

Business judgement rule in Czech Corporations Act

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Abstract

Czech private law is currently undergoing a thorough transformation. This includes adoption of a brand new Corporations Act, which is to supersede the current Commercial Code. The new legislation introduces several new rules governing liability of company executive officers. One of these is business judgment rule. It should provide company executive officers with a certain level of protection against litigation – if specific terms are met, it is presumed, that they carried out their responsibilities with proper care. I intend to demonstrate, that the Czech business judgment rule is flawed, despite the fact that it draws from foreign examples and that this regulation, although seemingly groundbreaking, in fact changes nothing in examination of the decisions of the company executive officers in Czech Republic.

The main goal of this article is therefore to analyze and criticize the business judgment rule in the new Czech legislation and to compare it to notable foreign legal systems. The methods used are inductive and deductive reasoning, author's own analysis of legal text, comparative method and compilation of available resources relating to the topic of the article.

Keywords: *Business judgment, Company executive officer, corporate body, company, corporation, Corporate law.*

JEL Classification: K22, K40

Introduction

Bailes Manning once said: „Some people are fortunate since they have never heard of the business judgment rule.”² That has been true for most Czech lawyers, as the concept of business judgment rule (further referred to as BJR) is a new one in Czech law. However, the BJR is included in the new Corporations Act that should enter into force on 1st January 2014 and plays only a small role in thorough reform of Czech Civil and Commercial law that is currently in the final phase of its introduction into our legal system. Therefore we stand before the question of how to cope with the new legislation and whether it will improve our legal system or not.

As this legislation is completely new, this paper will provide basic analysis of the regulation and compare it with similar rules in foreign legal systems. Therefore the main research methods used include authors own analysis of a legal

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² Manning, B., SYMPOSIUM: CURRENT ISSUES IN CORPORATE GOVERNANCE: The Business Judgment Rule in Overview, available at <https://litigation-essentials.lexisnexis.com/webcd/app?action=DocumentDisplay&crawlid=1&doctype=cite&docid=45+Ohio+St.+L.J.+615&srctype=smi&srcid=3B15&key=85d064e0062775a2d137e3b54aac81dc>

text and comparative method. In regard to the foreign regulations, compilation of available doctrinal literature is also used.

This paper shall at first briefly summarize the reasons for having a BJR and its uses. Then it shortly deals with different forms of BJR in US law and several other legal systems. Following section of the text will describe and examine the BJR in new Czech Corporations act. The final part of the paper analyzes the benefits that may be offered by the introduction of the BJR into Czech law, tries to oppose the reasons that led to its adoption to prove that it will not have significant impact on Czech companies and is therefore at least partially redundant.

Business judgment rule in US law and other legal systems

Majority of legal systems has set a certain level of care, which the company directors are obliged to uphold while executing their powers³ – this is usually called the duty of care. Despite that the exact wording of this rule differs to some extent in various legal systems, the construction of duty of care is very similar across different jurisdictions.⁴ It is not particularly surprising, as the basic principles of fiduciary duties like protection of shareholder interests or responsibility of directors originate from common sense which is not afflicted by otherwise significant cultural differences. For example the Czech law demands that company directors have to act with “the diligence of a proper caretaker” while English law states that they have to act with “the care, skill and diligence exercised by a reasonably diligent person.”⁵ ⁶ The similarities are obvious.

The starting point of any analysis of business judgment should probably be its regulation in US law, or more precisely in the Delaware law, as most US corporations are established under Delaware law for various reasons (therefore when I refer to US law further in this paper I usually mean Delaware law). The US courts have found out by empirical experience that it is hard to examine business decisions made by company directors because of a several reasons:

- There is no easy way to examine business decisions. Almost any business transaction carries an inherent risk with it and many of the most profitable businesses are characterized by high risks.
- The judge is not qualified to examine business matters⁷, though he is well-versed in law, he usually has much less experience with management of a company.

³ Andenas, M., Wooldridge, F., *European Comparative Law*, Cambridge: Cambridge University Press, 2009, ISBN 978-0-521-84219-8, pp. 265-266.

⁴ Cahn, A., Donald, D.C., *Comparative company law*, New York: Cambridge university press, 2010, p. 369.

⁵ Loose, M., Griffiths, M., Impey, D., *The Company Director, Powers, Duties and Liabilities*, Bristol: Jordan Publishing Limited, 2008, ISBN 978-1-84661-089-9, p. 275.

⁶ Companies Act 2006, section 174.

⁷ Laguado, C.A., *Factors governing the application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU*, available at http://www.javeriana.edu.co/juridicas/pub_rev/documents/6-Laguado.pdf, p. 122.

- The examination should not be made with hindsight⁸, as later obtained information was not available to the director while he was making the decision in question.

As a result of the above-mentioned, US courts refrained from interfering with business decisions. That led to the creation of BJR. The Delaware courts produced many definitions of BJR, from which I have chosen the following: *“It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”*⁹ This is complimented by the burden of proof lying with the petitioner rather than defendant: *“Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.”*¹⁰ Therefore the company directors are to some extent protected from derivative litigation.

The BJR is not supposed to completely negate the responsibility of company directors, but rather to lift some pressure put on them. *“The BJR doesn’t give directors the green light to act in a manner that is directly contradictory to their position, not made in good faith or for a proper purpose, all which are duties that directors are obliged to follow. The courts for the most part, however, aren’t willing to scrutinize decisions that are made in the legitimate course of directors dealings.”*¹¹

Douglas M. Branson has aptly commented that the US business judgment rule is not really a rule of conduct, but rather a judiciary review standard.¹² That means that BJR does not impose any obligations on individuals, but states that court shall not review decisions covered by the BJR doctrine.

In comparison to US BJR the courts of Great Britain did not form an explicit BJR, but rather abide implicit BJR as the courts usually refrain from examination of business decisions.¹³ The protection that the company directors enjoy is therefore much lower in UK than in the US.

Statutory BJR (written rule adopted by legislation) arose when the US concept of BJR had been implemented by other countries. This form of BJR is usually based on legal presumption that the duty of care is being respected if some basic requirements are met. As an example of statutory BJR might serve the current

⁸ Knepper, W.E., Bailey, D.A., Liability of corporate Officers and Directors, New York, Lexis Nexis, 2009, 8th edition, ISBN 978-1-4224-7562-1, § 2.01, pp. 2-1.

⁹ Kaplan v. Centex Corp., Del.Ch., 284 A.2d 119, 124 (1971); Robinson v. Pittsburgh Oil Refinery Corp., Del.Ch., 126 A. 46 (1924).

¹⁰ Puma v. Marriott, Del.Ch., 283 A.2d 693, 695 (1971).

¹¹ Find Law team, Directors’ Duties and the Business Judgement Rule, available at <http://www.findlaw.com.au/articles/4246/directors-duties-and-the-business-judgement-rule.aspx>

¹² Branson, D.M., The Rule That Isn’t a Rule - the Business Judgment Rule, Valparaiso university Law Review, issue 3, volume 36, year 2002, p. 631.

¹³ Laguado, C.A., Factors governing the application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU, available at http://www.javeriana.edu.co/juridicas/pub_rev/documents/6-Laguado.pdf, p. 136.

Australian legislation, according to which: “A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection 1 (the duty of care – author’s note), and their equivalent duties at common law and in equity, in respect of the judgment if they:

- (a) make the judgment in good faith for a proper purpose; and
- (b) do not have a material personal interest in the subject matter of the judgment; and
- (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- (d) rationally believe that the judgment is in the best interests of the corporation.

The director’s or officer’s belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.¹⁴

Such form of a business judgment rule can also be found in the law of Germany¹⁵ or Japan.¹⁶ Written BJR based on similar principles is also a part of a model corporations act drafted by American Law Institute.¹⁷

As seen above, the various versions of BJR have in common that it is only applied in case that certain conditions are met – the examination, whether the BJR is applicable is usually called “the test of business judgment”. The conditions for application of BJR usually include that the company director acted:

- in good faith
- on informed basis
- in the interest of the company.

Some other tests of business judgment may include further conditions like no self interest or no wastefulness. In my opinion, however, it is usually possible to derive the same conclusions from the free basic principles above (i.e. action in self-interest will also be made without good faith).

BJR may also be differentiated by the burden of proof. The US law for a start requires the petitioner to prove that there are reasons for not applying the business judgment doctrine. Some legal systems (i.e. German law) on the other hand put the burden of proof on the defendant (company director) who is therefore bound to prove that the conditions for application of BJR are met.¹⁸ This considerably weakens the protection granted by the BJR.

To summarize the aforementioned – the BJR(s) might be of varying strength, formed either as judiciary or statutory rule, and the burden of proof may

¹⁴ § 180 section (2) of the Australian Corporations Act (Act No. 50 of 2001 as amended) available online at <http://www.comlaw.gov.au/Details/C2013C00003>

¹⁵ § 93 section 1 of German Act on public limited company (Aktengesetz).

¹⁶ Beyer, V.L., Judicial Development of a Business Judgment Rule in Japan, *Bond Law Review*, issue 2, volume 5, year 1993, p. 213.

¹⁷ Knepper, W.E., Bailey, D.A., *Liability of corporate Officers and Directors*, New York, Lexis Nexis, 2009, 8th edition, ISBN 978-1-4224-7562-1, § 2.01, pp. 2-4.

¹⁸ Cahn, A., Donald, D.C., *Comparative company law*, New York: Cambridge university press, 2010, pp. 372-37.

lay with the company director or the petitioner. All these variables significantly affect the practical impact that the BJR has on the responsibilities of company directors.

Business judgment rule in the Czech Corporations Act

The new Czech Corporations Act contains a statutory BJR in § 55 section 1. It can be loosely translated into English as follows: *“Carefully and with needed information acts, who takes a business decision and in good faith may reasonably assume that he acts on informed basis and in justifiable interest of the corporation; that is not applicable in case that such decision was not made with required loyalty.”*

The original draft of the Czech BJR has been derived mostly from German law.¹⁹ This draft has undergone several changes during the legislation process and is currently only a distant echo of its German example. Therefore it is an original provision to some extent and its analysis might yield some unexpected results.

The actual wording of Czech BJR is not very good and sounds a bit awkward even in Czech language. Also it seems to be partially tautological – among other it says that *“with needed information acts ... who may reasonably assume that he acts on informed basis.”* The text also does not expressly mention the required level of care set by Corporations Act on company directors - the diligence of a proper caretaker. It rather uses the phrase: *“Carefully and with needed information”* to describe the level of care that is presumed to be fulfilled if all conditions for the application of the BJR are met. That is unfortunate but luckily this interpretation problem can be surpassed by using the definition of diligence of a proper caretaker in the new Civil Code.²⁰

This has been done to exclude the loyalty part of diligence of a proper caretaker from the BJR. While this is a legitimate goal, the Corporations act does also explicitly say in the BJR *“is not applicable in case that such decision was not made with required loyalty.”*²¹ This unfortunately makes the text of BJR hard to understand for no real reason.

The business judgment test according to Corporations act has three main elements. To apply the BJR it is to be found, whether the company director:

- i) acts in good faith,
- ii) may reasonably assume that he acts on informed basis,
- iii) may reasonably assume that he acts in justifiable interest of the corporation.

¹⁹ Explanatory report to the Corporations Act available at <http://obcanskyzakonik.justice.cz/fileadmin/Duvodova-zprava-k-ZOK.pdf>, p. 24.

²⁰ § 159 section 1 of Act no. 89/2012 Sb., Civil Code.

²¹ § 51 section 1 of Act no. 90/2012 Sb., on Commercial Companies and Partnerships (Corporations Act).

The BJR also covers only business decisions so in addition the court should examine, whether the directors took a business decision or executed their powers in another way.²²

The business judgment test is quite similar to those used abroad and therefore we should be able to draw from foreign experience. I must criticize, that the BJR excludes the application of BJR on cases with breach of loyalty. For the third time – director who acts with good faith and in interest of the corporation ex definition cannot be in breach of loyalty.

Because the abovementioned conditions for application of BJR are very general it will be on the courts to specify them. Informed basis and justifiable interest of the corporation are terms, which will be hard to fill with precise meanings.

The question of what level of information is required for application of BJR has been previously dealt with by foreign courts as this issue is usually the cornerstone of cases involving BJR. We should at least mention two court rulings from Delaware jurisdiction – the cases of *Trans union* (Smith vs. Gorkom) and *Cede* (Cinerama vs. Technicolor). While in the *Trans union* case the court had held that the company director had to obtain all available information, in the second case this strict rule had been mitigated. It is not justifiable to demand from company director to obtain all available information as that would be unreasonably strenuous. It would also require the director to invest significant portion of his time to gather all information, which might be too demanding and sometimes might cause the director to miss a time-limited business opportunity. In the *Cede* case the court took that into account and formulated a new standard of requiring information. It accents that the director should actively participate in the decision process, use his own initiative to look for information and seek and evaluate alternatives to the proposed decision.²³ I personally prefer flexible standard (like the one formed by the *Cede* case). I am however afraid that Czech courts will adapt a strict standard similar to that in *Trans union*.

The term „justifiable interest of a corporation“ is also hard to interpret as it can be very relative. It seems that the „justifiable interest“ is less than „best interest“ – it is therefore not the best way of dealing with the situation (which would be insanely hard to ascertain in advance) but also other reasonable ways of doing so. In consequence there usually will be more than one way of action that fulfills the criterion of „justifiable interest“. I rather like this standard and believe that it reflects the relativity of business operations quite well.

The main concern regarding the wording of Czech BJR I have is that the business judgment test is quite extensive and to ascertain, whether the company director is entitled to enjoy its protection or not, the court would have to examine director's actions quite thoroughly. Czech case law regarding the duty of care is not very well developed, because most cases were dealing with duty of loyalty. The

²² Štenglová, I., Havel, B., Komentář k § 51, in Štenglová, I., Havel, B., Čileček, F., Kuhn, P., Šuk, P., Zákon o obchodních korporacích. Komentář. Praha, C. H. Beck, 2013, ISBN 978-80-7400-480-3.

²³ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368-71 (Del. 1993).

criteria used for judging the duty of care in current case law are therefore quite simple. In fact, the analysis of director's actions needed to make the decision, if they are covered by the protection of the BJR, shall probably be as thorough as the examination of whether the duty of care has been breached. That kind of negates the usefulness of BJR.

As far as the BJR (or generally diligence of a proper caretaker) is concerned, the Czech law puts the burden of proof on the director, who therefore has to prove that the conditions for application of BJR are met.²⁴ That is quite reasonable, because the BJR is a form of director's defense and it would be otherwise very hard for the prosecuting party to get grip of information needed to disprove the BJR (problems of piercing of corporate veil).

The Corporations Act will also introduce a transfer of the burden of proof from company director in case that *"it's not reasonable to demand that he carried such burden of proof."*²⁵ That will be applicable mostly in connection with proving the good faith – absence of good faith can be reasonably proven but the existence of good faith is almost impossible to prove.

What are the reasons for adopting the BJR?

Introducing the BJR to a legal system that previously did not recognize such rule should (like any other change of law) be justified by benefits that will come with it. Three main benefits of introduction of a BJR are usually listed:

- (i) the BJR lifts the burden of thorough examination of business judgment from judges, as judges are hardly qualified to evaluate the economical aspects of such conduct
- (ii) the BJR gives company directors a reasonable level of protection and therefore allows them to exercise their powers without constant fear of prosecution
- (iii) the BJR brings economical advantage to corporation which may benefit from actions of directors who are not under undue pressure from litigation.

Business judgment rule gives protection to company directors and by that makes their position more stable.²⁶ As the BJR cannot be used on cases, which deal with disloyalty of the directors (i.e. cases based on conflict of interest), the directors cannot use BJR to protect them from prosecution of fraudulent conduct but only to protect them from consequences of business risks. Business risk is an inherent part of any business decision and such decisions are made without

²⁴ § 52 section 2 of Act no. 90/2012 Sb., on Commercial Companies and Partnerships (Corporations Act).

²⁵ § 52 section 2 of Act no. 90/2012 Sb., on Commercial Companies and Partnerships (Corporations Act).

²⁶ Onder, A., Siegelheim, A.J., Corporate Liability Exposure and the Potential Risk of Individual Director Liability Resulting From Employment-Related Decisions: An Analysis of Recent Case Law and Recommendations on Corporate Governance, *Employee Relations Law Journal*, issue 2, volume 34, year 2008, pp. 4-5.

hindsight – they are based on information available at the time of making such decision. Even the most carefully planned transactions might fail and it is not reasonable to expect the directors to make no mistakes whatsoever. Nobody should be expected to be responsible for all consequences of business decisions, if the decision was taken in good faith, on informed basis and in the interest of the company.²⁷ BJR is meant to mitigate the liability of company directors for such legitimate decisions that in the end (for various reasons beyond the control of such directors) have not brought successful results for the company.

The director therefore, at least in theory, has free hands because of BJR and may focus on how to make money for the corporation rather than how to protect himself from litigators. Some authors also express their opinion that this leads to their independence.²⁸ A free and independent manager might often be more effective than manager motivated primarily by caution – that is the main benefit for the company²⁹ and indirectly to company creditors.

The US law, which gave birth to BJR can be characterized as a “litigation culture”. Derivative claims raised by company shareholders are common and often put company directors under great amount of stress and might sometimes severely drain their resources. Because of that, the BJR in the US is often sought as a “safe harbor” from derivative claims. Derivative litigation is however not common in Czech legal culture – despite that the law knows derivative litigation the actual cases are not very numerous. It is therefore questionable, whether Czech law really needs a BJR, as company directors are not under undue pressure from derivative litigation. I actually believe that Czech company directors already feel quite free to exercise their power and most cases of director prosecution were based on breach of loyalty or resorted to breach of duty of care only because it was impossible to prove the disloyalty of the director in question. Is there really a need for additional level of protection for company directors?

Under such conditions it can also be argued that the Czech courts do not really need a BJR to ease their position – those few derivative litigation cases they have encounter are not enough to constitute any visible burden let alone a burden so heavy that it could hamper their ability to cope with incoming cases. That seems to be true despite that the new Corporations Act somehow extends the possible use of derivative actions. This is done mostly by allowing derivative actions to be filed against other persons than company directors, so it can be argued that it should not increase the pressure against company directors.

In addition, many cases against company directors in US are based on wrong estimation of the value of shares by company directors during the increase of share capital, mostly in connection with a takeover of the company by a new

²⁷ Explanatory report to the Corporations Act available at <http://obcanskyzakonik.justice.cz/fileadmin/Duvodova-zprava-k-ZOK.pdf>, p. 24.

²⁸ Branson, D.M., The Rule That Isn't a Rule - the Business Judgment Rule, Valparaiso university Law Review, issue 3, volume 36, year 2002, p. 637.

²⁹ Rosenberg, D., Galactic Stupidity and the Business Judgment Rule, Journal of Corporation Law; issue 2, volume 32, year 2007, pp. 301-322.

investor who subscribes the newly issued shares. Such cases, however, do not appear often before Czech courts. Shareholders of Czech companies are protected by pre-emptive rights to new shares, while their American counterparts usually are not. Also, it is not customary to carry out takeovers by issuing new shares for the investor in Czech Republic. In Czech Republic the investors more often actually buy out the current shares from shareholders, who therefore have control over the selling price.

This takes me to the conclusion that the current situation in Czech Republic does not call for introduction of a BJR. Such a rule will probably be redundant in our legislation and will get misinterpreted by courts unused to dealing with such matters.

Conclusions

The Czech Republic is going to adopt a statutory BJR as a part of new Corporations Act that is going to come into force on 1st January 2014. The wording of that BJR is flawed in many ways and will require careful interpretation by courts to reach its potential.

The BJR, no matter how fashionable it currently is to import corporate governance institutes from Anglo-American law, will not be able (and in fact is not meant) to solve the problems that Czech companies and their creditors have with breach of director's duties, because these are usually connected with breach of duty of loyalty rather than due care.

It is also questionable, whether Czech Republic with its typically continental low litigation legal culture really needs a BJR for a legitimate reason, because the company directors are not under excessive pressure caused by derivative actions.

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