Monitoring obligations and liability risks of supervisory boards during a corporate crisis

Peter Fissenewert
Buse Heberer Fromm, Berlin
fissenewert@buse.de

In Germany, supervisory board members are increasingly held accountable in court. The time in which supervisory board members were not much more than 'breakfast directors' is gone. Although German supervisory board members make hardly any entrepreneurial decisions, they are under obligation to monitor the work of executive board members. If the monitoring does not take place or is deficient, severe liability scenarios threaten and this is even more likely during a corporate crisis.

Introduction

Besides the executive board or the board of directors, the supervisory board may also be exposed to unsparing liability. The liability issue of members of a supervisory board has become noticeable only in recent years. The financial market crisis in particular has increasingly turned supervisory board members into the target of liability suits. Supervisory board members have thus felt the need to assert indemnification claims against executive board members in order to forestall their own liability risk. The increased liability risk of executive board members is accompanied by an intensification of the monitoring obligations and liability risk for the supervisory board.

In Germany, an estimated 500 supervisory board members are currently subject to court proceedings in connection with liability claims.

Meanwhile, this liability trend has also gained a foothold in insolvency law. In recent years, case law has increasingly dealt with the liability of the supervisory board in the event of de facto insolvency and has developed clear conduct and reaction obligations for supervisory board members. Supervisory board members would thus do well to familiarise themselves with their obligations within the scope of a crisis or insolvency. This is vital to avoid traps under liability law in the event of impending insolvency.

Standardised conduct obligations of the supervisory board according to law and DCGK

According to section 111 (1) of the German Stock Corporation Act (AktG), the supervisory board must monitor the management. This also includes the supervisory board's obligation to audit the establishment of a monitoring system pursuant to section 91 (2) of the German Stock Corporation Act (AktG).

If necessary for the good of the company, the supervisory board must convene a general meeting according to section 111 (3) sentence 1 of the German Stock Corporation Act (AktG).

In addition, the German Corporate Governance Code (DCGK) must be observed, as it contains material statutory regulations concerning the management and monitoring of listed German companies as well as internationally and nationally accepted standards of good and responsible corporate governance. Due to the excellent progress made in the field of compliance in German companies, even in unlisted companies, the fundamental principles of the DCGK are also applicable to these unlisted companies.

The code itself does not contain any direct statutory regulations.

According to subsection 3.1 of the DCGK, the executive board and the supervisory board must collaborate closely on behalf of the enterprise. The supervisory board must define the information and reporting obligations of the executive board in detail. According to subsection 5.1.1

of the DCGK, the supervisory board has the duty to regularly advise and monitor the executive board with respect to the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise. The DCGK does not contain any regulations on special obligations of the supervisory board in the event of crisis or insolvency of the company.

Pursuant to section 116 sentence 1 of the German Stock Corporation Act (AktG), the due diligence and responsibility of the supervisory board members is analogously governed by section 93 of the AktG except for section 93 (2) sentence 3 of the AktG concerning the due diligence and responsibility of the members of the executive board.

In summary, it can be seen that stock corporation legislation already provides a basis for asserting claims against the supervisory board in the event of monitoring faults. However, this combination of wording and approach of sections 116 and 93 of the AktG does not automatically establish an obligation of the supervisory board to ensure that insolvency is filed for. Such an obligation has only been introduced in literature and case law in the form of concretised monitoring obligations of the supervisory board.

Overview of the supervisory board liability during a crisis

The judgment of the Federal Court of Justice (BGH) of 16 March 2009 marked the start of precisely defined increased monitoring obligations and liability risks of the supervisory board during a corporate crisis. Here, for the first time the BGH focused on the internal liability of the supervisory board in the event of violations of the payment prohibition during de facto insolvency by executive board members and failure to ensure that insolvency is filed for. The supervisory board is thus under obligation to intensify control and consulting measures as soon as a negative development of the company's economic situation becomes evident. If this happens, the members of the supervisory board must make use of all available means to gather information from the executive board (eg, by requesting the executive board to fulfil its reporting obligation towards the supervisory board) and, if necessary, to ensure that the executive board or the management fulfils its obligations. In plain terms, this means that the executive board must duly file for insolvency and must not make any payments during the crisis that are incompatible with the due diligence of a prudent manager.

If the executive board/management does not comply with the proposals and resolutions of the supervisory board, the latter may dismiss the management in order to initiate the necessary steps during the crisis by appointing new management.

Previously, the BGH had already decided that members of the supervisory board of a dependent company according to section 116 of the AktG in conjunction with section 93 (1) no 1 of the AktG are under the obligation to constantly review loans granted to the parent company for a potential increase of the credit risk and to react to a deterioration of the debtor's creditworthiness by requesting collateral or terminating the loan. Otherwise, compensation claims could be asserted against them.

Other judgments followed, reflecting the tenor of the judgment of the BGH of 16 March 2009. Ever since, the significance of the supervisory board for the continued existence and development of the company in times of crisis has increased. Supervisory board practice now always demands a heightened intensity of monitoring and deeper involvement in entrepreneurial decisions of the crisis-battered company. Although the supervisory board is not required to intervene in the management, it must take all measures at its disposal, especially in regards requesting additional reports, convening meetings more frequently and ensuring that the executive board is staffed with persons capable of solving the crisis. In particular, the supervisory board must check whether the executive board requires personnel changes due to the crisis. For this purpose, the supervisory board must conduct a comprehensive analysis of the causes of the crisis and determine whether a change of the composition of the executive board would help to overcome the crisis. Failure to duly fulfil these supervisory board obligations could result in various liability scenarios.

Case law on increased monitoring obligations and liability risks of the supervisory board during a corporate crisis

Liability of the supervisory board due to repayment of a loan during the crisis

If the members of the supervisory board determine that de facto insolvency has been reached, they must ensure that the executive board duly files for insolvency and does not make any payments that are incompatible with the due diligence of a company's prudent manager. If the supervisory board culpably breaches this due diligence, it may be liable to the company for damages. If necessary, the supervisory board must dismiss any executive board member that it considers to be unreliable. The supervisory board bears the burden of proof that it has fulfilled its due diligence or that it is not to be blamed for the

non-fulfilment. The circumstances underlying the judgment represented a special case. Here, a loan that had been granted by a member of the supervisory board had been repaid to the respective supervisory board member. The fact that the repayment had been made was thus known to the supervisory board. Only the knowledge of the company's over-indebtedness was disputed. As far as the evidence was concerned, two positions clashed. In the previous instances, the liquidator had held that due to the accompanying circumstances (closure of branches, etc), the crisis and thus the heightened monitoring obligation should have been obvious to the supervisory member against whom the charges had been brought. Naturally, the affected supervisor board member claimed that there had not been any indications of a crisis.

The BGH also made a clear statement concerning the evidence. The BGH determined that the burden of proof lay with the supervisory board. According to the BGH, it was the responsibility of the supervisory board member to present details as to any hidden reserves or other assets relevant to an over-indebtedness balance sheet that were not shown in the commercial balance sheet.

In effect, this means that the supervisory board bears the burden of proof for all circumstances that speak against de facto insolvency. In view of the fact that the supervisory board must furnish evidence that no de facto insolvency existed, the supervisory board members are all the more under the burden of proof when the company is already de facto insolvent if they try to plead ignorance despite growing monitoring obligations.

Liability of the supervisory board in the case of payments to external creditors during the crisis

If the supervisory board determines that the company is de facto insolvent, it must ensure that the executive board duly files for insolvency and does not make any payments that are incompatible with the due diligence of a prudent manager. If necessary, it must dismiss any executive board member that it considers to be unreliable.

In the case of information that should be taken seriously, it is not enough for the supervisory board member to make an enquiry to the executive board and content themself with its negative answer.

If this is not observed, the supervisory board will be liable – in accordance with section 116 sentence 1 of the AktG in conjunction with sections 93 (3) no 6 and 92 (2) of the AktG – for a breach of the payment prohibition and for the failure to ensure that insolvency is filed for.

Liability of an optional supervisory board of a German limited liability company

In the so-called *Doberlug* judgment of the GBH, the liquidator of a municipal company (Stadtwerke Doberlug-Kirchhain GmbH in liquidation) asserted liability claims against the voluntarily appointed supervisory board of the German limited liability company (GmbH). The liquidator based their liability claims on the violation of the monitoring obligations by the optionally established supervisory board, as the director of the GmbH had breached the payment prohibition during de facto insolvency.

From a legal perspective, this case was especially interesting in terms of whether the confirmed principles of supervisory board liability in the event of de facto insolvency as presented above also apply analogously to a voluntarily appointed supervisory board.

In its judgment of 20 September 2010, the Federal Court of Justice reasoned that the supervisory board liability as presented above is relevant (to an optional supervisory board) only if the company actually incurred a loss due to the violation of the payment prohibition.

However, prohibited payments of liabilities only result in contraction of the balance sheet total, not in a financial loss. The insolvency assets are 'only' reduced to the disadvantage of the insolvency creditors. In the opinion of the BGH, this represents a loss on the insolvency creditor side, which is not covered by the scope of liability as far as the internal liability pursuant to section 116 of the AktG is concerned. Although the deliberations of the Federal Court of Justice allow for an external liability on the basis of section 116 of the AktG in conjunction with section 93 (3) of the AktG, this does not apply to optional supervisory boards. The BGH draws attention to the difference in competence weighting between a mandatory supervisory board and an optional supervisory board as the reason for this distinction and for the necessity of a loss as described above. It explains that the monitoring obligations must not be considered as equal, as the optional supervisory board lacks the competence to exercise an administrative form of monitoring, for example, to dismiss directors who violate the payment prohibition. The optional supervisory board should thus be privileged.

It remains to be seen whether this limited privileged liability of the optional supervisory board will be maintained in the future. Eventually, liability is expected in this area as well if the BGH continues to pursue its liability intensification trend. As the BGH

(still) privileges the optional supervisory board because it cannot be 'held responsible for the benefit of the public', the BGH has not (yet) determined that the optional supervisory board must dismiss the executive board in the case of doubt.

Liability of the supervisory board as de facto executive board

The wording of section 15 (1) sentence 1 of the German Insolvency Regulation (InsO) already specifies that the executive board alone is under the obligation to file for insolvency. However, an obligation of the supervisory board to file for insolvency of the German stock corporation (AG) may apply if the supervisory board or members of the supervisory board intervene in the company's management to an extent that makes them the de facto executive board. In this case, the supervisory board, as a de facto executive body, is under the obligation to file for insolvency in due time. Moreover, a direct obligation of the supervisory board to file for insolvency applies if the company does not have any management. If a German stock corporation does not have any management, each member of the supervisory board – pursuant to section 15a (3) of the InsO – is under obligation to file for insolvency, unless the particular person is ignorant of the inability to pay and the over-indebtedness, or of the non-existence of senior management.

According to case law, the court holds that claims for tax liabilities of a corporation may be asserted against the nominally appointed director of a GmbH even if he or she has merely been installed as a 'puppet', and the de facto directors are the ones who determine the fate of the company. These principles are also applicable to the liability of the supervisory board if it acts as a de facto executive board of the stock corporation.

Summary of the monitoring obligations/monitoring faults of the supervisory board

In summary, it is obvious that the supervisory board needs to intensify its monitoring activities when the company's situation deteriorates. Accordingly, its monitoring obligations pursuant to section 111 of the AktG increase. During a crisis, the supervisory board must therefore obtain a clear picture of the company's economic situation, making use of all information sources that are at its disposal.

In such a case, it might be necessary to elevate the supervisory board monitoring to the level of supportive or even administrative monitoring. For example, supportive monitoring includes the request for special reports that focus on the impending insolvency situation and, if necessary, the holding of special meetings. If the deterioration of the company's situation progresses, the supervisory board may even be under the obligation to exercise administrative monitoring. For example, this could involve the engagement of experts to analyse the over-indebtedness situation and submit restructuring proposals. As an extreme measure of administrative monitoring, it may even be necessary to consider the dismissal of the executive board.

By virtue of its primary competences, the supervisory board is thus under the obligation to step up its monitoring in critical situations. Against this background, it is ultimately impossible to block out the knowledge of a possible state of over-indebtedness or insolvency, which in turn means an automatic violation of the due diligence and liability of the supervisory board pursuant to section 116 of the AktG in the event of a violation of the payment prohibition (section 92 (2) of the AktG) by the executive board.

The increased liability obligation also includes a duty of the supervisory board to ensure that the executive board files for insolvency in due time. So far, this obligation does not apply to optional supervisory boards.

Conclusion and action recommendations

The growing number of congruent supreme court decisions on this previously almost untouched subject shows one thing in particular: the legal views on this theme have been set and can no longer be overlooked. Meanwhile, they require supervisory boards to exercise increased monitoring duties in times of corporate crisis. All supervisory board members of a stock corporation that is experiencing hardship should thus be aware of this subject and perform monitoring activities in excess of what is required rather than fall short of their auditing duties, especially as the legal certainty that has been established suggests that in the future, liquidators will include the liability of the supervisory board in their regular considerations.

Moreover, the auditing and monitoring measures should always be documented properly in order to serve as exculpatory evidence for the supervisory board in the case of doubt. Additionally, supervisory board members should continually educate themselves.

It is highly probable that the requirements for supervisory board liability will become even stricter. This also applies to the field of optional supervisory boards, which has been relatively privileged so far. Obviously, a company that voluntarily appoints a supervisory board desires an operable level of supervision. If this supervision fails, there is no reason why a voluntary supervisory board should enjoy any privileged status.

Though the subject of 'liability of the supervisory board during a crisis or insolvency' may appear to be a niche subject, it is actually not. Apart from the impressive number of insolvencies, it is to be noted that requests for institution of insolvency proceedings are often made too late. Recent case law clearly shows what role the supervisory board might play if the request for institution of insolvency proceedings is delayed – a subject that we will have to deal with more intensively in the future.

About the author

Peter Fissenewert is partner of the German law firm Buse Heberer Fromm. He is head of the German-wide insolvency and restructuring practice group.