THE EVOLUTION AND COMPLEXITY OF DIRECTORS' DUTY OF CARE

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Abstract

The duty of care, which sets the standard of conduct of a „good director" is currently governed by the Romanian Companies Act and the Civil Code. The corroboration of the two legal acts is challenging, the paper in hand aims at a comparative view of the legal norms and at the appraisal of the content of this fiduciary duty in the modern context of the competitive economy. The nature of this fiduciary duty and the cases when it can be defied according to the Romanian Law are discussed in terms of the literature and the case law that inspired the legislator. By creating parallels between the content of the agency and the traditional characters of the director's office, mainly tagged with legal prerogatives, the study will reveal the importance of the fiduciary characters of the director's function. The conclusions will catch the effects of standardizing the substantive exercise of the duty of care and the importance of defining the fiduciary character of directors' duties, both with respect to case law and as well for healthy business relationships.

Keywords: *duty of care, agency, director, fiduciary duties, directors' liability.*

JEL Classification: K22

1. Introduction

The modern corporate structure is in a continuous tension caused by the conflict between those who own the capital and those who hold the power of control and decision in the company. In this context, fiduciary duties are regulated in most jurisdictions as expansive and open terms, allowing courts to complete the will of the parties in unforeseeable situations and circumstances and to fill in the gaps which are not covered by law.

The applicable law to fiduciary duties should be understood as a response to the circumstances justifying the expectations from a person who works in the interest of another person. Under the purposes of the law, loyalty does not mean an infinite devotion to the beneficiary of the fiduciary duty, nor the neglect of the subject's autonomy or absolute subordination of the interests of the agent. In achieving the purpose of the relationship between the two parties, the duty of care sets the standard of prudence and reasonableness and the benchmark of business decisions, both established by market practices. This objective standard of conduct is measured by reference to a reasonable and prudent person in similar circumstances. If the trustee has specialized expertise, relevant for being maintained in office by his, principal then the standard will be the one of a reasonable and prudent person who owns those skills.

However, we pertain to the fiduciary duties as being characterized not just as a hypothetical objective conduct, but we also identify their subjective and intuitive nature. The intuitive character of fiduciary duties can be considered in terms of the principal, namely the shareholders, who cannot realistically foresee all business situations their representatives will face, but also in terms of the latter, by challenging their business judgment in the current activity of the company.

The cases of application of fiduciary duties are called by economists "*agency problems*"[2]. Eliminating or limiting the trustee's discretionary powers is not a satisfactory answer to this problem, due to the inability to anticipate all issues that an agent will address in the exercise of his office and due to the impossibility of shareholders to give prior written instructions for all possible business circumstances. This "*incomplete contracting*"[3], caused by the impossibility to precisely determine the

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[2] The original term of the Common Law doctrine is „*agency problem*". This concept mainly represents granting an agent the right to discretionarily carry actions, which are not being perfectly monitored by the principal and therefore may harm his wellbeing See R.H. Sitkoff, *The Economic Structure of Fiduciary Law,* Boston University Law Review, Vol. 91, 2001, p. 1041.

[3]F. H. Easterbook, D. Fischel, *The Economic Structure of Corporate Law,* Harvard University Press, 1991, p. 90-93.

concrete obligations of directors, grants them the space to develop commercial activities, which they can adapt to the changing conditions of the business world, based on their experience.

The inefficiencies resulting from misalignment of the agent's and of the principal's interests are called "*agency costs*" and the purpose of regulating fiduciary relationships is precisely to minimize these costs. The first strategy to approach the representation by minimizing the discretionary powers of the trustee[4] failed unequivocally and was replaced by the strategy of fiduciary governance, under which, the agent is conferred with broad action and representation powers, encouraging his active involvement in the company and his business risk-taking. This flexibility of fiduciary duties explains the success of the strategy of fiduciary governance.

2. What is the directors' duty of care (diligence and prudence)?

Duty of care is displayed by one of the most famous Common Law authors specialized in corporate law as "*a special case of common prudence and diligence*"[5]. Professionals and representatives are subject to the same moral duties in the exercise of their functions, but in addition to an ordinary trustee, corporate directors are not only required to comply with the legal provisions of the mandate agreement and with the corporate legislation, but also to act as professionals. We note that in the doctrine of the 80's, the duty of care was treated as a moral obligation of exercising an office, described by the reference author as the sum of four distinct subsidiary obligations. The first component would be the „duty to monitor” the business development in a reasonably manner as a whole and, therefore, to take appropriate measures in order to be informed and to obtain relevant information in the course of monitoring. The second component of the duty of care is the „duty of inquiry”, of research, the duty to investigate and " to ask questions". This duty implies the obligation to follow the way of information that could indicate signs of concern. The last two components relate to the use of the information obtained and the duty to engage in a proper decision making process in order to be able to adopt reasonable business decisions[6].

The duty of care, one of the three main fiduciary duties of a director, is therefore the duty to pay attention to business decisions and to take rational measures[7]. At a superficial glance, this fiduciary duty may seem unusually simple[8], namely directors have the obligation to participate in board meetings, to pay attention to decision-making procedures and to make decisions that are not completely irrational. Courts in the United States will not hold directors accountable for business decisions outside of conflicts of interest, apart from the cases where such decisions are "completely irrational." The consequence of this finding is to avoid the interference of justice in the internal policy procedures of the company, a term best known as the Business Judgment Rule.

The simplicity of the duty of care determined by a superficial analysis is not an erroneous conclusion. Although this obligation is primarily characterized by the complexity of current business decisions faced by a manager in the daily life of the company, the compliance or the breach of this fiduciary duty can almost be verified mathematically by analyzing the above mentioned components.

The Business Judgment Rule, a method of assessing the actual conduct of directors, intervenes as a limited analysis of the judgment and reasoning they envisaged before opting for a particular

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[4] *Disempowerment strategy* is explained in a detailed manner in doctrine by Larry. E. Ribstein in the paper *The Structure of the Fiduciary Relationship,* University of Illinois Law & Economics Research Paper no. 03-003, 2003.

[5] M. Eisenberg, *The Duty of Care of Corporate Directors and officers*, U. of Pittsburgh Law Review 51, 1989, p. 945.

[6] A similar analysis of the components of the duty of care was underlined by Prof. B.S. Black, Stanford Law School, at a Round Table, hosted by the Organization for Cooperation and Economic Development (OECD), Singapore, 2001.

[7] According to Delaware law, directors owe to the company was the Supreme Court of Delaware called "*the triad of fiduciary duties*": duty of care (due diligence and prudence), good faith and duty of loyalty. One of the first express mentions of this *triad of fiduciary duties* in the manner it is viewed by the majority doctrine and jurisprudence nowadays is reflected in the justifications of the Case *Aronson vs. Lewis*, 473 A.2d 805, 812 (Delaware, 1984). The description of fiduciary duties given by the court in this case is famous because it is one of the first clear expressions to enumerate the fiduciary duties in a concentrated formulation: „*directors are presumed to act reasonably, in good faith and in the honest belief that the action they undertook was in the best interest of the company*”.

[8] Bernard S. Black, *The Core Fiduciary Duties of Outside Directors*, Asia Business Law Review 2001, p.3.

approach or making a decision. The main function of this Rule[9] is to protect a *bona fide* director who made an informed business decision by complying with the rules of the decision making process and to avoid the analysis of the substance of this decision. The ultimate goal is to avoid the *ex post* intervention of the court in the life of the company and the substitution of a judge in the business judgment of a professional.

The first legal regulation of this duty was found in the Principles of Corporate Governance of the American Law Institute[10], namely the director's duty to act in a manner that represents in his perception the best interest of the company and by exerting the diligence that would be expected from an average careful person. We observe the insistence of doctrine and legislators of the words "*reasonable*" and "*average careful person*." The use of these terms to define reasonable care raises most of the legal issues. We consider that this choice of the legislature confers the parties the freedom to determine the reasonableness of the expected diligence, depending on each particular context. What may be reasonable diligence in a complex situation or with respect to a risky business decision will be different than the reasonable care in a company in the vicinity of insolvency, in a merger or in the process to expand its production.

Given these considerations and the complexity of a profitable business in the third millennium, we don't claim an exhaustive presentation of the content of this duty, but we intend to outline its features by reference examples of the relevant case law. A concrete evaluation of the compliance of the duty of care should consider the functions performed by directors, their knowledge, skills and abilities they can prove[11].

Unlike other professionals who must display due diligence, managers are generally not experts in specific business topics of the company. This does not mean, however, that they don't need or that they are not expected to hold specialized knowledge, skills or qualifications. In the case *Francis v. United Jersey Bank[12]*, the court noted as a general rule, that a director is required to obtain at least a rudimentary understanding of the business he or she manages. If he considers that he "*feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act*". Unlike administrators, expectations from officers with specific duties are higher, they are expected to have a particularized understanding and specialized skills, or experience in the type of business conducted by the company. If they have specific functions, such as financial officers, their mandate will be analyzed through by comparison to the skills required for those positions.

2.1. The duty to monitor

The monitoring and supervision component of the overall business development is always accompanied by the directors' obligation to pursue the identified information as a result of this continuous monitoring. This obligation is respected not only by direct observation of business evolution, but also by analyzing and improving procedures and techniques for the information process of the board of directors, of executive bodies or other external consultants. This component involves the duty of the management board to periodically monitor the adequacy of information systems and to ensure that they meet the applicable laws and principles[13]. Therefore, governing bodies have the

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[9] In the Common Law jurisprudence two versions of the Business Judgement Rule can be found. The first version views the Rule as a liability standard, by which courts take an objective examination of the substance of directors' business decisions. The second approach introduces the concept of the *Abstention Doctrine*, according to which courts refuse to analyze the decisions of the boards of directors in certain particular cases. Lately, the American doctrine introduces a new interpretation, according to which the Rule can be viewed as a doctrine of „*directors' immunity*".

[10] The principles proposed by the *American Law Institute*, see *American Law Institute – Principles of Corporate Governance- Analysis and Recommendations*, part VII, Remedies, Cap. 1, the first issue in June 1985, quoted in doctrine as „ALI Proposals". ALI principles represent principles and statutory models, which, even without being mandatory, have a great influence in the creation and application of corporate law, academia and research.

[11] *Supra* 4, Eisenberg, p. 949

[12] *Francis vs. United Jersey Bank*, 87 New Jersey, 15, 432, A2d 814 (1981)

[13] *Corporate Governance and American Competitiveness* by the members of the Association Business Round Table, The Business Lawyer, Vol. 46, No. 1, 1990, p. 241-252.

task to satisfy the structural and the organic integrity of the company[14]. The organic integrity represents the functionality and effectiveness of the management and the ensuring of constant existence and operation of an adapted internal information system that provides financial data to determine accurate decisions. This ongoing duty is inherent to the management function, it implies a constant proof of a steady information system and the initiative to constantly be informed.

The most illustrative example is the previously mentioned case, *Francis vs. United Jersey Bank*, in which Ms. Pritchard, the manager of a reinsurance company was not aware of important cash misappropriation by the vice president and by the CEO, because she was not actively involved in the business, rarely visited the company and didn't make any efforts to get acquainted with the insurance-reinsurance legislation or with the practices of the company. In this case, the court held that "*Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements*". Moreover, the court found that detection of misappropriation did not entail special expertise, but an ordinary reading of the balance sheets would have been sufficient.

The duty to monitor does not involve the obligation to obtain information about all aspects of corporate activities, this would be impractical and very costly. The limits are set again by the reasonable character, i.e. the awareness and attention that directors should seek. This limit depends on the specific circumstances and on the effects of that decision, the business judgment of the manager is determined on a case-by-case basis.

Regarding the performance of this obligation, the total delegation of the monitoring and surveillance duty is not permitted[15], because it is one of the primary responsibilities of management. An informed decision adopted in compliance with the general duty of supervision will not call into account any director, even if the final result is a failure, as long as that particular decision takes into account the general criteria for identifying the priorities considered by the director[16]. For example, the management examines relevant information, weighs the risks and then decides not to install an information security system due to the high costs of the process. In the same manner, the board may decide to delegate the supervision of certain determined processes[17].

The examples may be multiple, but their common grounds is that if a decision is the follow-up of deliberation qualifies for the application of the Business Judgment Rule, the members of the board cannot be held liable, even if the decision itself was not reasonable.

2.2. The duty to monitor, to research, to investigate and „to ask questions"

We consider that the second component of the duty of care is the duty of directors to track and to maintain their interest for the pieces of information that might indicate signs of concern for the evolution of business, namely not to ignore credible signs of possible difficulties of the company. If information from credible sources raises concerns about financial problems or irregularities, the director is obliged to take the initiative prior to the matter being brought before the Board. The exercise of responsibilities of directors can be episodic and not very often, but the responsibility itself is continuous and present every day[18]. The reference case to illustrate this component dates back to 1920, *Bates vs. Dresser*[19], concerning diversion of funds by the president and by a majority shareholder of a company. US Supreme Court held that lack of liability is determined by the reasonable compliance of directors with the duty of supervision and data that came to their attention

[14] B. Manning, *The Business Judgment Rule and the Director's Duty of Attention,* Business Law Review no. 39, 1994.
[15] Par. 4.01(b) ale *ALI Principles of Corporate Governance*
[16] Recommendation of the Committee on Corporate Laws, Section of Corporate, Banking and Business Law, American Bar Association, *Corporate Director's Guidebook*, Business Layer no 33, 1978, p. 1595-1603.
[17] Examples taken from M. Kolb, *The Delegation of Authority to Committees of the Board of Directors: Directors' Liabilities*, University of Baltimore Law Review no. 9, 1980, p. 189.
[18] *Supra* 14, B. Manning, p. 1484
[19] Case *Bates vs. Dresser*, 251 U.S. 524 (1920).

by exercising this obligation did not indicate any signs of concern. In cases with this object, the liability of board members should not be engaged, if their confidence is supported by frequent auditor reports and these are as well convinced that the president, which is an executive officer and shareholder, has the interest to act in the best interest of the corporation.

We consider the analyze given by the court on this component interesting, after determining whether the requirement of supervision was reasonably exercised. Although this component seems to be triggered or caused by the first element of the duty of care, we consider that this element has a character of its own. The duty to monitor requires directors to conduct active, enterprising research, and to take the initiative whenever their business judgment raises questions on the conduct of some operations. The active role of the director, expected in the execution of this component is the core element of the duty of care and unequivocally illustrates the conduct and the attitude the director should have towards the long-term policies of the company.

2.3. Duty to run a reasonable decision-making process and to adopt reasonable decisions

We opt for the concomitant approach of the last two components of the duty of care, as both characterize decision-making functions. We consider, however, that these two elements cannot be confused, since the essence of the first component is its procedural nature, while the second determines the quality of the actual business decision.

2.3.1. The Procedural Element

The general rules governing the decision-making process of the board of directors are based on the same principle of reasonable diligence, namely the duty to be adequately informed in advance in terms of the particular management decision. This information process will depend on several considerations, such as the magnitude of the decision, the time available, the costs involved, the need for specialized external counseling, the trust that directors can reasonably have in subordinates and advisers. These criteria are obviously not exhaustive, not only because of the changing circumstances directors may face, but also due to the business flair and intuition, which experienced directors listen once in a while.

The doctrine and jurisprudence of the last 200 years have shown that the procedural element cannot be limited to several limited criteria, the realistically available time constrains risk taking, not only the risk of detrimental economic consequences, but also the risk of not being aware of all the relevant factors which characterize a proposed deal[20].

2.3.2. The Element of substance and content

Unlike the procedural element of the decision-making process that is based on reasonableness the second element concerns the quality of the adopted decisions and it is based on a rule of protection – the Business Judgment Rule. This rule is comprised of three components, which also represent its application conditions. First, the existence of a business decision will be checked, no matter whether it is a commissive act or the refusal to take action or to initiate a transaction. Secondly, the scope of the Rule excludes *ab initio* the situations where directors have a personal or financial interest in the issue subject to the decision-making process[21]. The third procedural element is the adequate informing of the director prior to the vote or to the decision making.

The heart of the Business Judgment Rule is represented by a limited judicial review, in the cases where it is clear that the director adopted a decision to which he is disinterested and reasonably informed. Under these conditions, the quality of the business decision will not be verified in terms of the usual standard of reasonableness. Given that the standard of *ex post* review is one of the most

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[20] *Supra* 11, art. 4.01 (a)(1)-(a)(2), par. 46-47, 10th version, 1985.

[21] For example, the Rule is inapplicable in the situation when a director is called to vote upon the approval of an acquisition of the majority of shares one of his corporations by the company he manages.

debated corporate law institutions in the common law doctrine, we prefer to detail the standard under the traditional Corporate Governance Principles[22]. In essence, the rule has the effect of avoiding to call the director liable if he rationally considered that the decision was in the best interests of the company[23].

The Business Judgment Rule is not a simple case of honest but erroneous judgment[24]. The primary purpose of this rule is to distinguish between bad decisions and decisions that had an unfortunate outcome. If we compare the effects of this Rule with a car accident, we find that generally, the driver could have opted for a reasonable decision, and road decisions that have unfortunate outcomes are typically bad decisions. Complex business decisions, in contrast, are characterized not only by a context of incomplete information, but also by risks related to any other decision that could have been taken. In practice, there is generally a wide range of decisions that may be considered "reasonable". Therefore, the choice of one of the ways does not define a decision with adverse effects as being a wrong decision.

The *honest-error-of-judgment rule* covers precisely these narrow cases, in which, if the person could turn back time, he or she would choose another option in that situation. If the director has a reasonable judgement of the distribution of the achievement probability of risks, but the consequences are unfortunate, we can affirm that it he did not commit an error in the ordinary sense of the word.

Considering the *ex post* evaluation of diligence and prudence, the Business Judgment Rule should not be mistaken for the *Honest-error-of-Judgment Rule*[25]. The Business Judgment Rule has a larger coverage than the mere rule of honest mistakes, which can also be found in the ordinary civil liability of torts law. According to the Business Judgment Rule, directors will not be held liable, even if the decision itself is not reasonable, because the standard of corporate managers is lower than the standard required for the review of other professionals, even for doctors.

We believe that the answer is offered by the good faith element that cannot be omitted in any analysis of diligence and prudence. By regulating the Rule, the law does not aim to the adoption of courageous decisions, but it urges the thorough preparation of their adoption[26].

The suitable standard for the analysis of the content of business decisions can be seen from two points of view. First, it can be determined as a standard of rationality, directors will have to be able to explain the reasoning which led to the decision making process. As the court motivated the liability of a director in the Case *Selheimer v. Manganese Corp. Of America*[27], the reasoning is "*a minimum basic requirement of rationale*", namely the typical decision which lacks reasoning is the one for which rational arguments and a satisfactory explanation cannot be represented in a simple way[28].

The second alternative approach to the evaluation standard of the content of business decisions is alien to the procedural elements and mainly implies the check of truthfulness of the people who voted for the adoption of a corporate policy. In the Case *In re RJR Nabisco, Inc. Shareholders Litigation*, the Court held that there is " *no legitimate basis whatsoever to impose damages (or enter an injunction) if truly disinterested directors have in fact acted in good faith and with due care on a question that falls within the directors' power to manage the business and affairs of the corporation. To recognize in courts a residual power to review the substance of business decisions for "fairness"*

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[22] *Supra* 11, art. 4.01 din *ALI Principles of Corporate Governance:*

[23] Due to the fact that the Business Judgement Rule is a standing-alone institution, of a rare complexity, the paper at hands will not detail the doctrinal and jurisprudence debates on it interpretations, but it will be limited to an objective display of its core features, unanimously recognized by the doctrine and by Delaware Courts.

[24] *Supra* 4, Eisenberg, p. 961-962

[25] In the years 2000, in the Common Law doctrine arose debates regarding the analogy on doctors' liability to liability if directors, the reference author is Franklin A. Gevurtz.

[26] D.A. Burgman, P.N. Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the* Trans Union *Case,* Journal of Corporate Law no. 11, 1986.

[27] *Selheimer v. Manganese Corp. Of America* 423 Pa. 563, 224 A.2d 634 (1966), is a case where the court concluded that the directors directed all the company's funds to a factory that had a single production line, even though they were aware of the fact that this couldn't have been profitably operated on the long run, due to the infrastructure of the location, of the depositing space etc.

[28] *Sam Wong & Sun, Inc. v. New York Mercantile Exch.*, 735 F.2d 653, 678 n.32 (2d Cir. 1984).

or "reasonableness" or "rationality" where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors".

The central idea to be detached from this reasoning is that that the quality analysis of business decisions will only verify if the directors wasting shareholders' wealth. The characteristic of business law is not the analysis of the quality of managers' decisions and quality standards envisaged by judges should not aim to evaluate reasonableness, but the quality of rationality and judgement.

Unlike a traditional standard of good faith, the standard of rationality represents a balance between fairness, equity and liability rules. This standard expands the decisional field of directors, doesn't discourage them from adopting bold decisions, keeping a minimal degree of responsibility[29] of decision-making bodies for their decisions.

3. The governing Rules of the Duty of Care in Romania

Romanian Companies are also characterized in the current economic reality by the conflict of interest between authority and power, this tension is determined by the uneven information of the two sides regarding the current affairs of the company[30]. The intervention of legislators in the Romanian corporate law surprised the judicial practice by the numerous and comprehensive provisions of the Civil Code[31], as opposed to the special legislation regarding the mandate of directors[32].

Although the rules governing the appointments of directors are clear and predictable, their corroboration can be difficult due to the reference norms in the special legislation and in the ordinary civil law. The Civil Code expressly provides that it is the ordinary law of companies, applicable to all forms of corporate organization forms[33]. The usefulness of the Code proves to be higher in the case of limited liability companies, given that *sui generis* legislation of joint stock companies contains exhaustive and sufficiently specific provisions[34].

The modernization of Romanian corporate law was not only reached by the adoption of the Civil Code and by repealing the Commercial Code, but also through successive amendments to the "*Commercial* Companies Act" no. 31/1990, republished, currently "Companies Act"[35]. The separation of ownership and control, the stability of functions of the executive, the importance given to members of the board of directors are just a few examples. A concrete example would be that, beginning with 2006, stock companies have since their establishment the right to opt between the management in the unitary or in the dual system. The response of the Romanian legislature to the principles of corporate governance of OECD[36] is a definite step towards increasing decision-making powers of the executive of the company and the trust they are offered to act independently[37].

The tendency of the legislature to achieve higher decision-making flexibility within companies is an appreciated change. Of the two ways of modernizing company law, namely extending the power of the directors or of shareholders/associates, the Romanian legislature clearly

[29] William Quillen, a former President of the Delaware Supreme Court asserted that "*the lawyer defenders of corporate management are trying to preserve as a prerequisite for director liability is fraud*", W. Quillen, , *Business Judgment, and Neutral Principles*, Delaware Journal of Corporate Law no. 10, 1985.

[30] Radu N. Catană, *Dreptul Societăților Comerciale, Probleme actuale priind societățile pe acțiuni. Democrația acționarială*, Sfera, Cluj-Napoca, 2007, p. 160

[31] The legal texts of the Civil Code mentioned in the paper at hands refer to the New Civil Code, Law no. 287/2009.

[32] The Civil Code regulated the Corporation Contract (art. 1881ff) and the Mandate Contract (agency, art. 2009 ff.)

[33] Art. 1887 Civil Code, art. 139 par.1 of Law no. 71/2011 regarding application measures of Law no. 287/2009

[34] In Title III of the Law no. 31/1990, republished, "*Functioning of companies*", Chapter I included ordinary regulations for all types of companies and art. 72 provided that "*duties and liability of directors are governed by the norms referring to the mandate contract and by the special provisions of this law*".

[35] Modification brought by art. 18 pct. 31 of the Law no. 76/2012 on the application procedures of Law no. 134/2010 regarding the Civil Procedure Code

[36] *Enterprise Policy Performance Assessment–Romania*, OECD, 2005 http://www.oecd.org/countries/romania/.pdf

[37] However, the initiative of the legislator was not warmly saluted on the Romanian market. Originally from the German model, the dual system is not similar to the French originated law principle. As proof, this form of administration was not successfully in France either, due to the complications it involves, such as the obligation of having external financial audit and the requirement to mention the management form on all documents issued by the company. However, some stock companies opted meanwhile for dual board system, e.g. ING Romania, Transelectrica, SIF Transilvania.

opted for broadening the rights of the corporate executive[38]. Inspired by the US model of the *Business Judgement Rule*, of making corporate decisions without discouraging inherent risk of trade and innovation of any kind, the Romanian model confirms its preference for the "*risk of director error to that of judicial error*".

Unlike the Common Law, the Romanian corporate law presents similarities to the German system and tries to obtain a fair balance between creditors' rights and the fulfillment of the business purpose by granting directors increased confidence. Likewise, German law offers directors a wide decisional range and expects them to react as rational players[39]. The expanding trust of directors is observed at almost every change of Romanian corporate law. Unlike the initial version of the Law no. 31/1990, directors can currently decide on the relocation of the main office and even the change of secondary objects of the company. Freedom of action is confirmed by the renunciation of excessive forms regarding disposal acts of directors concerning the company's property[40].

In keeping with this trend, the Romanian legislator enriched the regulations relating to fiduciary obligations, both in the ordinary legal texts and in the special legislation. Traditionally, the director's office is charged with prevailing legal or statutory obligations.

Statutory obligations are inherent to the office and organically determine the management office. These statutory obligations can be found in the Civil Code, in the Companies Act no. 31/1990, in Law no. 297/2004 on the stock market and not least, in the articles of association. These are not within the nature of the mandate, but, as they are formulated in a more technical and concrete manner by the legislature or by the parties, they relate to the core management function of the company.

Although these rules are the result of the internal public order of the company[41], the purpose of statutory duties is the protection of the company and of the shareholders, and less to protect the directors. Through the successive amendments, the legislature tries to regulate the concrete exercise of these theoretical obligations by defining their fiduciary character.

The large confidence granted to directors by regulating the duty of care is doubled by the duty of loyalty, namely directors may not be incompatible[42] and cannot carry out competing activities without the shareholders' prior approval, nor on their own, or for other juridical entities. At the time of their appointment, the conditions of lack of doubt regarding a possible conflict of interest will be checked[43]. The special legislation governs the duty of care in art. 144 ind. 1 of Law no. 31/1990, as amended by Government Ordinance no. 82/2007. Following the interpretation of the legal text, it is clear that the legislature chose the faithful takeover of the Business Judgment Rule found in Common Law, the director is presumed to act reasonably, fairly and prudently in the interest of the company. The burden of proof belongs to the claimant that invokes the opposite.

3.1. The Mandate (agency) in the Civil Code – relevant aspects for the mandate of directors

In the concept of the Civil Code, the idea of the contractual nature of the mandate prevails at the cost of the former rigid and imperative regulation. According to the doctrine and to the national case law, the legal nature of the director's role is the one of a corporate agent.

The representation is undoubtedly an intrinsic element of management according to the mandate (agency), given the explicit regulation contained in art. 2012 Civil Code.

Under the 1864 Civil Code regulations, the mechanism of legal representation was explained on a doctrinal basis of the classical mandate (agency) contract, which by its nature was a contract that

[38] The use of the term "director" in this paper is understood to be extended to the member of the Directorate stock companies that adopt the dual management system..

[39] M. Siems, *Die Konvergenz der Rechtssysteme im Recht der Aktionäre: ein Beitrag zur vergleichenden Corporate Governance in Zeiten der Globalisierung*,. Mohr Siebeck, 2005, Part II, Ch. 3 *Konvergenz durch Kongruenz* , p. 331.

[40] Art. 70 ind. 1 of the Law no. 31/1990 introduced by Government Ordinance no. 2/2008 for the modification and completion of Law no. 31/1990 and Law no. 26/1990 of the Commercial Registry.

[41] *Supra* 30, R.N Catană, p. 170

[42] Art. 17 of the Government Ordinance no. 82/2007 modified by art. 138 ind. 2 of the Law no. 31/1990

[43] Art. 197 par. 2 and 3 Law no. 31/1990

assumed representation. By taking over the previous regulations of Decree no. 31/1954, concerning representation, in the current Civil Code, the legislature has not only adapted the characters of representation to current realities, but also contributed to enhancing the representation powers of directors. A change which stresses the idea of the representation, is the fact that board members or managers of stock companies cannot have the status of employees of the company during their term in office, being incompatible with the institution of the "*intuituu personae*" mandate[44].

The decisional flexibility is also granted by the right to represent the company, which usually belongs to each director, except for contrary stipulations in the articles of association. In return, directors are personally and jointly liable for the damages they caused to the company[45].

The emphasis on this confidence is supported by the interdiction of the transmission of the director's office, without the consent of the shareholders, otherwise the director is personally liable for the violation. The original version of the Companies Act in 1990 expressly provided that the company does not commit to any third parties for the damages caused by the director, but due to the development of the institution of the apparent mandate, the current jurisprudence tends to the restoration of the damage by the company, followed by the subsequent exercise of the recourse right against the director[46]. In this case, the Civil Code expands again the provisions of stricter special legislation by allowing the possibility of the substitution in certain urgent situations or in exceptional circumstances, with the obligation of the immediate notification of the principal[47].

According to art. 1914 Civil Code, directors have the right to sign all documents that are necessary for the fulfillment of the object of the company, "*in the absence of shareholders' opposition*", a provision that is supplemented by art. 70 of Law no. 31/1990, republished, which provides that directors are entitled to decide on "*all operations [...] apart from the restrictions referred to in the articles of association*". The acts done by the management bodies within the limits of the powers they have been conferred are documents of the legal entity itself and bind the company itself, even if those acts exceed the powers of representation conferred to managers[48]. We consider that the intention of the legislature is obviously to highlight the exceptional direct liability of managers to third parties, due to the fact that directors are entitled to decide on "*all necessary operations to fulfill the trade purposes of the company, apart from the restrictions referred to in the articles of association*"[49].

This formulation of the legislator, which includes "*all necessary operations [...] apart from the restrictions referred to in the articles of association*" is complemented by the comprehensive and permissive provisions of ordinary law. Irrespective of the civil or commercial nature of the mandate, it extends to all necessary acts for its execution, even if these are not expressly stated. The novation of the interpretation is emphasized by art. 2017 Civil Code[50], a provision which is complemented by art. 802 Civil Code.

Through a regulation adapted to the current civil and commercial circuit, the legislature admits that the agent is sometimes forced to deviate from the instructions he received and his business judgment is challenged. We consider that the corroboration of these provisions is one of the best examples of the modernization of the rules on representation by taking into account the unforeseen trading situations and by and augmenting the confidence in the decisional abilities of directors.

Therefore, directors owe statutory duties and fiduciary duties to the company, and less to the shareholders, which are protected by law by the regulation of the action for damages against management or board members.

[44] Art.137 ind. 1 par. 3 Law no..441/2006 corroborated with Government Ordinance no. 82/2007.
[45] Art. 75, art. 198 par. 2 of Law no. 31/1990
[46] Art. 71 of Law no. 31/1990, actualized version of 2013 and art. 41 of the first version of the Law no. 31/1990
[47] The evolution of the institution of substitution of the agent can be observed by comparing the art. 2023 Civil Code with the regulation of art. 1542 Civil Code 1864 and art. 71 of the Law no. 31/1990.
[48] Art. 218 Civil Code
[49] Art. 219 Civil Code corroborated with art. 70 of the Companies Act.
[50] The former regulation, art. 1537 Civil Code 1864 provided that „*the agent can't trespass the limits of his mandate. The faculty to close a transaction comprises the one to make a compromises"*.

The supreme interest protected by law is the interest of the principal, namely of the managed company and not of the persons holding the capital or the authority. A good example of this is that even in the event of termination of the mandate, the duties are not suddenly repealed as well, but according to art. 2030 Civil Code, the mandate does not stop immediately if it was given for carrying on an activity on a continuing basis.

We cannot assert that the director represents the shareholders, the main feature of the mandate is the exercise of his own powers, and the law assigns to the General Assembly of the Shareholders and the director completely distinct skills. The appointment and removal of directors by shareholders is a legal power conferred to them, independent of the mandate (agency). According to the British theory "*Nexus of Contracts*"[51], the director is not the trustee of the company, but the company itself, he is a body without which there the entity could not exist. We consider therefore that the conclusion of this mandate contract is a just an appropriate ”juridical coat” of the relationship between the company and the director, but the liaison between the manager and the company remains governed by the principles of separation between power and control[52]..

Although the content of the mandate agreement is covered in more detail by the Civil Code, both by imperative and by suppletive norms, the new formula aims at creating a legal horizontal relationship, mainly supported by fiduciary duties and by the character *intuituu personae* character of this institution. In addition to the legal and to the statutory obligations which the agent must comply with, the concrete manner he executes its mandate becomes more flexible and the law tries to grant much more credit to the directors' judgment and to his decisional capacity.

The structures of Romanian companies provide enough possibilities for the shareholders to control the directors, the most important being their nearly discretionary appointment and revocation[53]. The persons holding the company don’t need other mechanisms to control or influence, even less in the cases of limited liability companies that have a more pronounced *”intuituu persoane*" character, but even stock companies with a dual management system grants those who own the power well developed internal control mechanisms. By outlining the conflict of interest rules, the legal reform increasingly tends towards the transformation of the representative role of the agent in a categorical decision-making role, in a capacity to make decisions and implement them[54].

The *ad nutum* revocation principle of the mandate was maintained in the Civil Code of 1864, but the discretionary revocation is nuanced in art. 2031 of the current Civil Code, which provides that the revocation can occur "*at any time [...] regardless of the form in which the mandate agreement was signed and even though it was declared irrevocable*". Therefore, if the notion of trust disappears from the legal relationships arising from the agency, whose essential feature is the *intuitu personae* character, the revocation retains its discretionary nature.

The confidence granted to directors is also related to their liability for abusive acts. Both the company and creditors are protected by the express acceptance[55] of office by the person appointed as a member of the board. This provision is coupled with the requirement for the director to conclude from that moment a professional liability insurance. After the German model, the director of a Romanian limited liability company can only be claimed by the shareholders and not by creditors, as long the insolvency proceedings were not initiated against the company. These provisions existed in the initial version of the law[56] and were built on the same concept of trust, therefore they suggest the remedy of the deficiencies by the persons who appointed the director and whose trust has been violated.

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[51] Stephen M. Bainbridge, *The Board of Directors as a Nexus of contracts: A critique of Gulati, Klein and Zolt's Connected Contracts Model,* University of California Los Angeles School of Law Research Paper No. 02-05, 2002. The theory „*Nexus of contracts*” is an idea launched by a number of lawyers and economists, who argue that the company is nothing more than a collection of contracts between different stakeholders, as shareholders, directors, employees, clients, etc.

[52] *Supra* 30, R.N Catană, p. 165.

[53] Art. 137 ind.1 alin. 4 of the Law no. 31/1990

[54] Additionally to the provisions of art. 1914 and 1918 Civil Code, previously detailed, art. 1919 grants directors ”with the right to representt”, the right to represent the company in courts.

[55] S. Cărpenaru, Gh. Piperea, S. David, *Legea Societăților, Comentariu pe articole,* C.H. Beck, 2014, p. 486.

[56] Art. 73 of the current version of Law no. 31/1990 has the same content as art. 43 of the first version of the Law.

The rationale of this remedy is based on the fact that the "*social danger*" created by the blamable acts of directors is reduced, as long as the company is solvent. As a consequence, the personal liability of the manager tends to be seen in the modified versions of the Companies Act as "*a breech of shareholders' trust* ", whereas in relations with third parties, the company is" on the side of the manager" who represents it[57].

3.2. Directors' duty of care in the Civil Code and in the Companies Act

The legal fiduciary relationship is defined in the American and British doctrine[58] as being that relationship in which one party acts in the name and on behalf of the other party, the foundation of this relationship being the concept of trust. Following the same rationale, the Romanian legislature understood the regulation of fiduciary duties as a spring from the mandate and of business management.

We will not focus on the duty of loyalty, but we note that this fiduciary duty arises from the general duty of good faith in the execution of the mandate, provided by art. 970 Civil Code, in conjunction with the requirement of the management of companies' property of the Companies Act. In the same manner, the legislature regulates the obligation of information and transparency, which is in an interdependent relationship with the duty of loyalty, namely the avoidance or declaration of conflict of interest between the manager and the company. The general duty is regulated by the Civil Code in art. 2018 par. 2 (ex. art. 378 Commercial Code) and is supplemented by provisions of the special law.[59]

The central concept that we intend to develop is the duty of care, expressly provided expressly by art. 144 ind. 1 of Law no. 31/1990, republished. By the wording of this standard of conduct, namely "*board members will exercise their mandate with the prudence and diligence of a good manager*," the legislator retained the common law essence of due diligence and prudence, but the text also remains loyal to the nature and essence of business management. The provisions regarding business management, art. 1330 Civil Code, provisions are not applicable, contrary to the wording chosen by the Romanian legislature.

In the same manner, par. 2 of art. 144 ind. 1 faithfully adopts the Business Judgement Rule, namely *"the director does not violate par. (1) if, while making a business decision, he is reasonably entitled to consider that he acts in the interest of the company and based on adequate information."*

By the chosen wording, the legislature includes in the content of the Rule classical doctrinal components, mentioned in the previous section, namely the duty to be up to date with relevant information on the evolution of corporate life, after the performance of the duty of supervision.

Further, art. 144 ind. 2 para. 3 of the Company Law accurately captures the third component of the duty of care, namely the obligation to use the data obtained following the investigation with the result and purpose of adopting effective measures for the purposes of remedying problems. The text "*Directors shall notify the Board of Directors of any irregularities detected during the performance of their duties*" reveals the transparency that should characterize an effective and professional management[60]. We consider though, that the obligation to supervise and monitor the development of the business as a whole is not expressly shown in the content of the legal text. We welcome the flexible definition of the business decision in art. 144 ind. 1 para. 3, especially since the legislature includes in the concept of business decision both commissive act, as well failures to act, therefore even the failures to take action rule can be protected by the Business Judgment Rule, provided that it meets its premises.

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[57] Art. 24 of the Law no. 441/2006 for the modification of art. 55 par. 1 of the Law no. 31/1990.

[58] Hood., P., *Director's Duties under the Companies Act 2006: Clarity or Confusion?*, The Journal of Corporate Law Studies, Hart Publishing Vol. 13, 2013, p. 1-49

[59] Art. 117^2, art. 131 par. 5, art. 153^9 of the Law no. 31/1990, art. 224 of the Law no. 297/2004.

[60] The presumption of the onerous character of the mandate for the pursuit of a professional activity is not necessarily applicable to a director's office, because according to art. 77 of Law no. 31/1990, his remuneration is established prior to the start of his term in office.

The duty of supervision of the business as a whole can be deduced from the text of art. 144^2 par. 1 and 2, which reiterates the applicability of the regulations regarding the obligations of trustees and the fact that they are responsible for the actions of their inferior staff they senior staff. Thus, directors will be liable to the company "*when the damage wouldn't have occurred if they had exercised the supervision imposed by the duties of their office*."

The component of the duty of care which requires directors to employ a reasonable decision making process and to adopt reasonable business decisions is only included in art. 144 ind. 1, para 2, when the director "*is reasonably entitled to consider that he acts in the interest of the company*." We appreciate that following the reference norms of art. 72 of Law no. 31/1990, the legislator left as a matter of course the fact that the core of the duty of care is the guiding of his conduct in the interest of the company.

One of the few examples that illustrates the duty of care in the Romanian jurisprudence is *Decision no. 2827 of 27 September 2011 pronounced in an appeal by the Commercial Division of the Supreme Court*. The Supreme Court reiterated the interpretation of the provisions of art. 144 ind. 1 of the Companies Act, namely that the law only provides protection against negligence and fraud, and not against inherent business risks, when a decision made in good faith turns into a failure. In this regard, the Supreme Court also stated that as long as "*the director's discernment is not affected by a personal stake, he is properly informed about the nature of the business and he is convinced that the decisions taken are in the interests of the company, then the directors is relieved of any liability*".

Through the second reference Decision, *Decision no. 2907/19.05.2011 pronounced by the Commercial Division of the Supreme Court,* the Supreme Court maintained the legality of the decision of the boards of directors of Romania's National Bank, ordering the withdrawal of the authorization granted to a person who was holding the position as member of the board of a commercial bank. His violations of the duty of care was held when he voted in favor of granting advantageous credits to a company that owned 49% of the share capital of another company, where he was a member of the board as well.

We consider that the Supreme Court rejected the appeal of the director exclusively by applying the provisions relating to fiduciary duties but according to the *status quo* retained by the court and to the reasoning of the Decision, motivation, we consider that the marking of the duty of loyalty would have been more appropriate than the acknowledgement of the violation of the duty of care.

The court acknowledged the applicability of art. 144 ind.1 of the Companies Act, but observed the conflict of interests covered by art. 144 ind. 3, which is in our view a typical breach of the duty of loyalty and not of the duty of care. As detailed in the previous section, good faith is a characteristic of due diligence and prudence, but in essence, the concept of good faith is typical to duty of loyalty. The court considers that "*the lack of objectivity and impartiality by a person having powers / qualities, both within the company and within the credit institution it is obvious, because the two don't converge to a common interest*." Although the lack of good faith of the claimant, former director, is obvious we consider that the court makes a confusion between the two fiduciary duties, which according to the current legal regulation only has theoretical importance, since the effects of penalty are the same in cases of violations of either fiduciary duty.

4. Conclusions

The duty of care is a critical component of business law, being in a continuous change and reinterpretation. This fiduciary duty is the most solid basis and the strongest argument in order to allow directors to receive appropriate protection elements and to avoid disproportionate liability for the errors they commit.

Directors are subject to the ordinary law rule that if a person assumes a role whose execution involves the risk of harming others, he or she has the moral and legal obligation to exercise their role diligently and prudently[61]. In pursuit of his activity, the director may commit acts that harm the company, facts which may consist of in inadequate decisions, unprofitable contracts, wrong fulfilling of duties under the management agreement, under shareholders decisions, under the articles of association or according to the law. The defining criterion for assessing the wrongful conduct is to analyze the circumstances in which the decision was adopted. But different assessment criteria are to be used in relation to the type of the company. While in joint stock companies, the liability or the fault have as assessing criterion the behavior of a good administrator, the ordinary director of limited liability companies relates to the interpretation of the rules governing the mandate.

On the one hand, fiduciary duties require the director to risk in the interest of the principal, but on the other hand any risk taken can be followed by the payment of enormous compensation to the subject. From this perspective, operations under fiduciary duties become intuitive, making it impossible to create an available model of conduct and a general decision-making scheme.

In the context of the complexity of the business world, the exhaustive description of a director's duties is virtually impossible to be provided by law, by shareholders or by the director himself. This is the main reason why the legislature made use of the rules governing the mandate (agency), which thanks to its the vastness and generosity captures not only the nature, but also the essence of fiduciary duty.

The symbol of shareholders democracy, represented by prerogative of directors' liability, is modernized in the context of globalization and it is taken by the Romanian legislature by the faithful acquiring of the Business Judgment Rule from Common Law, implemented by most countries in continental Europe. This restructuring of corporate governance is initially a shock to the Romanian legal tradition and culture, in the event of introduction of an institution that blocks the liability of a person, although his act meets the conditions of a tort or of contractual liability. In this context, not only the fault takes on a new value, but the approach of the civil procedural system becomes different, due to the needs in terms of assimilation of new institutions and the need to create an appropriate framework without distorting the essence of their application or their effects.

The convergence of international and European governance models influenced the Romanian legislation towards an effective and modern regulation, whose perfection is hampered by evident cultural differences, especially in terms of structure.

By abiding the principle *lex specialis derogat generalis*, the Civil Code 2011 allows a flexible interpretation of the general conduct and of concrete business decisions of a director, due to the reference norms of the Companies Act referring to the rules governing the mandate. Thanks to more generous and less technical provisions of the mandate contract, of the business management and of the company contract, courts will be able to turn to the ordinary civil law, which provides the possibility of interpretation of the Companies Act in cases when it contains more precise provisions or higher standards.

The trust and the *intuitu personae* character specific to the fiduciary relationship are reflected by the legislature through the successive changes of the Companies Act and by creating a broad interpretation by the provisions governing the mandate (agency). These rules characterize the fiduciary relationship and show not only the internal protection and prevention function, but also the external function of protection of third parties who enter into transactions with the agents.

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