to be obtained in advance; failing to obtain such (formal) approval constitutes a breach of the executive board member's duties, for which the company may hold him liable. Such breach cannot be remedied by an ex post approval by the supervisory board.

The supervisory board is in turn responsible for enforcing damage claims against executive board members irrespective of whether or not a supervisory board member would thereby expose himself to liability vis-à-vis the company. The limitation period for such claims may only begin to expire once the limitation period for the damages claims against the executive board members has expired.

These findings add to the (very strict) position that the BGH has taken with respect to the liability regime for board members of a German stock corporation.

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