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THOUGHT LEADERSHIP

# POSSIBILITIES AND LIMITS OF MANAGEMENT EXCULPATION

## CONTENTS



## An analysis against the background of the current discussion on compliance and the introduction of corporate criminal law

**This paper examines the conformity of a company's actions to legal regulations and its analysis focuses primarily on the responsibilities of the board of directors of a public limited company.**

First, the concept of liability of corporate bodies is explained. This is followed by an analysis of possible liability. The question of exoneration through external advice has previously been examined in the literature and in corporate practice (cf. Jean J. du Plessis et al. (2017), *German Corporate Governance in the International and European Context*, p. 477 et seq.).

However, this analysis goes beyond exoneration by means of external (legal) advice and takes a broader view of the topic. The focus is on the question that is relevant in practice: where the limits of exoneration for a corporate body lie and what is the irreducible core of personal duties and responsibilities that remain with the corporation.


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## EXTERNAL AND INTERNAL ADVISERS

A corporate body will use internal advisers such as tax advisers and lawyers in the performance of its duties. However, in addition to consulting internal specialist departments, it is quite common to obtain external legal and tax advice. One of the reasons this might be done is as a way of shifting liability risks (at least partially) to external parties with whom a commissioning and liability agreement is concluded.

## BUSINESS-JUDGEMENT RULE

Another aspect protecting the managing director of a limited company from liability is the so-called business-judgement rule. According to this rule, the executive board is protected from liability in respect of business decisions if the decision should turn out to be economically negative in retrospect or business risks arise from it. A release from liability occurs on the basis of the business-judgement rule if the management, when making its decision, could reasonably assume that it was acting in the best interests of the company on the basis of the information made available to it. However, in its conduct, management may not weigh business aspects and legality against one another. A violation of the business-judgement rule might be relevant under criminal law. In order to avoid such a judgement, sufficient documentation of each risk decision and the decision-making process behind it is recommended.

## TAX CRIMINAL LAW

An important aspect, also from the point of view of (tax) criminal law, is the question of an excusable error of law on part of the executive board. It is possible that the corporate body has taken all due care to form its own picture of a certain fact but is simply mistaken about it: for example, the legality and scope of its actions, or a specific aspect of content. According to the German Federal Constitutional Court (*Bundesgesetzhof – BGH*), the management cannot be accused of culpable conduct if it has sought the advice of an independent, professionally qualified legal entity in the absence of its own expert knowledge. Thus, the governing body may exculpate itself under civil law if the expert opinion obtained turns out to be wrong afterwards. However, exculpation is not without limit. Accordingly, strict requirements are to be set for a legal error that excludes guilt.

## LIMITS TO EXCULPATION

The possibilities of exoneration for a board member are subject to restrictions at key points.

Due to their position as members of an executive body, board members and managing directors are not able to delegate all their tasks and duties to third parties or within the company. It follows from the position of the executive body that some of the duties – so-called core duties – cannot be delegated. The managing director himself must therefore perform a part of the duties of a managing director. The remaining non-delegable core essentially consists of the protection and control of the company by the managing director.

When consulting external and internal advisers, the managing director still has the non-delegable duty of careful selection. He or she must ensure that support staff have sufficient knowledge and experience as well as the appropriate character and physical health to perform the delegated tasks.

Regarding external advisers, the corporate body must pay close attention to ensure that the ‘right’ advisers are called in, i.e. advisers who are trained and experienced for the task at hand and who have the appropriate expertise. In this respect, a core obligation remains for the executive board.

In addition, the corporate body must ensure the independence of the adviser engaged. The independence of the external adviser means that a non-biased audit must be commissioned. A lack of independence could exist, for example, if the company commissioning the external adviser were to already specify the result of the audit.

For internal advisers, the principle of duty of care to instruct applies, according to which the manager must instruct the employees concerned and explain the tasks assigned.

This points to the limits of detachment, which seem to be narrower in the case of internal advice than in the case of external advice. This discussion must be seen against the background that internal employees (e.g. in-house lawyers and in-house tax advisers) are employed by the company, so that they are legally (employer’s right to issue instructions) and economically (by means of salary and employment) dependent on the basis of the employment contract.

## THE QUESTION OF INDEPENDENCE?

The problem of the independence of internal staff arises particularly in connection with company lawyers. In comparison to external advisers there might be room for a conceivable dependency, since from an economic point of view, external advisers would at most risk one brief in the event of a disagreement with a board member.

It remains the duty of the executive board to subject the results of the work of internal employees and external consultants to a plausibility check in order to counteract the risk that the executive board may receive incorrect or insufficient advice and information. This results in the non-delegable duty of the board member to provide complete and comprehensive information to the employees and consultants involved. If this does not take place, no effective exoneration is available. For the purpose of effective exoneration, the managing director must

document the plausibility check and the work steps chosen in the process.

The board of directors has various non-delegable monitoring duties. This includes, on the one hand, the establishment of a monitoring system internal to the board to ensure the flow of information between board members. In the case of vertical delegation to specialised departments or internal employees, the executive board has a duty of supervision.

In particular, there is a duty to intervene in cases of concrete suspicion. Monitoring must be carried out on a regular basis, at least on the basis of random samples. Using the example of tax law, the question of the non-delegable core area of the executive board can be developed even further: the board of directors has collective responsibility for the company. This principle means that in the case of a board with several members, each individual board member bears collective responsibility as those measures and transactions that are of particular importance to the company, or which involve an extraordinary risk, should be the responsibility of the entire board of directors. Accordingly, the duty to make a tax return, for example, can turn into a non-delegable collective responsibility task if the particular return is of particular importance for the company or entails an extraordinary risk.

In particular, management and supervisory board members are subject to duties of confidentiality, which are an outflow of the duty of loyalty to the corporate body. A legal standard for this is found in the first sentence of section 116, in conjunction with the third sentence of section 93(1) of the German Joint-Stock Companies Act (*Aktiengesellschaftsgesetz* – AktGEG). If these are violated and the company suffers loss as a result, an effective release from liability is difficult to imagine. In such a case, for example, the members of the company's executive board are jointly and severally liable for the loss incurred according to the first sentence of section 93(2) AktGEG, in conjunction with article 421 of the German Civil Code (*Bürgerliches Gesetzbuch – BGB*).

## POSSIBLE LIABILITIES

Suppose that a corporate body has formed its own opinion, which proves to be erroneous. However, the corporate body itself can only be found to have committed the punishable offence of tax evasion if, for example, the objective characteristics of tax evasion (under article 370 of the German General Tax Code (*Abgabenordnung – AO)* are present and the corporate body acted intentionally and culpably.

It is interesting to note that section 30 of the German Administrative Offences Act (*Ordnungswidrigkeitengesetz – OWiG*) already provides for a quasi-corporate criminal law in the area of administrative offences. The company may be fined if a manager is guilty of a (negligent) breach of his or her supervisory duties, and if this results in criminal conduct by employees.

The delimitation could be more difficult to achieve in the future under proposals for a new corporate criminal law statute, the so-called Association Sanctions Act (*Verbandssanktionengesetz – VerSanG*). This has already overcome its first legislative hurdles and the draft bill was submitted to the Bundestag on 21 October 2020 for adoption. The points still open for discussion do not affect the core concept of the law, so that enactment as soon as the first half of 2021 seems realistic. The Act is to come into force two years after its promulgation. This means that the Act will probably come into force in mid-2023 or at the beginning of 2024 at the latest.

This law provides for a massive increase in the threat of sanctions for association-related offences and is therefore intended to create incentives for compliance measures. Thus, this law will have a significant impact on compliance structures in many companies. For example, the external pressure to prosecute will increase, as will pressure to conduct so-called internal investigations. Finally, there will be a necessary increase in cooperation with prosecuting authorities.

In addition to the possibility of liability under civil law, corporate bodies also run the risk of being held liable for tax purposes.

On the one hand, company organs are liable under article 69 of the German General Tax Code for taxes that were not assessed or not assessed in time due to intent or negligence. When assessing fault, the circumstances of the individual case and the personal circumstances of the company's representative must be taken into account. For example, in a company crisis, each managing director must therefore monitor whether withholding taxes are properly withheld, declared and paid in order to avoid liability. Furthermore, all managing directors have the duty to supervise the employees responsible for tax matters internally and to ensure that the company's tax obligations are fulfilled correctly and on time.

A second relevant tax liability is that under article 70 of the German General Tax Code. According to this, the company itself may also be held liable if employees of the company have committed tax evasion or reckless tax understatement.

## CONCLUSION

The daily work of a member of the executive board of a German joint-stock company (*Aktiengesellschaft*) is associated with extraordinary personal and professional challenges.

Therefore, it is important for the board member to take care to conduct his office in such a way that (a) no loss occurs and (b) that he has at least behaved carefully enough to be able to exculpate himself vis-à-vis the company and the shareholders and not be held personally liable.

There are possibilities for exculpation. These include the careful selection and supervision of internal employees as well as external advisers and the observance of the principle that they must act independently. In addition, however, a complete and thorough description of the facts must be given to the auxiliary staff employed, their work be monitored and finally be subjected to an appropriate quality check by the board.

Thus, exculpation is only possible if the board member abides by tight restrictions. These must be documented by him. It is therefore advisable to provide for a precise compliance process for the use, selection, monitoring and communication of the board's internal and external advisers by and with the board. This is also necessary in terms of criminal law, since legal limits must be observed here as well. This is even more important against the background of the proposed new corporate criminal offences under the Association Sanctions Act and the existing sections 30 (see above) and 130 of the Administrative Offences Act. The good news for board members, however, is that even action leading to a compliance-management system with the goal of carrying on about 90 to 100% of the company's business in proper order can have an exculpatory effect.

## EPILOGUE: HOW THE LIMITS TO THE EXCULPATION OF MANAGEMENT ARE CONNECTED TO TRANSFER-PRICING ISSUES

At the beginning of 2021, a search of the premises was ordered on the German headquarters of a retail chain by the local public prosecutor's office. The German-based company, which is known widely in Europe as a home-improvement retailer, has already been searched several times in previous years on suspicion of tax evasion. According to a spokesperson for the company 'the adjustment of settlements between group companies that are both complex and legally difficult to evaluate is in dispute', i.e. the issue is the determination of transfer prices.

This current case illustrates the extent to which there is a liability risk for management in the area of transfer pricing. The accusation of tax evasion simultaneously raises the question of external liability as well as internal responsibility. Insofar as the accusation may be true, it is clear that someone must be held liable.

The question is whether it is the management or its external consultant that should be held liable. Hiring third parties cannot exculpate the corporate body per se. Rather, the managing director must always assure himself of the reliability and regularity of the work delegated to a third party. After all, the responsibility of management with regard to the selection of the external consultants relates not only to the consultant's professional expertise but also to the consultant's personnel recourses. This does not solely apply to the field of transfer pricing, but rather to all core obligations that remain with the management. As a result, the possible exculpation of the management may quickly exceed its limits and trigger a case of personal liability.

The possible extent of such liability makes the choice of the most appropriate transfer-pricing method more challenging. Therefore, a thorough and constant analysis of TP-experts is even more necessary.

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