

Directors' and Officers' Liability

Austrian Report

Martin Karollus, Johannes Kepler University Linz



Legal Forms: Public and Private Company – Stock Corporation and LLC

- In the field of capital companies, the main legal distinction is drawn between the stock corporation (*Aktiengesellschaft*) and the limited liability company (*Gesellschaft mit beschränkter Haftung*), and not between a 'public' and a 'non-public' ('private') company.
- Stock corporations are not necessarily listed and the shares are not necessarily traded publicly.
- Therefore, the common terminology of a 'public company' as a synonym of stock corporation is not suitable for Austrian law.



Public and Private Company – Stock Corporation and LLC

- Within the Stock Corporation Act, several distinctions are made between listed (*börsennotierte Gesellschaften*) and non-listed corporations: certain provisions are only applicable to listed corporations or to non-listed corporations.
- Furthermore, the Austrian Supreme Court has decided to grant more flexibility for the articles of association of a non-listed corporation.
- In the legal literature, this development is described as the 'two-track stock corporation law' (*zwei-spuriges Aktienrecht*).



Public and Private Company – Stock Corporation and LLC

- On the other hand, a limited liability company is indeed 'private' in the sense that shares are not traded publicly and a transfer of the shares is usually restricted by the articles of association.
- By that and also in some other respects, a limited liability company in practice very often resembles a partnership.
- However, one major difference is the strict protection of the corporation's capital (real contribution of capital, prohibition of repayments, ...).



Combination of a Partnership with Stronger Versions of Liability Protection

- Austrian law allows a legal form with limited liability (eg a limited liability company or a stock corporation, but also co-operatives, incorporated associations, etc may be used) to be a general partner of a partnership.
- By that, the advantages of both types of companies can be combined (flexibility and taxation on the one hand and limited liability on the other hand).
- The most common example of such a combination is the *GmbH & Co KG*.



Combination of a Partnership with Stronger Versions of Liability Protection

- However, both by statutory law and by case law, such a 'limited liability partnership' is in some respects treated like a limited liability company, thus diminishing the advantages of having chosen a partnership and narrowing the gap to limited liability companies.
- Most recently, the Austrian Supreme Court decided that the prohibition of repayments (*Verbot der Einlagenrückgewähr*) is to be applied too.
- It is not yet clear which further developments in this respect are to be expected.



Structure of Organs Stock Corporation

- In an Austrian stock corporation, the following four organs are mandatory ('two-tier system'):
 - managing director(s) (board of directors, *Vorstand*)
 - supervisory board (*Aufsichtsrat*)
 - shareholders' meeting (general assembly, *Hauptversammlung*)
 - auditor (*Abschlussprüfer*)



Structure of Organs Stock Corporation

- In a stock corporation, the key role is attributed to the managing directors.
- The shareholders' meeting only has a limited scope of competence:
 - It may decide only in matters conferred on it by statutory law or – as an exception – by case law (eg *Holzmueller* doctrine), or if the decision is passed on to the shareholders' meeting by the directors or by the supervisory board.
 - It has no power to appoint or remove directors.
 - Or to render instructions to the directors.



Structure of Organs Limited Liability Company

- In a limited liability company, only the following two organs are mandatory in any case:
 - managing directors (*Geschäftsführer*)
 - shareholders' meeting (*Generalversammlung*)
 - ➔ It is possible that one human being (sole shareholder and sole director) is the only member of both organs.
- Under specific conditions, also a supervisory board (*Aufsichtsrat*) and/or an auditor (*Abschlussprüfer*) are required.



Structure of Organs Limited Liability Company

- In a limited liability company, the shareholders' meeting is the dominant organ.
- It is entitled:
 - to pass a resolution in all matters it wishes to decide on;
 - to render directions to the managing directors; and
 - to appoint or remove the managing directors.



Appointment and Removal of the Managing Directors

Stock corporation:

- Managing directors are appointed by the supervisory board.
- The appointment is for a fixed time, up to five years.
- Before that, the supervisory board may remove a managing director only for a good cause.
- If there was no sufficient cause, the removal decision is effective anyway, but it may be challenged by the removed director.



Appointment and Removal of the Managing Directors

Stock corporation:

- The shareholders' meeting has no competence to appoint or to remove a managing director.
- A motion of no confidence of the shareholders' meeting constitutes a good cause, thus giving the supervisory board the opportunity to remove the managing director if it wishes to do so.
- The members of the supervisory board – apart from those who are delegated by the works council – are appointed by the shareholders' meeting or by individual shareholders.



Appointment and Removal of the Managing Directors

Limited liability company:

- The managing directors are appointed in the articles of association (if a shareholder is appointed) or by the shareholders' meeting.
- Usually, the appointment is not for a fixed time, but for an indefinite period.
- The function lasts until it is terminated (removal, resignation, death, loss of legal capacity, ...).



Appointment and Removal of the Managing Directors

Limited liability company:

- Unless stated otherwise in the articles of association, the shareholders' meeting may remove a managing director at any time by majority vote; a good cause or a justification is not necessary.
- If a majority vote cannot be reached: upon request of a shareholder, a managing director may be removed by a court for a good cause.



Basis of Liability

- The liability of managing directors or members of the supervisory board is based on corporate law, not on contract or on tort.
- Statutory provisions in corporate law state that directors and members of the supervisory board are generally obliged to act in accordance with the standard of care, and that they are liable for all damage caused to the corporation by a violation of that standard.
- The legal duties derive from the function itself, and not from the employment contract.
- Violations of contractual or tortious duties may be an additional reason for liability.



Scope of Duties

- In general, the organs are obliged:
 - to safeguard the corporation's interest in the best way;
 - to take advantage of all opportunities;
 - to prevent the corporation from being harmed;
 - to increase the profitability over the long term (in contrast to short term profit maximisation);
 - to secure the existence of the company on a sustainable basis; and
 - to fulfil all requirements set by law and by the articles of association.



Standard of Care

- The relevant standard of care is that of an orderly and conscientious manager (stock corporation) or an orderly businessperson (LLC).
 - Despite the different wording of the statutes, in principle the same standard applies to both legal forms.
 - Factors like the scale of the company or the business focus are decisive for the concrete specification on a case-to-case basis.
- It is irrefutably presumed that directors and members of the supervisory board have certain abilities (knowledge, skills and experience) which are necessary for their function.



Business Judgment Rule

- The BJR was incorporated into the Austrian Stock Corporation Act and the Limited Liability Companies Act by an amendment in 2015:
 - *In any case, a director acts in accordance with the diligence of an orderly and conscientious manager, if a business decision is not influenced by a conflict of interests, and based on an informed judgment, the director is entitled to assume that he is acting in the best interest of the company.*
- Before that, the Austrian Supreme Court had adopted rather similar principles in case law, beginning in 2002.



BJR: Comparative Law Approach, Scope

- The wording of the Austrian provisions on the BJR resembles the BJR provisions in Germany and Liechtenstein.
- According to the Austrian Supreme Court, legal literature and case law from Germany and Liechtenstein may be relevant for the interpretation of the Austrian BJR.
- The BJR also applies to members of the supervisory board.
- The Austrian Supreme Court has held that the BJR is relevant for all legal forms, in particular for a private foundation (*Privatstiftung*).



BJR: Rationale and Goals to be achieved

- Liability should be restricted to acts which are totally unintelligible, whereas 'slight mistakes' or acts that can be explained at least to some extent shall not trigger liability.
- Only a plausibility check of the organ's acts shall take place, and no 'full blown second guessing'.
- The organ's discretion is to be respected, and the danger of a hindsight bias influencing the assessment by the courts shall be reduced.
- Excessively risk-averse behaviour on the part of directors and members of the supervisory board shall be avoided (but on the other hand: implied limits in case of excessive risks?).



BJR and General Standard of Care

- The BJR is a *lex specialis* (an exception) to the general duty of care. It only states under which conditions liability is excluded in any case.
- If the requirements of the BJR are not met (eg due to a conflict of interests or a lack of appropriate information), that only means that the BJR is not applicable.
- In this case, the acts of the organ are to be assessed under the general duty of care, and it is still possible that the result is no liability under this standard.



Dissenting Director

- Directors are severally liable for damage caused to the corporation.
- However, liability is personal: a director may only be held liable for his or her own fault, and not for the others' fault.
- Each director is responsible for monitoring the other directors at least to some extent.



Dissenting Director

- In case of dissent, a director is obliged to take all steps necessary to prevent the corporation from being harmed.
- In important cases, that may also include an obligation to turn to the supervisory board or to the shareholders so that these organs can stop the other directors' actions or remove them.



Damage to Shareholders' Interests

- In general, a director or a member of the supervisory board is only liable to the corporation and not to its shareholders.
- In many cases, shareholders' damages are only reflective. If the corporation's claim is successful, the shareholders benefit indirectly.
- Furthermore, there is no legal relationship with shareholders: the duty of care is only owed to the corporation and not to its shareholders.
- Shareholders are entitled to demand that claims are pursued by the corporation (stock corporation) or to pursue the claims themselves on account of the corporation (LLC).



Obligation to File for Insolvency

- Under Austrian law, managing directors are legally obliged to file for insolvency in cases of
 - illiquidity (*Zahlungsunfähigkeit*); or
 - over-indebtedness (*Überschuldung*).
- If this requirement is not met, directors are liable both to the corporation and to its creditors.
- The corporation may claim recovery for further losses (the deterioration of the net assets) incurred by the delay.
- If insolvency proceedings are started later on, the corporation's claims are pursued by the insolvency receiver.



Obligation to File for Insolvency

- Liability to creditors is based on the concept that the obligation to file for insolvency is a legal provision with the aim of protecting creditors (*Schutzgesetz*).
- As for the calculation of damages, a distinction is drawn between:
 - **'old' creditors** who were already creditors before the obligation to file for insolvency was violated; and
 - **'new' creditors** who became creditors only after the violation of the said duty had already started.



Obligation to File for Insolvency

- The distinction is based on causation:
 - **'Old' creditors** are entitled to claim the damages resulting from the decreased insolvency dividend on the obligation, compared to the hypothetical dividend if the filing for insolvency had been performed in a timely manner (*Quotenschaden*).
 - **'New' creditors** can demand to be put into the position they would have been in if they had not entered into the transaction with the insolvent company (reliance interest, *Vertrauensschaden*), eg the loss incurred by transferring goods or rendering services to the company.



Obligation to File for Insolvency

- In practice, usually only claims of 'new' creditors are pursued individually, in many cases by social security agents.
- As long as insolvency proceedings are pending, only 'new' creditors are entitled to pursue their claims individually, whereas the deterioration of a company's assets is exclusively pursued by the insolvency receiver.



Shareholder Authorisation of Disadvantageous or Unlawful Acts

- In a **stock corporation**, shareholders (the shareholders' meeting) are not entitled to render any instructions to the directors or to adopt a resolution on matters of business management (on their/its own initiative).
- However, the directors and, if the decision is subject to an approval of the supervisory board, the latter may pass on the decision to the shareholders' meeting.
- The directors are bound by the shareholders' decision (if any) and exempted from liability.



Shareholder Authorisation of Disadvantageous or Unlawful Acts

- The exemption from liability also applies to acts which are disadvantageous to the company (but not contrary to mandatory provisions).
- Full and accurate information provided to the shareholders is a necessary precondition for exemption from liability.
- Exemption from liability has no effect if creditors pursue the claim.
- If the shareholders' resolution violates mandatory provisions, it is null and void and therefore no exemption from liability takes place.



Shareholder Authorisation of Disadvantageous or Unlawful Acts

- In a **limited liability company**, the shareholders' meeting is entitled to render instructions to the directors or to approve measures taken (or to be taken) by the directors.
- The directors are bound by the shareholders' instructions and exempted from liability. Likewise, an approval by the shareholders' meeting exempts directors from liability.
- In both cases, the exemption from liability has no effect if the corporation's creditors rely on the claim.



Shareholder Authorisation of Disadvantageous or Unlawful Acts

- If the shareholders' meeting instructed the directors to commit an unlawful act (violating mandatory provisions) or if such an act was approved, the shareholders' resolution is null and void.
- In these cases, the directors are not bound by the instruction (but obliged to disregard it), and they are not exempted from liability.



Authorisation by the Supervisory Board

- Both in a **stock corporation** and in an LLC, certain matters specified by law, by the articles of association or by a resolution of the supervisory board are subject to approval by the supervisory board.
- In the absence of an approval, directors are liable for exceeding their competence, even if the act itself would have been in line with the standard of care.
- An approval by the supervisory board does not exempt directors from liability.
- Moreover, directors and members of the supervisory board are severally liable.



Limitation Period

- The limitation period for claims of the corporation is five years.
- It starts to run when the corporation (ie other directors, who themselves are not liable, members of the supervisory board or [dominant?] shareholders) gains knowledge of the damage and of the facts on which the claim is based.
- Therefore, in practice it could take much more than five years until limitation occurs. This could raise problems in connection with the 'claims made' principle in D & O insurance if the extended discovery period is too short.



Liability for Damage to Third Parties

- In general, under Austrian law, directors or members of the supervisory board are not liable to third parties.
- The director has no legal relationship with the third party, and the duty of care is only owed to the corporation.
- However, there are many exceptions to this rule, and their number seems to be increasing steadily.
- Liability vis-à-vis third parties may take place in the following cases:



Liability for Damage to Third Parties

- **Derivative action**
 - If a stock corporation does not fulfil its obligations, creditors are entitled to pursue the corporation's claims against directors or members of the supervisory board.
 - Creditors of a limited liability company may pursue such claims based on compulsory enforcement.
 - In these cases, *only the corporation's* claims as they exist (with minor modifications) may be pursued, whereas no additional claims of third parties are created.



Liability for Damage to Third Parties

▪ *Culpa in contrahendo*

- In general, only the prospective contractual partner (ie the corporation) is liable for *culpa in contrahendo*, and not persons acting on behalf of the contractual partner.
- However, the organ is held to be liable personally (1) if it had a significant own economic interest in the transaction (*wirtschaftliches Eigeninteresse*) or (2) if the director caused the third party to specifically put his trust in the organ's personal qualities and/or integrity (*Erweckung eines besonderen persönlichen Vertrauens*).
- The concrete scope of this liability is unclear.



Liability for Damage to Third Parties

▪ Violation of a legal provision with the aim of protecting a third party (*Schutzgesetze*)

- Relevant provisions may be found in all areas of law, including but not limited to criminal law.
- In order to find out whether a legal provision is a *Schutzgesetz*, it is necessary to examine its purpose and find out if it is designed to protect individuals and not only the public interest.
- Examples: obligation to file a petition for insolvency; obligation to inform the landlord of triggering events for an increase of rent, ...



Liability for Damage to Third Parties

▪ Doing harm to goods specifically protected by law (*absolute Güter*)

- Examples: life, health, personal rights, property, IP rights, ... → not: mere economic loss.
- In cases of bad intent, it is rather clear that the director – just like everybody else – is responsible for the tort.
- In cases of negligence, all depends on the determination of the director's obligations: which actions are to be taken in order to prevent harm to specifically protected goods (eg to what extent is it necessary to organise the enterprise in a way that a retention of title is protected)?



False Annual Statement and Incorrect Prospectus

- Directors are in general not liable to third parties for a false annual statement or for an incorrect prospectus.
- However, in the case of bad intent, the false annual statement or the incorrect prospectus may constitute a criminal offense.
- In this case, the director who committed the criminal offense is liable to third parties.



Violation of Cartel Law

- Under Austrian law, it is still not clear whether directors – in addition to the company – are personally liable for damage caused by a violation of cartel law.
- The current statutory provision on liability for damage caused by a cartel does not specifically deal with this issue ('*who culpably commits a violation?*').
- The issue is heavily disputed in legal literature.



Violation of Cartel Law

- In one Austrian Supreme Court decision, liability of directors was ascertained for cases of bad intent and also of negligence. However, in a more recent decision this issue was explicitly left open, without any reference to the former decision.
- The upcoming Implementation Act to the EU Directive 2014/104/EU on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union seems to restrict liability to enterprises and associations of enterprises.



Infringement of Competition Law

- According to established case law, directors are personally liable for an infringement of competition law if they contributed to the infringement or at least negligently violated their duty to prevent or to stop it.
- However, up to now the Austrian Supreme Court has only had to deal with actions for injunctions and not with damages claims.
- Legal literature holds the view that similar principles must apply to damages claims.
- In the case of wilful deceit (eg intentionally false advertising), personal liability can not be disputed.



DIRECTORS' AND OFFICERS' LIABILITY

**Thank you very much
for your attention!**

o Univ-Prof Dr Martin Karollus
martin.karollus@jku.at
Tel. 0043 (0)732 2468-3521



DIRECTORS' AND OFFICERS' LIABILITY