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Company Directors' Duties to Investors: the Developing Law

It is a fundamental rule of corporate governance that a company's directors must act, always, with the highest degrees of care, diligence and loyalty to the company and its owners. This rule expresses simple fairness to the owners but it is more than that; this rule is essential if companies are to attract significant investment and it is an absolute requirement for public confidence in business and capital markets as a whole. It has been demonstrated empirically that companies that are governed honestly and fairly produce more value for their investors and, by implication, for their employees and other stakeholders¹).

Every company law imposes duties of these kinds in some form and to some extent, and most or all company laws provide penalties and remedies when these duties are violated. At the same time, the laws on this subject should be clear and understandable and should not be so restrictive or so punitive that they discourage qualified people from becoming directors, or prevent honest risk taking and entrepreneurship by directors when that is in the company's interest.

1. See, e.g., "Protection Money", a review of research on the relationship between corporate governance and company valuations, in *The Economist*, 11. December 1999., 75. See also "In Praise of Rules: A Survey of Asian Business", in *The Economist*, 7 April 2001, 4, in which recent research is reported which concludes that good corporate governance can raise the value of companies by 20%-30%, and in which it is further stated that "the best western companies are now moving from the "conformance" to the "performance" model of governance. This means directors no longer simply comply with the rules but try to do better than that, realizing that the best practice is a competitive advantage. By contrast, most companies in East Asia are still a long way from even conforming".

The discussion below will describe the duties and liabilities of company directors in three areas: directors' duty of care, directors' personal liability for their business mistakes, and directors' duty of loyalty in personal conflict of interest situations. This third area includes, among other things, a director's duty to protect confidential information of the company, a director's duty not to engage in business competition with the company, and a director's duty to serve only the company's and the shareholders' interest when the director has a personal interest of his own in a contract or transaction with the company.

In each case the relevant articles of the Yugoslav Law on Enterprises will be referred to and suggestions will be made as to how that Law on Enterprises might be revised. Some of these suggestions are derived from Western, particularly United States, practice and experience. The point should be made that, while the United States' common law system differs greatly in form from the civil-law systems of Yugoslavia and other European countries, many solutions to company law problems are applicable universally. Indeed, while it is clear that the common law and civil law systems will retain their important formal differences, they are converging in the results they produce in practice. This is especially so in business and company law.

A preliminary point should also be made regarding terminology. This paper uses the word "director" to mean a person in a company who owes the company the duties which are referred to in the first paragraph above and are discussed in more detail below. In normal usage a "director" is (only) a member of a company's board of directors. Often, however, these duties are also owed to the company by persons who are not directors (for example, by controlling shareholders or senior employed managers), and in some circumstances the duties themselves may be different depending on, for example, whether they are borne by independent directors or by employees with a management function. The law should define and apply those distinctions clearly but – except to make this point here – this paper will not deal with them further.

1. Directors' Duty of Care

A director's duty of care is difficult to define without citing examples but it is, essentially, the legal duty of a director to act with a very high degree of care, deliberation and diligence when he makes decisions for the company and when he monitors and directs the company's management. In actual corporate life this means that a director should attend all board meetings that he possibly can (and resign from the board if he is unable to attend a significant number), give full attention to all matters that come before the board including those that may be outside his own personal expertise, make a special effort to supervise the managers' performance and ask them hard and uncomfortable questions when necessary, and generally treat the shareholders' investment in the company as he would treat his own investments.

Some simple examples illustrate what this means in practice. Example: Mr. A is a prominent and respected banker and who has served for ten years on the board of XYZ Manufacturing Company. He is now in bad health and he and the company agree that he

will no longer attend monthly board meetings but will continue as a board member to advise the company but only on financial matters. Under these facts Mr. A has breached his duty of care to XYZ because the duty of care is a duty to participate and lend his counsel in *all* board deliberations and a duty to be attentive to *all* the company's affairs. Having breached his duty of care he might be held personally liable if the company goes into bankruptcy for reasons he did not pay attention to.

Another example is Mrs. X, a rich, glamorous and prominent celebrity who is on the board of ABC Company. Her only contribution to the company is to entertain customers, and by doing that she has brought the company a great deal of very profitable business as well as favorable publicity. She helped the company and its shareholders greatly. The company, however, goes bankrupt because of theft and mismanagement of which she knew nothing. Under these facts she may have breached her duty of care – because the duty includes an obligation to oversee and monitor the company's entire business – and she can be held personally liable to the shareholders for that.

The difficulty of defining the duty of care in actual practice is illustrated by a very controversial American case, *Smith v. Van Gorkom*, 488 Atlantic 2d 858 (Delaware, 1985). The decision in that case struck fear in the hearts of many American company directors at the time but it has had the effect of raising the standard of care which directors, in the United States at least, are legally required to follow. A case with similar facts would be unlikely today in Eastern Europe, but it may be worth describing here because it illustrates the kinds of judgments a court must make in defining the duty of care in a lawsuit. Thus it helps make the point that the statutory law on this subject should be as clear as possible.

The case involved a publicly-traded financial services company called Trans Union whose chief executive officer had been approached by an outside party with a proposal to buy all of Trans Union's stock through an offer that the outside party would make to all of Trans Union's shareholders with the Trans Union board's approval and recommendation. The proposal was very favorable to Trans Union's shareholders; among other things, the proposed offer price was 50% higher than the price at which Trans Union's stock was then trading on the New York Stock Exchange. Moreover, Trans Union's independent outside law firm advised Trans Union's directors that they could be sued personally by unhappy shareholders if the directors did not approve the offer and did not submit it to the shareholders with the board's recommendation. In these circumstances the directors very quickly (in a board meeting lasting only two hours) approved and recommended the offer, which was then submitted to the shareholders who overwhelmingly approved and accepted it at a specially-called shareholder meeting. Following the shareholders' approval, the merger was completed and the shareholders received their money.

Then, however, despite the high price which had been obtained, a group of the former Trans Union shareholders sued the former Trans Union directors personally, claiming that they had violated their duty of care. The claim was that if the directors had taken more time and care, and been more diligent in advocating the shareholders' interests, they could – and they would – have obtained an *even higher* price for the company.

In defending the lawsuit the ten former directors demonstrated that they were very experienced in financial matters and that the five of them who were independent (non-employee) directors had a total of 78 years experience as chief executive officers of other major companies and 53 years as Trans Union directors, and that one of them was a prominent professor at one of the United States' most prominent university business schools. They argued that they clearly knew better than the court what their own company was worth and how much it could be sold for. (Also, there was no claim that any of the directors had a personal conflict of interest.)

To great surprise in the legal community, the court of five judges, by a three-to-two vote, agreed with the suing former shareholders and held that the directors had been grossly negligent and had violated their duty of care when they approved the sale so quickly. The court held that the directors had failed in their duty in several ways, including by not hiring an outside investment banker to provide an independent opinion on the price, and failing to take enough time and care in analyzing and actively negotiating the extensive agreements which the lawyers had prepared. The court pointed out, among other things, that the acquisition agreements which the board approved did not have a provision (which is now common in company acquisition agreements) that would have permitted Trans Union to accept a higher offer from another outside party even after the contract with the proposed buyer was signed.

The decision was appealed but the case was privately settled before it was finally decided on appeal. Under the terms of the settlement the former directors were required to pay the former shareholders more than \$20 million, of which \$10 million (but only that) was paid by the board's insurance company.

Court litigation like this may lie far in the future for Eastern Europe, but it can teach the lesson – applicable everywhere – that standards of director conduct are evolving and becoming higher, and that severe personal consequences can be visited on directors who violate those standards.

It should be noted that *Smith v. Van Gorkom* was decided under a company law (namely, the law of the U.S. State of Delaware) which has no statement of the duty of care in its company statutes. Instead, in Delaware the duty of care is judge-made case law. This is also true of about half the U.S. States; the other half, however, *do* state the duty of care in their statutory law. The following is an adaptation of how many States express the duty in their statutes:

“A director shall discharge his duties (a) in good faith, (b) with the care an ordinarily prudent person in a like position would exercise under similar circumstance, and (c) in a manner he reasonably believes to be in the best interests of the company.”

Because this language is necessarily somewhat subjective, the U.S. statutes typically contain additional provisions stating that the director is entitled to rely on management executives, outside lawyers and accountants and other experts in making business judgments.

In the Yugoslav Enterprise Law a similar formulation appears in Article 268 which (combined with Article 280(2)) states that directors:

“shall perform their duties in the best interests of the joint stock company and exercise management with the care expected of good businessmen.”

This is less detailed than the American formulation and it does not include the concept of “good faith” as the American language does. It could thus be suggested that Article 268 should be revised and expanded. At the same time, Yugoslavia has other law that is relevant, such as Article 18 of the Law on Contracts and Torts which imposes a duty to act with the care of a good businessman or a good expert.

Putting these together it would seem that Yugoslav law now imposes a duty of care standard on directors which is very much like that which has developed in the West. The remaining job is to make this clear to potential investors and to empower the courts to act independently and enforce these duties in litigation.

2. Personal Liability of Directors for Their Business Mistakes

An issue that is different from (but related to) the duty of care is that of when, and to what extent, the law should hold directors personally liable in damages for their business mistakes, *i.e.*, for business decisions which directors have made with due care but which, later and with hindsight, turned out to be bad decisions, sometimes even to the point of bankrupting the company and destroying the shareholders' investments. In that situation a director should *not* be personally liable – on the contrary, the law should encourage a director to make business decisions that involve risk and which therefore might turn out wrong. (Under German law a director has the burden of proof in a dispute as to whether he has met the duty of care. See Article 93 of the German *Aktiengesellschaft* law. It is suggested that such a rule is too harsh and, if seriously applied, can discourage qualified persons from being willing to serve as directors and to take risks on behalf of the business.)

To protect directors against liability for good faith business mistakes, American law has developed a supplement to the duty of care that is called the “business judgment rule” which can be stated as follows:

“A director who makes a business judgment in good faith will not be personally liable for damages or other legal penalties arising from his making the judgment if: (a) he does not have a personal interest in the judgment, (b) he is informed regarding the subject of the judgment, and (c) he believes with justification that the judgment is in the best interests of the company.”

The author of this paper has been involved in many cases where the business judgment rule was applied. These cases have been where a company has paid too high a price (in

hindsight) for buying another company and has later had to sell it at a loss, and situations where a company has invested heavily in a new product line which then failed on the market. Such cases are often in the newspapers – a spectacular recent one involved BMW's acquisition of Rover Cars which BMW later disposed of with losses and write-offs exceeding eight billion DM.

The business judgment rule is also illustrated by this simple example: X Company has been making bicycles successfully for more than 30 years. Its board now decides after careful study using independent consultants that it should expand into the motor-powered moped market and that it can do so profitably. It does this. It then loses money on its mopeds because its competitors cut their prices to a level which X Company's board and its consultants knew was possible but could not have expected. The shareholders of X Company sue the directors for the loss in value of their stock because of this disastrous decision. The directors win the lawsuit because they are protected by the business judgment rule.

In America, where lawsuits by shareholders against directors are common and are often successful, the law must include a the business judgment rule. In Yugoslavia such lawsuits are not now common. If however the business judgment rule were added to the Law on Enterprises, it could be done by inserting the above-quoted language at the end of Article 280(2).

3. Directors' Duty of Loyalty in Conflict of Interest Situations

Another fundamental duty of a director is his duty of loyalty to the company. The law should make it clear that, simply by becoming a director, a person commits his personal allegiance to the company and agrees that the interests of the company and its shareholders will prevail over any individual interest of his own when there is a conflict between them. It also means that a director must not use his corporate position to make a personal profit or to gain other personal advantage.

The duty of loyalty can arise in very different (although often overlapping) types of situations and it has many different aspects. The Yugoslav Law on Enterprises refers (in Articles 90-93) to three of these, a director's duty (1) to keep a company's trade secrets, (2) not to compete with the company, and (3) to serve the company's interests rather than his own interests when he has a personal interest in a contract with the company (for example, where he is selling something to or buying something from the company or where he earns a fee or commission on a transaction between a third party and the company). Others are situations in which a director: (4) borrows money from the company; (5) votes to set his own salary or fees or to determine the salary or fees of other directors who will then be determining his salary or fees; (6) can use "inside" company information to further his personal interests in some way (e.g., by buying or selling stock of the company based on financial information known only to him); (7) has the ability to take for himself, personally, a business opportunity that has come to the company but which he knows of only because he is a director of the company (e.g., the opportunity to buy some land or to buy another business that the company would otherwise have bought); and (8) serves as a director of two compa-

nies which are not in competition with each other but which have transactions between them.

The extremely broad variety of conflict situations can be seen using a few examples. One example is the following, which involves a transaction with a director's wife but does not involve a contract with the director – and which thus would not be covered by Article 93 of the Law on Enterprises. The example: AAA Company needs a new office building in City B. Mr. X is a director of the AAA Company. His wife, Mrs. X, owns a majority of the stock of XYZ Company, which just happens to own a building in City B of the kind that AAA Company needs. Mr. X does not disclose to the AAA Company that his wife owns that stock. The board of AAA Company then approves the purchase of the building from XYZ Company and the purchase takes place. Under these facts Mr. X should be personally liable for damages if AAA Company later finds out about his conflict of interest and shows it could have gotten the building for a lower price if it had known the facts before it made the purchase.

Another example which would apparently not be covered by Article 93 of the Law on Enterprises: Mr. A is President of DEF Company. Mr. A arranges for DEF Company to buy a piece of equipment on which Mr. A gets an undisclosed commission. The price of the equipment is increased to cover the commission. DEF Company then buys and uses the equipment. The equipment later turns out to have defects that make it unusable by the company and which injure several company employees. Under these facts Mr. A should be personally liable to DEF Company for the amount of the commission and possibly also for the damage caused by the defects. This should be the case even if the price had not been raised to cover Mr. A's commission.

Two more short examples to illustrate the great variety of problem situations. *First:* Mr. B is President of GHI Company which owns a Mercedes limousine. He takes a one-week vacation with his family in the Mercedes without asking permission of the board. He also lets his wife use it for weekend shopping trips. Mr. B is personally liable for reimbursing XYZ Company for the use of the car. *Second:* Ms. Z is a director of ZZZ Company whose stock is listed on the stock exchange and because of her position she knows of an event, not known to the public, that will cause the company's stock price to go up. She sells her stock on the stock exchange, the event happens, the stock price goes up, and she is now richer. Under some laws Ms. X would be liable to the company for her profit.

Given this variety of fact situations, it is difficult to define a director's duty of loyalty in general terms. The author is not aware of any law which adequately does so. Following, however, is the author's own effort to do it:

“A director who has a personal interest in a matter affecting the company has a duty to act fairly, in good faith and with loyalty to the company with respect to that matter.”

A definition like this must then be supplemented with a broad definition of “personal interest”. That second definition should make it clear that the director has a personal interest in any act or transaction whenever he or a “family member” is a party to the act or trans-

action; where he or a family member has a financial relationship with a party to the act or transaction; or he or a family member is under the controlling influence of a party to the act or transaction. Obviously this calls in turn for yet further definitions – of “family member”, “financial relationship”, etc.

This definitional problem may be why most company laws deal only with specific types of director conflicts and deal with them one by one – as the Yugoslav Enterprise Law does in Articles 90-93 with three types, those involving trade secrets, competition with the company and personal-interest contracts. Regarding these three, suggestions for revision of the law can be made. As to the *duty to keep trade secrets*, the definition of trade secrets in Article 90(1) is unduly narrow because it includes only documents and data which are designated by decision of the enterprise administration. In real business life, trade secrets constitute valuable company information whether or not they are officially designated as such, and moreover the law should not permit something which is not really a trade secret to become one simply by being so designated. Thus it is suggested that the designation restriction should be deleted. It is also not right to require in Article 90(3) that all shareholders and employees be notified of the designation of a trade secret. That is never practical in a big company. Moreover, trade secrets should normally *not* be divulged to all shareholders and employees. Trade secrets should, in general, be known only to senior executives who have a need to know them and to other persons who have signed confidentiality agreements with the company.

Regarding the duty not to compete with the company: Article 92 should be made both broader and more flexible. While Article 92 prohibits joint stock company directors from having the same status in a competing company, it does not prohibit them from competing in other ways. Further, it has an absolute prohibition of the activities in question. This is inflexible; it is common in international business transactions for shareholders or disinterested boards – particularly in limited liability companies with sophisticated investors – to authorize specific activities of directors or managers when that is considered necessary to obtain their services for the company, and the law should recognize this.

It is therefore suggested that a provision such as the following be used – adapted for Yugoslav circumstances:

“A director may not directly or indirectly engage in business competition with the company unless either: (a) there is no reasonably foreseeable harm to the company from such competition or (b) the competition is authorized by a majority vote of disinterested directors or shareholders to whom all material facts regarding the competition are known and have been disclosed”.

Regarding acts and transactions between a director and the company in which the director has an interest, Article 93 covers contracts in which a director has an interest and states that such contracts may be entered into with the approval of other directors. This raises the issue of what happens if the contract is entered into without that approval? Is the contract void? Is it voidable at the company’s option? (That is the case under English law.) Is it

voidable, but only if the director cannot show that the contract was fair to the company? (That is the case under Delaware law.) The law should answer these questions.

It is also suggested that Article 93 should be expanded to cover transactions not involving contracts, and also expanded to state that the contract or transaction may be approved by a majority of a quorum of *shareholders* (not only directors) who have no personal interest in the contract. This latter point recognizes that the shareholders are the ultimate interest-holders in the company, and it also provides a solution for cases where there is not a quorum of disinterested directors to approve the contract.

Further, Article 93 should be strengthened by stating explicitly that only *disinterested* directors may vote to approve the contract and that the approval of the contract –whether by directors or shareholders – will be effective *only if all material facts concerning the director's personal interest were disclosed or are known to the directors or shareholders before they voted their approval*. The reason for this last point is illustrated dramatically by today's newspaper headlines on the (U.S.) Enron Corp. case. The Enron case involves transactions between (1) the Enron Company, on the one hand, and (2) some partnerships that were controlled by an Enron senior executive officer, on the other hand. The relationship between Enron and those partnerships was approved by Enron's board of directors. However, shareholders of Enron have now (a) sued the Enron senior officer personally, claiming that he violated his *duty of loyalty* to Enron by secretly profiting more than \$30,000,000 personally from the partnerships, and (b) also sued all of Enron's directors personally, claiming that they violated their *duty of care* when they approved the relationship between Enron and the partnerships. In the directors' defense it has been claimed that when they approved the relationship they did not know – and reasonably could not have known – the facts concerning the senior officer's involvement in the partnerships – and thus that (i) their approval was not effective and (ii) they are not personally liable for having given the approval.

Conclusion

Director responsibility and accountability to investors – and clear, understandable rules for this – are essential for attracting investment, foreign or domestic. Investors and their advisers know this. Many potential investors will not invest unless these conditions are met. All investors will invest more if these conditions are met.

A good company law is a major help in meeting these conditions. The issues in company law are complicated and detailed, but it is worth thinking them through and then dealing with them clearly in a carefully drafted law. Almost nothing is more important than this for attracting investment.