A safe harbor for all?

D&O liability in M&A transactions: the protection extended by the business judgment rule

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As the recent cases EnBW/EDF and BayernLB/Hypo Alpe Adria show, managers of German companies are increasingly faced with personal liability risks in the context of M&A transactions. In practice, it can be difficult to tell whether certain actions are protected by the business judgment rule. M&A transactions are, to a large extent, shaped by business decisions and judgment calls. In light of the magnitude and complexity of the decisions made in the context of a major transaction, management is confronted with a number of difficult questions, including: At what point in a heavily contested auction is the offered purchase price excessive and the acquisition no longer in the best interest of the buyer? How much risk can a manager impose on the company without exposing oneself to personal liability? This article describes the parameters of lawful conduct when making business decisions in connection with the acquisition or divestiture of an enterprise or parts thereof.

M&A transactions: the business judgment rule might provide a safe harbor—but not always.

The business judgment rule

Officers have to apply the duty of care of an orderly and careful manager. Pursuant to German statutory law, such duty is not breached if the officer reasonably assumes to be acting on the basis of adequate information and in the best interest of the company when making a business decision.

When it comes to business decisions, a manager has fairly broad discretion. The arguments supporting this notion include that (a) D&O liability is not meant to cover lack of success, but rather careless conduct, (b) exaggerated risk aversion on the part of management needs to be warded off as this would run counter to shareholders' interests and would be detrimental to the economy, (c) the idiosyncrasies of business decisions, which are often characterized by uncertainty and made under time pressure, need to be taken into account and (d) managers need to be protected from excessive requirements set by the courts who issue rulings with the benefit of hindsight (hindsight bias).

In order to not constitute a breach in duty of care, the manager's action must satisfy the following tests: The manager →

must (a) make a business decision, (b) act in good faith, (c) act independently of special interests and inappropriate influence, (d) act in the best interest of the company and (e) act on the basis of adequate information.

Business decisions

In order for their actions to be privileged under the business judgment rule, the manager needs to have made a (failed) business decision. This is different from the violation of, or failure to make, a decision to which the manager was legally obliged and for which no safe harbor is available. Thus, pushing a deal through single-handedly without obtaining the required board approval is obviously a breach that cannot be remedied by, for example, the urgency of the decision or the assumption of having acted in the company's best interest.

In contrast to legally bound decisions that do not offer any discretion, business decisions, due to their forward-looking nature, are strongly influenced by prognoses and assessments that are not actionable. A decision will be deemed a business decision if at the ex ante point in time of the decision, no information on the future course of events is available that would be known ex post, and it thus cannot be predicted with sufficient probability that a certain decision would have a more positive or negative outcome than other options. The decision to acquire or sell a business for what price and under what terms and conditions is generally a business decision in which the manager can exercise his or her discretion. This does not mean, however, that all individual decisions made and steps taken in the course of the process are at the manager's sole discretion. Statutory or contractual requirements, such as board approval of certain decisions, could reduce a manager's discretionary leeway to zero.

A business decision is not only the decision to take action, but also the failure to take action. However, the latter must be a conscious decision not to act. It is one of the responsibilities of a manager to seek and seize business opportunities without overemphasizing potential risks, but at the same time avoiding excessive risk. The manager is generally free to refrain from concluding a deal. Such a conscious decision not to act constitutes a business decision. In only very extreme situations may one argue that not entering into a deal constitutes a breach of a manager's duty of care. An example of this would be when the potential buyer could have easily acquired and integrated the target, and the continued existence of the potential buyer is in jeopardy or is even impossible without the acquisition.

Good faith

A manager will not breach the duty of care in making a business decision if he or she reasonably assumes to be acting on the basis of adequate information and in the best interest of the company.

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According to legislative reasoning, one "could not reasonably assume" (to be acting in the best interest of the company) if the risk taken on as a result of the business decision was misjudged in an absolutely irresponsible manner or if the manager's conduct otherwise can be regarded as a breach of his or her duty. Hence, only extraordinary scenarios or technical blunders that result in a high risk of inevitable damage and for which there are no reasonable business grounds will cause the manager to become personally liable. Simple miscalculations or errors of judgment are not sufficient as they occur on a regular basis. A manager's judgment and conduct will be regarded as simply unjustifiable if, unnecessarily and in reckless disregard for customary market standards, he or she does not try to protect the company from obvious material risks in the course of the transaction.

In high-pressure situations, a different standard might apply. However, the manager must not misjudge the risks in an absolutely irresponsible manner. A potential buyer might be faced with a high-pressure situation in a competitive auction or bidding process. In order to increase their chances of winning the bid, bidders occasionally tend to take on certain risks they would otherwise reject. Such conduct would be regarded as irresponsible if the risks and their magnitude are obvious, but the manager simply ignores them. If, for instance, there are concrete indications that the target's business model could be based in material parts on unlawful business practices, it would be irresponsible to acquire the target without assessing those risks more thoroughly.

Acting independently of special interests and inappropriate influence

A manager must make decisions independently of conflicts of interest and outside influence as well as without immediate self-interest. Should the manager act in his or her interest or in the interest of affiliated persons, it would, a priori, be assumed that the manager's decision was influenced by special interests that are not in the company's best interest.

This, however, does not mean that a manager may not pursue his or her personal interests or engage individuals with whom he or she has a personal relationship. Particularly in the M&A business, long-term personal relationships are often the source of efficient advice and cooperation based on trust and may thus facilitate cost efficiency, quality management and deal certainty. Acting in one's own personal interest would be admissible if and to the extent the interests of the manager and the interests of the company are aligned. In M&A transactions, this is usually the case when management receives a special bonus or participation in sales proceeds or when the manager expects a raise or promotion in addition to the successful transaction's anticipated benefits for the company and its stakeholders.

Acting in the best interest of the company

A manager acts in the best interest of the company if his or her actions, from an ex ante perspective, serve to strengthen the long-term profitability and competitiveness of the company and its products and services. What is customary in the industry, however, is not a relevant standard. Hence, there are no generally applicable guidelines. A large acquisition, in particular, might result in substantial short- or mid-term losses due to the extraordinary one-time financial burden. However, such strategic measures are not against the company's best interest as long as the costly transaction is intended to serve the long-term objective of realizing or increasing profits in the future and to leverage viable business opportunities.

Acting on the basis of adequate information

When making a business decision, the manager must reasonably assume to be acting on the basis of adequate information. According to German case law, there would only be room for a manager →

to exercise discretion if the manager thoroughly ascertains the decision-making basis and weighs the pros and cons of the various courses of action available. In doing so, the manager must exhaust all available (but not all conceivable) sources of information and on such a basis, evaluate the advantages and disadvantages of the existing alternatives under consideration of the identifiable risks. It was not the lawmaker's intention to make business decisions subject to strict judicial scrutiny or seemingly objective. Indeed, business decisions are often and to a large extent based on instinct, experience and imagination as well as a feel for future developments, for the markets and for the reactions of customers and competitors. These elements of decision-making cannot be fully replaced by supposedly objective information. The German legislature rightly concedes that available information that appears to be objective can be subjectively tainted by business trends or general market sentiments and that the manager who behaves countercyclically and does the unexpected may be particularly successful. The law is not intended to discourage managers from taking business risks; however, it does aim to stop managers from making reckless and careless decisions at the expense of stakeholders.

Such aspects as the available time and expected costs in relation to the size and risks of the transaction as well as the availability of information play a key role in an acquisition and the decisions made in connection with such a deal. It is recognized that, particularly in the event of great urgency, comprehensive preparation of the decision-making process can be difficult if not impossible, and the more urgent the decision, the more it might be necessary to refrain from seeking additional advice or conducting further review. However, if the risk is disproportionate to the opportunities presented by the deal, a manager would most likely have to abstain from making a momentous decision without proper preparation.

A manager who contemplates a material acquisition and does not have the necessary expertise has to obtain adequate internal or external advice with respect to the commercial, financial, tax and legal risks involved. This does not mean, however, that the manager may hide behind routinely obtained expert opinions or market analyses. The question whether and to what extent external advice needs to be sought will eventually have to be answered on the basis of the business necessities and capabilities of the company, not on formal protection strategies.

Duty to document

Since the manager carries the burden of proof as to whether the requirements of the privilege under the business judgment rule are met, it is critical that the decision-making process is properly documented. It is advisable that documentation be concise, correct and comprehensible. In practice, it will be virtually impossible to attain complete or comprehensive documentation given the sheer volume of information that must be considered and in light of the fact that key elements of the decision-making process, such as instinct, experience and imagination, cannot be documented. The manager needs to set priorities. The attempt to achieve supposedly complete documentation is not really expedient and may even prove counterproductive. As soon as material facts are missing from an otherwise very detailed documentation, it might be assumed that the manager unduly ignored or did not sufficiently challenge certain risks.

Summary

Failed business decisions made by managers in the context of M&A transactions will be privileged under the business judgment rule if the manager satisfies all of the requirements outlined above—that is, he or she must (a) make a business decision, (b) act in good faith, (c) act independently of special interests and inappropriate influence, (d) act in the best interest of the company and (e) act on the basis of adequate information. Since the manager carries the burden of proof, appropriate documentation of the decision-making process is highly recommended in order to avoid personal liability. <–

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