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DIRECTORS' LIABILITY UNDER U.S. AND SLOVAK LAW: A COMPARATIVE ANALYSIS

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Abstract

This thesis analyzes duties and liability of corporate director's that stem from their unique position in the company. Focus is on two main director's duties, namely the duty of care and the duty of loyalty, which are compared under the U.S. and Slovak law.

The thesis will also examine the methods that are used in order to limit or eliminate the liability of the director's, mainly focusing on the protection provided by the business judgment rule and limitation of liability by statutes under the American law; and on the different methods recognized by the Slovak law.

Attention will be also directed to the possibilities provided by both systems for enforcement of director's fiduciary duties, focusing mainly on the comparison of differences and similarities of derivative suits.

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1. Introduction

The corporate scandals on the both side of the Atlantic triggered discussions on the question of the duties and liability of the corporate directors'. The responses that have been undertaken centered on the necessity of increased liability of boards of directors'.

In my thesis I will compare the director's liability[1] in two different law systems, represented by the U.S.[2] and Slovak law. The choice of the systems scrutinized is not coincidental as each represents different model. While the U.S. law has been chosen as the model of common law system, with the rich case law related to the issue of directors' liability, the Slovak law represents model of civil law system in which the director's liability had been recognized only some years ago. Within the analysis of the U.S. law, this thesis will mostly focus on the law of the State of Delaware that is a premier legal home to companies around the world[3].

Up until the late 1990s, the directors of Slovak companies were in practice, if not under the law, virtually immune from the liability for the breach of their statutory duties.[4] With the view to harmonize Slovak legislation in line with European Union law, the law introduced *inter alia* new duties and specified the liability of the directors'.[5] However, the regulation contains many uncertain provisions that need to be clarified. The Slovak courts should provide some guidance in

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[1] The term 'directors' liability' refers to the civil liability of the directors', not the criminal nor administrative liability.

[2] The corporate law in the United States is mostly regulated by laws of state under that is company incorporated ("internal affairs doctrine"), *see e.g.,* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMIC, 14 (Foundation Press) (2002)

[3] More than half a million business entities have made Delaware their legal home including 280,000 corporations and 400,000 alternative entities. More than 50% of all publicly-traded companies in the United States including 60% of the Fortune 500 have chosen Delaware as their legal home. *See <http://www.corp.delaware.gov/aboutagency.shtml>*

[4] *See e.g.,* Allen & Overy, *A manager's Ten Commandments, A Guide to Management Responsibility and Liability under Slovak Law,* at 1 <http://www.allenovery.com/AOWeb/binaries/23761.pdf>

[5] Act No. 500/2001 Coll. Amendment to Act No. 513/1991 Coll. on the Commercial Code

this area. As of yet, required interpretation has not been provided. As the case law relating to the thesis topic is underdeveloped, Slovak courts could look to the rich case law of the United States.

This thesis focuses on the general duties of directors' of the publicly held corporations[6], thus not examining their closely held counterparts.[7]

The examination of directors' liabilities will proceed in six parts. To provide a starting point, chapter 2 of this thesis explores the main differences in the board structure and defines powers of directors in order to delineate their duties and liabilities. In chapter 3, thesis turns to the main duties, the duty of care and the duty of loyalty, and analyzes the differences and similarities of their regulation under the U.S. and Slovak law, showing stricter standard adopted by the latter. Chapter 4 explores the possibilities of limiting the directors' liability, arguing that the business judgment rule and limitation of director's liability under U.S. law, strongly protects directors in their discretionary powers. Furthermore, it will demonstrate that Slovak law established a strict liability of directors', which can be excluded under certain conditions. In the chapter 5 thesis examines the enforcements of director's liability when breaching his fiduciary duties. The thesis explores the requirements that must be met in order do establish a derivative claim. It argues that there seems to be few incentives for shareholders to bring a derivative suit.. Finally, this thesis in chapter 6 concludes that despite the different approaches adopted by both law systems, the content of the duties seems to be similar.

[6] The Slovak counterpart is "*akciová spoločnosť*" (joint stock company)

[7] The business corporations in the U.S. are generally divided into two main categories: close corporation (or closely held corporations) and public corporations (publicly held corporations). They are distinguished by the presence or absence of a secondary market for their shares of stock. *See e.g.* BAINBRIDGE *supra* note 2, at 9

2. The main differences in the role of the Board of Directors under the U.S. and Slovak law.

In my thesis I will compare the director's liability in two different law systems, represented by the U.S. and Slovak law. Before analyzing relevant rules applicable to directors' liability, it is inevitable to provide some general principles of corporate law referring to the directors.

The main difference of both systems is their board structure. One-tier board system represents the common law tradition. American corporation statutes provide that a corporation shall be managed by or under the direction of its board of directors.[8] On the other side, Slovak company law follows the two-tier corporate structure, largely modeled by the German law[9]: a board of directors *(*"*Predstavenstvo*") deciding on the management of the company and representing the company, and a supervisory board *(*"*Dozorná rada*")[10] monitoring the action of the directors. With regard to different board structure, powers and duties vested in directors' differentiate.

Unlike Slovak law, directors of U.S. corporation are divided into two types: outside (non-executive) and inside (executive) directors, with various criteria as to the standard of their independence.[11] Until recently corporation law did not require the existence of outside directors

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8 *See e.g.*, Model Business Corporation Act § 8.01 (2002) (hereinafter: MBCA), Delaware General Corporation Law § 141(a) (hereinafter: DGCL)

9 *See e.g.*, MÁRIA PATAKYOVÁ A KOL., OBCHODNÝ ZÁKONNÍK KOMENTÁR [Commercial Code Commentary] 465 (C.H.Beck, 1st ed. 2006). The concept of two-tier system was established by the SLOVENSKÝ OBCHODNÝ ZÁKON [Slovak Commercial Act] (1875)

10 § 191, 197 OBCHODNÝ ZÁKONNÍK [Commercial Code] (hereinafter: Commercial Code or CC) A supervisory board is a mandatory organ in a joint-stock company consisting of at least three members. The general meeting elects members, yet in the company with more than 50 employees one third of the members are elected and removed by the employees of company.

11 *See e.g.,* ROBERT W.HAMILTON, *Corporate governance in America 1950-2000: Major changes but uncertain benefits*, 25 J. Corp. L. 349, 373 (2000) (An outside director has been defined as a non-employee and non-management director)

and their majority within the company's board was only recommended[12]. However, following the 2002 corporate governance reforms, companies are increasingly required to have a substantial presence of independent directors on their boards.[13] Furthermore, the courts emphasize the distinction by holding inside directors to a higher standard of care because they participate more fully in the daily operation of the corporation.[14] Thus, the distinction has implications in their roles and powers as the member of the boards.

In the U.S., state corporation laws almost uniformly provide a default rule, that the business of the corporation shall be managed by or under the direction of board of directors, which has a power to select and remove the officers.[15] Thus inside directors manage company on day-to-day basis, while outside directors, as ones without any ties to the company, should monitor and oversee the management on behalf of all shareholders. Hence, the role of the latter could be compared to the functions that belong to the supervisory board in Slovak joint-stock companies. If we scrutinize statutory powers vested in the board of directors within the comparing systems, Slovak boards' statutory powers seems to be narrower, as for certain transactions prescribed by law the consent of the shareholders meeting or supervisory board is necessary.[16]

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12 *See e.g.,* American Law Institute Principles of Corporate Governance: Analysis and Recommendations (1994) (hereinafter: ALI Principles of corporate governance), also *see* Benjamin E. Hermalin and Michael S. Weisbach, *The effects of Board Composition and Direct Incentives on Firm Performance*, 20 Journal of Financial management 101 (1991) (the most U.S. companies have had a majority of nominally independent directors since the 1970s without any legal requirement to this effect)

13 Daniele Marchesani, *The concept of autonomy and the independent director of public corporations*, 2 Berkeley Bus. L.J. 315, 324 (2005)

14 *See* Marcia M. McMurray, *An historical perspective on the duty of care, the duty of loyalty, and business judgment rule*, 40 Vand. L. Rev. 605, 620 (1987), also *See* Bynum v. Scott, 217 F. 122, 125 (E.D.N.C. 1914)

15 Theodor Baums&Kenneth E. Scott, *Taking shareholders protection seriously? Corporate governance in the United States and Germany*, 53 Am. J. Comp. L. 31, 53 (2005)

16 For example, prior issuing new shares.

In contrast to Slovak law, U.S. statutes permit full delegation of board power to committees, except that these are barred from acting on matters requiring shareholders approval, changing the bylaws, etc.[17]

However, despite the above mentioned differences, there are some issues that are regulated in both systems similarly. For example, the members of the board of directors are appointed and removed by the shareholders meeting.[18] The limits on the authority of Slovak directors to act on the behalf of the company, either by the articles of associations, the shareholders' meeting resolution or the decision of the supervisory board, do not have any effects vis-à-vis third parties.[19] Therefore, such an act of the director would be valid and the company could have a claim against the director for any resulting damages. The same apply under the American law.[20]

[17] *See e.g.*, § 141 (c)(2) DGCL, § 8.25 MBCA
[18] § 194 CC
[19] § 191(2) CC
[20] *E.g.*, § 124 DGCL

3. Consideration of directors' duties

Directors have legal obligations and liabilities that stem from their unique position in the company. These duties are generally created in both systems by state laws, yet in the U.S. also by state jurisprudence and federal securities statutes.[21] Their function is not only to set standards of conduct for a board member to follow, but also reviewing standards for a court to use in deciding whether a director's behavior has been appropriate in a particular case.[22]

The *U.S. concept* of directors as fiduciaries is also inevitable for the understanding of U.S. company law and directors' duties. This concept had its origin in the common law of trusts.[23] The Delaware Court of Chancery held in *Guth v. Loft, Inc*., that "directors and officers have fiduciary relationship with the corporation and its shareholders".[24] The corporations' directors are subject to two traditional fiduciary duties: duty of care and the duty of loyalty, which imposes on them the primacy corporate law parameters within which they manage corporate affairs.[25] These duties will be addressed, with their counterparts in Slovak law, in the next subsections. In addition to them the third fiduciary duty, good faith, has been proposed by case law[26]. Yet, Delaware Court of Chancery subsumed this duty within the duty of loyalty, establishing that it is impossible to breach a duty of good faith and not at the same time to breach a duty of loyalty. [27] I will discuss these duties in more detail in the following sections.

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[21] *See e.g.,* Sarbanes- Oxley Act of 2002,

[22] *See* James A. Fanto, *Basic duties of directors, in* Practicing Law Institute Directors' and Officers Liability, PLIREF-DIRLIAB s 2:2.3, 2-19 (2006)

[23] *See* Joseph T. Walsh, *The Fiduciary Foundation of Corporate Law*, 27 J.CORP. 333, 333 (2002)

[24] Guth v. Loft, Inc., 5 A.2d 503 (1939)

[25] *See* LARRY D. SODERQUIST, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, CASES MATERIALS, PROBLEMS, 436 (1997)

[26] Cede II, 634 A2d 345 (Del.1993) ("good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty")

[27] *See* Myron T. Steele, Chief Justice of the Delaware Supreme Court, *Director liability: The perspective of the Delaware courts, in* BOARDROOM EXCHANGE 2006, 29, ¶ 2 (Feb. 4, 2007) < http://www.pwc.com/extweb/pwcpublications.nsf/docid/B8E7CBD55C8A433D852570C0006DD24F/$file/BoardroomExchange2006.pdf>

Although directors of Slovak joint-stock company are not in the position of fiduciaries, their general duties resemble the ones of U.S. directors. Slovak Commercial Code § 194 establishes the "duty of due care" as a general obligation for performing their duties and applies to all actions taken by a director. As I will explain in the next section, this duty encompasses both the duty of professional care and the duty of loyalty. It is also important to stress that opinions of scholars regarding the classification of general duties are not very clear. Yet, prevailing opinion includes within general duties, besides the duty of care, the duty of confidentiality, the duty not to compete with the company and duty to inform.[28]

In the following sections I would scrutinize two main duties of the directors, that is the duty of care and the duty of loyalty. Thus, other range of director's special duties, such as those arising out in the company's insolvency, or in mergers, are not object of this thesis.

3.1 Duty of care

The first aspect of directors' duties in both scrutinized systems is the duty of a care, representing the basic standard of the director's conduct. While company law and courts acknowledge that directors need the discretion to pursue the entrepreneurial and profit-making activities of the corporation, they also recognize that directors must meet certain standards of diligence and accountability to serve the corporation and its shareholders properly. [29]

3.1.1 U.S. concept of duty of care

Unlike in Slovakia, the duty of care has been recognized and imposed by American courts since the mid-eighteenth century. [30] Yet, the various courts required different standards of care. [31]

[28] *See e.g.*, Peter Čavojský, *Poznámky k uplatneniu zodpovednosti za škodu v kapitálovych spoločnostiach*, 2/2004 Obchodné právo 18, 19 (2004)
[29] *See* SODERQUIST, *supra* note 25, at 436
[30] *See* Murray, *supra* note 14, at 606

These common law standards, which all include some degree of negligence, are: (1) only the degree of care required to avoid gross negligence, (2) the degree of care that an ordinarily prudent director in a like position would exercise under similar circumstances, and (3) the degree of care that an ordinarily prudent person would exercise in conducting personal business affairs.[32] The majority of states have codified the duty of care, mostly adopting the standard provided by the Model Business Corporation Act, requiring directors to exercise their duties "in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with the care an ordinarily prudent person in a like position would exercise under similar circumstances".[33] Other states, among them Delaware, rely upon a doctrine of judge made law. With regard to special role of the Delaware courts, I will focus specifically on the concept of duty of care in this jurisdiction.

Delaware courts first addressed the duty of care in 1922, in *Lofland v. Cahall*, when the court held, that the directors were trustees of the shareholders and their behavior must reflect "the utmost good faith and fair dealing".[34] A year later, in *Allied Chemical & Dye Corp. v. Steel & Tube Co.* the court determined that to prove a dereliction of the duty of care the accepted price must be "so far below what is found to be a fair one that it can be explained only on the theory of fraud".[35] Thus, a gross negligence standard was accepted, which emerged out of the courts' reluctance to second-guess business decision, today expressed as the business judgment rule.[36]

The gross negligence appears to be replaced by the ordinary negligence standard in the landmark case *Smith v. Van Gorkom*, stressing the duty to be reasonably informed in directors'

[31] *See e.g.,* Stephen J. Lubben, Alana Darnell, *Delaware's Duty of Care*, 31 Del. J. Corp. L. 589, 595-596, (2006)
[32] Murray , 607
[33] *See* § 35 MBCA, *see* also § 8.30 Revised Model Business Corporate Act [RMBCA]
[34] Lofland v. Cahall, 118 A.1-3 (Del. 1922)
[35] Allied Chemical & Dye Corp. v. Steel & Tube Co, 120 A. 486-494 (Del. Ch. 1923)
[36] *See* Lubben, Darnel *supra* note 31, at 597-598

decision-making process.[37] The class action was brought by the shareholders of Trans Union Corporation, claiming that board of directors violated their duty of care by approving merger and recommending it for the shareholders' approval.[38] The Delaware Supreme Court held that although directors acted in a good faith, they had breach their duty of care by approving merger of the corporation without considering all information reasonably available to them and relevant to their decision. [39] Thus court imposed upon board of director's duties to make a preliminary inquiry into the value of the business and whether higher price might be obtained before concluding a sale contract. This controversial decision has been criticized by many scholars, arguing that while the board's actions might have violated a simple negligence standard, yet it is difficult to argue that those failures constituted a gross negligence.[40] A year later, as a response to this decision, Delaware enacted its Delaware General Corporation Act section 102(b)(7), allowing shareholders to adopt provisions eliminating or limiting personal liability of directors for monetary damages for a breach of fiduciary duty of care. The issue of liability's limitation will be examined in the chapter four of this thesis.

However, the recent case law suggests that directors will be liable if acting with the gross negligence.[41]

The important question is what elements constitute the duty of care. Eisenberg suggests that the duty of care might be considered as the aggregate of four relatively distinct duties: (1) the

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[37] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)
[38] *Id.*
[39] *Id.* at 874 ("The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.")
[40] *See e.g.*, Willam T. Allen, Jack B. Jacobs, Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care wit Delaware Public Policy: a Critique of Van Gorkom and its Progeny as a Standard of Review Problem,* 96 Nw. U. L. Rev. 449, 458 (2002)
[41] *See infra* note 119

duty of inquiry, (2) the duty to employ a reasonable decision-making process, (3) duty to make responsible decisions and (4) the duty to supervise or monitor the conduct of the corporation's business.[42]

The duty of inquiry suggests that if the information provided by the firm's employee is inadequate or reveals the problem with the corporation, the director has the duty to request more information; the extent of such inquiry shall be such as the director reasonably believes to be necessary.[43] Furthermore, to fulfill the duty of care, the directors cannot be only an ornament, or a "dummy".[44] The directors are under a continuing obligation to keep informed about the activities of the corporation and should have performed general monitoring of the corporate affairs and policies.[45]

Jurisprudence and commentary suggests that directors cannot passively await "red flags" in a corporation; they have responsibility for ensuring that appropriate systems of information gathering and problem detecting are in the firm that will pick up the "red flags" of potential company's' problems.[46]

The law recognizes that directors can rely on a corporation's officers, employees, committees of the board of directors or service professionals for, information, opinions, reports or statements presented to the corporation, provided that it is within the latter's competence to do so. [47]

3.1.2 Duty of "professional care" under Slovak law

[42] Melvin Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 948 (1990)
[43] *See e.g.*, ALI Principles of corporate governance § 4.02-4.03,at 188-189, 196
[44] Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981), The court held liable a director who failed to discovered misappropriation of trust funds because she knew nothing of the corporate affairs of the company, visited the corporate offices only once, and never read or obtained the annual financial statements.
[45] *Id.*
[46] *See e.g.*, James A. Fanto, *Basic Duties of Directors*, PLIREF-DIRLIAB s 2:2.3), 2-24, (2006)
[47] *See e.g.*, DGCL § 141 (e)

The key issue for performance of directors' duties is their duty of "due care". Under the Slovak Commercial Code, members of the board of directors are obliged to act with "due care", which includes duty to perform with "professional care" and in compliance with the interests of company and all its shareholders.[48] Thus, the duty of due care is understood as the broader term, encompassing the duty of professional care.[49] This subsection will consider a requirement of professional care, while latter is addressed in subsequent section.

The provisions related to the duty of professional care are rather rigorous. The definition of the professional care is provided neither by the law, nor by a judicial guidance. The criteria of professional care generally require the directors to possess not just general knowledge, but a higher level knowledge, skill and experience expected of a professional director in the relevant position.[50] Thus, the standard of care imposed on the Slovak directors is higher than standard of the American directors.

Although not providing the exact definition, the code indicates at least two other duties of the directors that relates to the duty to act with the professional care. Firstly, the latter are obliged to make informed decisions.[51] They have to seek out all available information related to the subject of the decision and take them in the consideration when making the decisions.[52] This requires a high active involvement of the directors while seeking the information. Yet, there are

[48] § 194 (5) of the CC defining the duty of "due care"(" náležitá starostlivosť") entered in the force in January 1st 2002 and by adopting the standard of "professional care" ("odborná starostlivosť") reacted on the insufficient standard of duty of care that did not required the directors to perform professional care. Many commentators criticize that the criteria of the due care as inappropriate, claiming that the directors should be liable not only for when no acting with the care of ordinary prudent person in the similar conditions, but also if the latter do not act 'professionally'. *See e.g.,* IRENA PELIKANOVÁ, KOMENTÁŘ K OBCHODNÍMU ZÁKONNÍKU, 194 (2 díl, LINDE PRAHA a.s.) (1995)
[49] OĽGA OVEČKOVÁ a kol., OBCHODNÝ ZÁKONNÍK KOMENTÁR 1, 631 (Iura edition) (2005)
[50] *See* Allen&Overy *supra* note 4, at 6
[51] § 194 (5) CC
[52] *Id.*

no legal guidelines as to what extent a director should conduct a research.[53] Unlike the American law, the Slovak law does not expressly recognize the right of the directors to rely with the good faith on the reports or the opinions of the others.[54] Secondly, the directors have a general duty of confidentiality to his company. As a result, a director can not pass 'confidential information' to a third party if its disclosure may cause damage to the company, or jeopardize the interests of the company or its shareholders.[55] This obligation should be interpreted alongside with the duty to act in the best interests of the company and all its shareholders.

If the duty is challenged in the litigation, the burden of proof is on the directors to prove that they acted with the professional care.[56] If the directors caused the damage when breaching their duty, they will be jointly and severally liable for the damages arising therefrom.[57] Although the collective liability has it positive aspect in encouraging the responsible monitoring of directors by directors, the negative aspect is that it may discourage competent persons from engaging as the directors because of the risk of liability for the acts of less competent counterparts.[58]

3.2 Duty of loyalty under U.S. law

In addition to the duty of care, directors are subject to another fiduciary duty, known as a duty of loyalty. As already mentioned,[59] fiduciary duties have their genesis in the trust law. Since

[53] *See* Allen&Overy *supra* note 4, at 7
[54] *See* note 47
[55] § 194 (5) CC This should be distinguished form the duty of confidentiality in the respect of the any information constituting the 'business secrets' of the company. The latter is defined by the law as any information that inter alia is not commonly accessible to third parties.
[56] *See Chapter 5*
[57] §194 (6) CC
[58] Vassil Breskovski, *Directors' Duty of Care in Eastern Europe*,29 Int'l Law. 77, 95 (1995)
[59] *See supra* note 23

at least 1742 courts have required corporate directors to discharge their responsibilities with the fidelity to the corporation, which became known as the duty of loyalty.[60]

The duty of loyalty is a principle that covers a wide range of possible applications.[61] It has been generally accepted that the duty of loyalty requires directors to exercise their powers in the interests of the corporation and not in the directors' own interest or another or organization. The focus here is on the transactions between the corporations and its directors and the conflict of interests that may arise.[62] In addition, the duty of loyalty prohibits directors from usurping, for their own advantage, an opportunity that rightly belongs to the corporation; this principle is generally known as the corporate opportunity doctrine.[63] Slovak law recognizes a similar standard that is expressed in the duty not to compete with the company.

The Delaware Supreme court in *Guth v. Loft, Inc.,*[64] held that directors owe a duty of "undivided and unqualified loyalty to the corporation which they serve". The court found the president and director of Loft liable for breach of the duty of loyalty for taking personal advantage of an opportunity that came to him because of his position in the corporation.[65]. The corporate opportunity doctrine as delineated by case law holds that a director may not take a business opportunity for his own, if: (1) the corporation is financially able to exploit the opportunity; (2) the corporation is within the corporations' line of business, (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimical to his duties to the corporation.[66] Yet, it suggests that in certain situations a director may take a corporate opportunity. The determination

[60] *See* Murray, *supra* note 14, at 623
[61] *See e.g.,* SODERQUIST, *supra* note 25, at 529
[62] *Id.*
[63] *See e.g.,* BAINBRIDGE, *supra* note 2,at 321
[64] *See supra* note 24
[65] *Id.* at 510
[66] *See* SODERQUIST, *supra* note 25, at 533-534

whether or not a director has appropriated for himself something that in fairness should belong to the corporation, is a factual question to be decided by reasonable inference from objective facts.[67]

Another issue addressed by the duty of loyalty is a question of self-dealing where the conflict of issue emerges.[68] Unlike the Delaware statute, MBCA Section 8.60 specifically defines "conflict interested transactions". Such transactions include transactions effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest).[69] The director must also know that he or a related person has a beneficial interest in the transaction or is so closely linked to the transaction that the interest would reasonably be expected to exert an influence on the director's judgment if the director were called upon to vote on the transaction.[70]

In early common law, conflicted interest transaction were per se voidable by the corporation without regard to whether they were fair to the corporation or had been approved by the relevant authority.[71] A few courts took a more rigid position and held that conflict of interest transactions were void; yet later as the duty of loyalty was codified by a majority of states, the statutes permitted the conflict of interest to stand.[72]

Section 144 (a) of DGCL states that a conflicted interested transaction shall not be void or voidable solely because of the director's conflict or solely because the director is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's votes are counted for such purpose, if:

> (1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or

[67] Johnston v. Greene, 121 A.2d 919 (1956)
[68] *See e.g.*, ROBERT W. HAMILTON, *Corporations*, 311 (2nd edition, Black letter series)(1986)
[69] MBCA § 8.60
[70] *Id.*
[71] *See* BAINBRIDGE, *supra* note 2, at 308
[72] *See* Murray, *supra* note 14, at 624

> transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
> (2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
> (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

Thus the first two provisions recognize that transaction could be approved either by a disinterested board majority or in good faith by a vote of shareholders if following full disclosure. Based on the case law, the Delaware Supreme court requires approval be made by a majority of disinterested shareholders.[73] The third provision covers situations, where the director did not disclose interested transaction or contract, yet it was fair for the corporation at the time of approval. The interested director bears the burden of proving the fairness of the transaction.[74] But what constitutes fairness? Fairness is an abstract concept and what constitutes fairness to the corporation depends on the facts of the particular case and the court's determination of what is relevant.[75] In the case *Weinberger v. UOP, Inc.*, [76] the Delaware Supreme court described the test:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock... However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

[73] Flieger v. Lawrence 361 A.2d 218 (Del. 1976)
[74] Marciano v. Nakash, 535 A.2d 400, 405 (Del. 1987)
[75] *See* SODERQUIST, *supra* note 25, at 514
[76] Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)

In *Cinerama, Inc. v. Technicolor, Inc.,*[77] the court stated that in assessing the entire fairness of the transaction, "the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them exercise such choice as the circumstances could provide".

One other issue that is of practical relevance to these statutory provisions is what the consequences of the interested transaction are. Will courts review of properly approved transaction? As such, the statute does not fully validate such transaction, but rather only shields them from per se invalidation.[78] The court in *Cede & Co v. Technicolor, Inc.,*[79] held that approval provides business judgment protection, provided it is an approval of an interested transaction by either a fully-informed disinterested board of directors, or the disinterested shareholders. This means that such approvals will preclude a judicial review.

A finding of self-dealing or interest by a corporate fiduciary does not necessarily mean that a Delaware court will void a transaction, and the Delaware Supreme court has expressly held in *Marciano v. Nakash*[80] that Section 144 of the DGCL "does not provide the only validation standard for interested transactions".[81] The consequence would be that the business judgment rule will not protect the transaction and the courts will review the fairness of the transaction.

3.3 Duty of loyalty under Slovak law

The Slovak Code, similarly to American law, recognizes the primacy of the company's interests. The duty of loyalty under Slovak law requires directors to subordinate their personal

[77] Cinerama, Inc. v. Technicolor, Inc., 663 A2d 1134, 1140 (Del. Ch. 1994)
[78] *See* BAINBRIDGE, *supra* note 2, at 312
[79] *See* note 26 at 366
[80] *See supra* note 74, at 405

interests to those of the corporation and all its shareholders.[82] The law expressly provides that director can not place the interests of its own, only some shareholders, or other stakeholders above the corporations' interests.[83]

The directors are subject to the wide-ranging strict obligation not to compete with the company.[84] They may not take advantage of corporate opportunities. These rules can not be derogated from by any agreement or articles of association, although the stricter standards could be imposed.

Firstly, they may not act as directors or members of any corporate organ of another company engaged in an identical or similar business, that is not part of the same group.[85] The law does not provide any explanation on what does and what does not constitute this similarity.

Secondly, they can not act as a general partner of the other company.[86] In this case it is irrelevant that other company is not engaged in any similar activity. The reason behind this prohibition is that general partners owe an unlimited personal liability towards the company.

Finally, directors are prohibited, either on their own behalf or on behalf of others, engage in any trade that is in line to the company' business.[87] Yet, statute does not provide what "trade" means.

The disadvantage of such regulation is that provisions are too detailed in the specification of the possible conflict of interest's situations, yet not covering all possible cases that could cause harm to the corporation.

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[81] Paul Bork, *Fiduciary Duties of a Director of a Delaware corporation*, at 8 (2005), < http://www.foleyhoag.com/files/tbl_s5084FileUpload/FileName5632/67/fiduciaryDuties-bork102805.pdf>
[82] § 194 (5) CC
[83] *Id.*
[84] § 196 CC
[85] *Id.*
[86] *Id.*

In sum, the rules governing directors' duty not to compete with the company expose Slovak directors to the more restrictive standard than directors of American public companies under the corporate opportunity doctrine. Yet, the question is how effectively can be those strict standards enforced against the directors. Furthermore, the rules regulating the conflict of interest between the director and the corporation, in particular with regard to self-dealing, are much less developed than in the U.S.

[87] *Id.* ("*obchody*")

4. Limiting directors' liability

Directors should be accountable for their decision, yet it is generally accepted that a balance should exist between exposing them to a liability and protecting them. The American and Slovak system seems to provide this balance by using a different means.

Under American law, there are three types of measures that corporation may put in place to protect their directors from the potential derivative liability exposure: (1) liability limitation; (2) indemnification; and (3) Directors and Officers (D&O) Insurance.[88] Another significant measure that is specific for common law countries and is guaranteed not by the corporation but the courts represents the business judgment rule.

Although Slovak corporate practice recognizes some measures, such as directors' insurance, the approach adopted towards limitation of directors' liability is quite opposite.

4.1 The Business Judgment Rule

The business judgment rule developed concurrently with the duty of care[89], as the American courts recognized that directors need to be protected while exercising their business judgment. The difference is that while the duty of care represents the standard of directors' conduct, the business judgment rule provides the standard of review, which governs whether directors will be held liable or a transaction set aside as a result of the particular action or inaction.[90] Thus, the rule shields directors from being personally liable for the mistakes[91] in their judgment, as long as their

[88] *See e.g.,* Seth Aronson, Sharon L. Tomkins, Ted Hassi, Tristan Sorah-Reyes, *Shareholders Derivative Actions: From Cradle to Grave*, 1557 PLI/Corp 125,198 (2006)
[89] *See* Murray, *supra* note 14, at 613
[90] *See e.g.,* Melvin A. Eisenberg, *The divergence of Standards of Conduct and Standards of Review in Corporate Law,* 62 FORDHAM L. REV. 437 (1993)
[91] *See e.g.,* Smith v. Prattvile Mfg. Co, 29 Ala. 503,509 (1857) (directors were not liable for honest mistakes or errors in judgment)

behavior comply with the certain conditions stated either by statutes[92], or by the case law. Not surprisingly, Delaware belongs to the second group.

Before providing some definition of the business judgment rule established by either statutes or case law, I would like to mention some justifications for the rule. First, as the directors are not infallible, there is a need to recognize the possibility of error and apply a relaxed standard before imposing a liability so as to maintain the pool of potential directors.[93] Secondly, the courts have neither the ability nor the desire to substitute their judgment for that of more experienced professionals[94], recognizing that "after-the-fact litigation is a most imperfect device to evaluate corporate business decision".[95] Furthermore, some authors suggest the concept of "hindsight bias"; the human tendency to view decisions as having been obviously poor ones after learned that the outcome was poor.[96] Finally, the law should encourage and afford a broad protection to informed business judgments (whether subsequent events prove them right or wrong) in order to stimulate a risk taking, innovation and other creative entrepreneurial activities. [97]

The business judgment rule has been defined by the American Law Institute in its Principles of Corporate Governance § 4.01c[98], which states:

> (c) A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
> (1) is not interested [§ 1.23] in the subject of the business judgment;
> (2) is informed with the respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
> (3) rationally believes that the business judgment is in the best interests of the corporation.

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[92] Many states enacted the business judgment rule in statutes, see *e.g.,* Florida Statutes Annotated, Title XXXVI, Chapter 607.0831,

[93] *See e.g.,* Elizabeth S. Miller, Tomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 Del. J. Corp. L. 343, 350 (2005)

[94] Karacik v. Pacific Eastern Corp., 21 Del. Ch. 81,97,180 A. 604, 611 (1935)

[95] Joy v. North, 692 F.2d 880 (2d Cir.1982)

[96] *See e.g.,* DAVID G. MYERS, INTUITION: ITS POWERS AND PERILS 89-93 (2000)

[97] *See supra* note 12, The Introductory Note to § 4.01, 135

[98] However, at least one commentator suggests that it is not clear if the courts agree that the business judgment rule can be so precisely articulated, S*ee* SODERQUIST *supra* note 25, at 461

The Delaware Supreme Court in *Sinclair Oil Corp. v. Levien*[99] formulated the rule as a presumption:

> A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.

In consistent with this doctrine the court in *Aronson v. Lewis*[100] formulated that the business judgment rule is:

> [A] presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

Thus, the rule operates as a presumption that the court will not intervene with or second-guess, decision making process. [101] This is true unless the presumption is rebutted or unless a more exacting standard of review, such as entire fairness, applies because of the nature of transaction before the court.[102]

The question that arises with the application of the business judgment rule is whether it allows courts to review a substance of directors' decision-making (substantive review) or it permits the review of the mechanisms and procedures used by the board of directors in arriving at its decision (procedural review).[103]

[99] Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).
[100] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)
[101] Norman Veasey, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 1543 PLI/Corp 103, 128 (2005)
[102] *Id.*
[103] *See e.g.*, BAINBRIDGE, *supra* note 2, at 274

The Delaware Chancery court held that the business judgment rule will not allow review of directors' business judgments, that in retrospective are "substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', as long as the process employed was either rational or employed in a good faith effort to advance corporate interests."[104] As a result, the rule does not allow for review of the substance. Opposed to that some authors pointed out, that Delaware courts nonetheless display an apparent willingness to do so when the directors' actions approach the borderline of good faith. [105] Apparently, the outcome in the much-litigated case involving Walt Disney Co. seems to confirm this opinion. I would devote some attention to this litigation, as it could give some guidance on the directors' duties not only for the Slovak courts when deciding similar cases, but also for the directors' itself.

To start with, shareholders filed a derivative suit, alleging that the board of the Walt Disney Company breached its fiduciary duties when they blindly approved an employment agreement with then president Michael Ovitz and then, again without any review or deliberation, ignored Michael Eisner's dealings with Ovitz regarding his non-fault termination. Mrs. Ovitz was hired by Mrs. Eisner, company's CEO in August 1995 and terminated without any cause on December 1996, triggering a severance package valued at nearly $140 million.[106] The plaintiffs also alleged that Ovitz breached his duty as an officer and director to the corporation by maximizing his own interest in his employment and termination negotiations at the expense of the corporation.

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[104] In Re Caremark Intern. Inc. Deriv. Lit., 698 A.2d 959, 967 (Del. Ch. 1996)

[105] See *e.g.,* David Rosenberg, *Galactic Stupidity and the Business Judgment Rule,* The Berkeley Electronic Press, 4, Paper 1067, Year 2006, (Febr. 10, 2007) < http://law.bepress.com/expresso/eps/1067>

[106] Disney CEO Michael Eisner offered Michael Ovitz the position of president at Disney and then negotiated most of the terms and conditions of Ovitz's employment. For the large part, Eisner acted unilaterally without notifying the board until he and Ovitz were in substantial agreement. The compensation committee then met for just over

The Delaware Court of Chancery in *Brehm v. Eisner* dismissed with prejudice the plaintiff shareholders' complaint, holding that the plaintiffs failed to provide sufficient evidence to rebut the business judgment rule.[107] Yet, it held that "the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company" and that the processes of the board "were hardly paradigms of good corporate governance practices".[108]

The Delaware Supreme Court, however, reversed the Court of Chancery's dismissal to the extent that it was prejudicial and afforded the plaintiffs "a reasonable opportunity to file a further amended complaint" properly alleging the directors' breach. [109] The court also took this opportunity to make its clearest statement that the duty of care in Delaware involves no substantive review of the merits of the contested decision:

> As for the plaintiff's contention that the directors failed to exercise "substantive due care," we should note that such a concept is foreign to the business judgment rule. Courts do not measure or quantify directors' judgments. We do not even decide if they are reasonable in the context. Due care in the decision-making context is process due care on only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.[110]

Nonetheless, the court allowed the plaintiffs to amend their complaint so that it would allege more specific facts that might present a doubt that the directors' approval of Ovitz's employment package was protected by the business judgment rule.[111]

one hour with limited informational materials before approving Ovitz's employment agreement, which employment agreement, which was then submitted to and approved by the Disney board.
[107] Brehm v. Eisner 746 A.2d at 244 (Del. 2000)
[108] *Id.* at 249
[109] *Id.* at 248
[110] *Id.* at 264
[111] *Id.* at 266

The Delaware Court of Chancery in 2003 *In re Walt Disney Co. Derivative Litig.*,[112] departed from the language used by the Supreme Court in Brehm and took a hard look at the actions of the directors. The court held that the plaintiffs' complaint pled facts sufficient to rebut the business judgment presumption and denied the defendant directors' motion to dismiss.[113] The plaintiffs had claimed that "the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."[114] If such allegations are true, the court said, defendants might have breached their obligation "to act honestly an in good faith in the corporations' best interests" and their conduct therefore could well have fallen outside the protection of the business judgment rule.[115]

This decision initiated the discussions among legal academics, whether the duty of good faith as described in the decision is a third, separate fiduciary duty of directors'[116]. The majority of the authors seems to reject this idea and described a good faith in the court's decision as a duty "that alternates between loyalty and care without actually encompassing either".[117] Some asserts that the duty describes the directors' motives and defines it as a prohibiting behavior where the director consciously knows he is disregarding the duties of faith or loyalty.[118]

The Court of Chancery in 2005[119] held that directors did not act in bad faith, although were at most ordinarily negligent[120], in connection with hiring and firing of Ovitz. In accordance with

[112] In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 278 (Del. Ch. 2003)
[113] *Id.* at 291
[114] *Id.* at 289
[115] *Id.*
[116] *See e.g.*, Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456,482 (2004)
[117] Sean J. Griffith, *Good Faith Business Judgment: A Theory or Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J., 23-23 (2005)
[118] Lyman Johnson, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 Wm. Mitchell L. Rev. 1149. 1202-1203 (2004)
[119] In re The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del.Ch. 2005) < http://courts.delaware.gov/opinions/(xep3nrjipj5mpa45oz5m2jvi)/download.aspx?ID=64510>
[120] *Id.*

the business judgment rule (because, as it turns out, business judgment was exercised), ordinary negligence is insufficient to constitute a violation of the fiduciary duty of care.[121] The court further explained that the board's minimal oversight and rather quick approval were not "ideal" corporate governance practices, but that lawsuit took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decision were actionable would be misplaced.[122]

The court expounded on the duty of good faith, admitting that "decisions from the Delaware Supreme Court and the Court the Chancery are far from clear with the respect to whether there is a separate duty of good faith".[123] Furthermore, the court stated that at least in the corporate fiduciary concept, it is probably easier to define bad faith rather than good faith, as Delaware law presumes that directors act in good faith when making business judgment. [124] In order to determine an appropriate standard whether directors have acted in good faith, the court quoted that the duty requires director to act at all times with an "honesty of purpose" and in the best interests of the corporation.[125] In addition, directors cannot act with "intentional dereliction of duty".[126] The plaintiffs' allegations that the directors "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks attitude", was rebutted by relying on the objective process by which the board made its decision to hire Ovitz.[127] Finally, the court

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[121] *Id.* at. 134
[122] *Id.* at 2
[123] *Id.* at 119
[124] *Id.* at 120
[125] *Id.* at 124. The court cited some examples showing the failure to act in the good faith. For instance, when fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.
[126] *Id.* at 123
[127] *Id.*

concluded that Eisner did not breach his fiduciary duties and acted in good faith in connection with Ovitz's termination.[128]

The Delaware Supreme Court in 2006 affirmed the ruling that "the business judgment rule presumption protected the decision of the compensation committee and the remaining Disney directors, not only because they acted in the due care but also because they had not acted in bad faith". [129]

In sum, the business judgment rule strongly protects most board decisions from the courts' judicial review. Even when courts review those decisions, they scrutinize not the outcome, but the process of decision making. Moreover, as the case indicates, the courts rarely hold directors liable.

4.2 Exclusion of liability under Slovak law

The American concept of business judgment rule does not exist under Slovak company law. The directors' decisions, when challenged at the court proceedings are subject to the judicial review. In the contrast he business judgment rule, where the good faith and decision made on the informed basis are presumed[130], the director of Slovak company bear the burden of proving a required adherence to his duties. Once the lawsuit claiming the breach of his duties is filed, the director as a defendant has a burden of proof[131], thereby imposed to a more severe standard than director of American company. In the case of the later, the burden of proof lies with the plaintiff.

[128] Id at. 172. The court first concluded that according to the Company's certificate of incorporation and bylaws, not board but Eisner alone possessed the authority to terminate Ovitz and grant him the severance payment
[129] In re The Walt Disney Co. Derivative Litig., 906 A2d 27 (Del. 2006)
[130] *See supra* section 4.1.
[131] § 194 (7) CC

Under Slovak law, directors' liability for the damage caused to the company by the violation of their duties[132] is a strict liability, meaning that director is responsible regardless his culpability.[133] Unlike American law, directors' liability can be neither limited nor eliminated. Yet the law facilitates two grounds that provide for exclusion of directors' liability. It is worth to mention that these provisions were codified along with the possibility of shareholders to file derivative suits.

Firstly, director will not be liable for his actions, proving that he acted with professional care and in good faith that such action is in the best interests of the company. [134] Thus both requirements need to be present and proven. Concretely, he would need to prove that his actions were exercised having been properly informed. However, the law does specify neither what constitutes a breach of a duty to act in a good faith, nor the duty of good faith itself. Though simplified, the good faith is a psychological category that needs to be proven by the objective criteria.[135] The inclusion of the subjective category of a good faith, as one of the condition of for exempting directors' liability seems to be adopted by the legislator with the aim to moderate his strict liability.

The second reason exempting directors' liability involves decisions by which director implements the shareholders' meeting resolution, provided that such resolution does not violate the law or the articles of association.[136] The authorization of a transaction by the supervisory

[132] later in this chapter only "liability"
[133] *See supra* note 28, at 16
[134] § 194 (7) CC
[135] *See supra* note 9, at 475
[136] *Id.*

board will not of itself exempt the members of the board of directors from the liability.[137] The language of these provisions is not very clear.

Some commentators[138] interpret this provision suggesting, that director can breach his duties without being liable, if implementing the shareholders' meeting resolution that is not contrary to the law and articles of associations, yet for example, against the interests of the company. Others explain that director in this situation could not be exempted from the liability, as a requirement of performing required professional care could not be successfully proven.[139] In addition, if he would object to such a resolution, thus having knowledge resulting from his professional care that such resolution conflicts with company's interests, this could not exempt him from the liability as the above mentioned requirement of good faith could not be proven. However, the Commercial Code provides some solutions. Firstly, a director could file within the three months period, the petition claiming invalidity of such resolution.[140] Secondly, some authors suggests that he could decide not to implement such a decision, on the bases that he could not be sued while properly exercising his duties of care and good faith.[141] Finally, there is a possibility for a director to resign.

As the language of these provisions does not seem to be clear enough, it is certainly necessary to clarify it either by legislator,[142] or by the Slovak Supremes' Court explication.

[137] *Id.*
[138] *See supra* note 28, at 2
[139] *See supra* note 49, at 467
[140] § 183 CC (The company would be represented in the courts proceedings by the appointed member(s) of the Supervisory Board)
[141] *See supra* note 138
[142] *See e.g.*, Czech Commercial Code states that directors would be not liable in this case, proving that at least one of them informed the shareholders of resolution inappropriateness

4.3 Liability limitation under U.S. Law

The statutes limiting the directors' liability were adopted in response to the cases holding the directors in breach of their duty of care[143], and to the following swing in the insurance markets making directors' and officers' liability insurance painfully expensive or simply unavailable.[144] Delaware amended in 1987 section 102 (b)(7), enabling corporations to insert in their certificates of incorporation a provision limiting or eliminating directors' liability for monetary damages for breach of the duty of care. Some states have enacted a similar provisions, other limit the damages that can be recovered against directors.[145]

Section 102 (b)(7) states that liability can not be limited or eliminated:

> (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective.

Thus limitation is made possible only regarding the directors' duty of care, not duty of loyalty. Furthermore, primarily directed to relieve the insurance crisis by eliminating financial liability for directors, the amendment also served as an effort to relax the liability.[146] Thus directors remained liable, however, for gross negligence, not for ordinary negligence applied prior to the enactment of the statute.[147]

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[143] *See supra* note 37

[144] *See e.g.,* Stacy D. Blank, *Delaware Amendment Relaxes Directors' Liability,* 44 Wash. & Lee L. Rev. 111, 117 (1987), see also Thomas C. Lee, *Limiting Corporate Directors' Liability: Delaware Section 102(b)(7) and the Erosion of the Directors Duty of Care,* 136 U. Pa. L. Rev. 239, 240-241 (1987)(the lower standard is required by Indiana and Virginia)

[145] *Id.* Lee, at 242

[146] *Id.* Blank , at 118-119

[147] *Id.*

The statute does not apply to officers, although they are also subject to duty of care. In *Arnold v. Society for Savings Bancorp, Inc.,*[148] the Delaware Supreme court held that as to a defendant who is both a director and an officer, an exculpatory provision applies only to action taken solely in his capacity as a director.

4.4 "Limitation" under Slovak law.

In contrast to American law, any limitation or elimination of directors' liability either by agreement or articles of association is explicitly forbidden.[149] Such agreements would be void, on the grounds of violating the law.

This strict prohibition to eliminate directors' liability was adopted in order to provide protection for investors, especially foreign ones. The practice shows that this, maybe negative aspect did not discourage competent persons from engaging as the member of the board of directors. This could probably be attributed to the rise of directors' liability insurance, which is not prohibited by the statute and widely used in recent years. In order to attract qualified directors' companies are paying the premiums for such insurance. Yet I believe that in the coming years, the Slovak law might adopt the provisions limiting the liability, but hardly eliminating it. Although Slovak Commercial code does not recognize the possibility of indemnification known in American law[150], some commentators suggested that it is possible.[151]

[148] Arnold v. Society for Savings Bancorp, Inc., 650 A.2d 1270 (Del.1994)
[149] § 194 (8) CC
[150] *See e.g.,* DGCL § 145 mandates indemnification where the directors are "successful on the merits or otherwise" in a derivative suit. It also permits indemnification of expenses (including attorney's fees) actually or reasonably incurred in connection with the defense of a derivative suit. Indemnification for derivative suits under the DGCL is limited to expenses; it does not permit reimbursement or indemnification of settlements or judgments.
[151] *See supra* note 138, at 24

Though, the elimination or limitation is forbidden by the Commercial Code, Slovak law permits shareholders to approve the waiver or settlement of claims arising from the breach of directors' duties.[152] Thus, in contrast to American law, this is possible also when duty of loyalty is violated.

A company may waive or settle a claim for damages upon the expiry of three years after the claim has arisen, provided that the shareholders meeting consent thereto. Secondly, condition protecting the minority shareholders requires that no minority shareholders holding at least five percent of the issued share capital records the objection in the minutes.[153] Unfortunately, there is no information on whether companies use such devices.

Thus, even though the elimination or limitation of director's liability is not possible in Slovakia, the corporate market evolved its own tools that relieve the directors from the burden of liability.

[152] § 194 (8) CC
[153] *Id.* ("základný kapitál")

5. Enforcement of the duty of care and loyalty

The existence of directors' duties of care and loyalty can only have practical effects if these rules can be effectively enforced. Otherwise it is just a theory. The term enforcement refers to the litigation brought against director. In this chapter I will discuss who and on what conditions, can sue directors if they breach their fiduciary duties and compare the American and the Slovak solutions.

In order to answer the question who can bring the action against the directors, it is well accepted principle of American law that fiduciary duties of director are generally owed to the corporation as an entity, rather than to individual shareholder.[154] The duty owed by directors to the corporation flows from the principle that the board of directors is responsible for the management of the business of a corporation.[155] Therefore, it falls to the corporation to take action for breach of these duties. The American company will act through the board of directors, the Slovak through its supervisory board.

Secondly, shareholders can seek relief on the behalf of the company by filing a derivative action. The purpose of the derivative action is similar under American and Slovak law, yet codification of such action has been recognized by the Slovak law only five years ago.[156] It was devised so as to permit shareholders to seek relief on the behalf of the corporation in those cases where corporation for some reason elected not to pursue the claim.[157] The shareholders would have been helpless had there not been developed such a device.[158] The latter was developed by the

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[154] *See e.g.*, BAINBRIDGE supra note 2, at 362

[155] James Gadsden, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, 24-FEB Am. Bankr. Inst. J. 16, 46 (2005)

[156] *See supra* note 5

[157] *See e.g.*, BAINBRIDGE supra note 2, at 385

[158] DETLEV F. VAGHTS, BASIC CORPORATION LAW, 455 (3rd edition, University Casebook Series) (1989)

courts in the U.S and by the statutes' codification in Slovakia. In the next sections I will analyze the regulation of shareholders' derivative suits in U.S. and Slovak law.

5.1 Enforcement under U.S.law

To start with, the derivative action developed by the courts has a long history. The courts in *Aronson v. Lewis*[159] recognized two causes of action: it is an action to compel the corporation to sue and it is an action brought by a shareholder on behalf of the corporation to redress the harm to the corporation. Thus it is in effect two actions: "one against the directors for failing to sue; the second based upon the right belonging to the corporation".[160]

Yet, when is an action of shareholder derivative? The courts distinguish between the derivative and direct actions, stating that different procedural and substantive rules are applicable to them.[161]

A direct action arises out of causes of action belonging to the shareholders in their individual capacity; it is typically premised on the injury directly affecting the shareholders and must be brought by the shareholders in their own name.[162] The common examples of direct actions include suits to compel the payment of a dividend, to protect the voting rights or to obtain inspection of corporate books and records.[163]

In contrast, a derivative action is one brought by the shareholder on behalf of the corporation for harm suffers by all shareholders in common.[164] The cause of the action belongs to the corporation as an entity and arises out of the injury done to the corporation as an entity.[165]

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[159] *See supra* note 100, at 811
[160] Brown v. Tenney, 532 N.E.2.d 230, 232 (Ill. 1998)
[161] *See* HAMILTON, *supra* note 68, at 383-384
[162] *See* BAINBRIDGE, *supra* note 2, at 362
[163] In re Worldcom, Inc., 323 B.R. 844, 850 (Bankr. S.D.N.Y. 2005)
[164] Levine v. Smith, 591 A2.d 194, 200 (Del. 1991)

The courts admit that the line of distinction between derivative and direct actions is often narrow one. In some cases the courts applied a "special injury" test, requiring the shareholder to show that they have suffered a special or distinct injury from other shareholders in order to bring a direct claim.[166] The Delaware Supreme Court recently disapproved the use of the concept of special injury as a tool in determining whether claim is direct or derivative.[167] The court held that it must be turn solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually).[168]

The standing requirement of the derivative action varies among the jurisdictions. These requirements are governed by the state law statutes, or by the case law. Generally, in a derivative suit, the plaintiff must have been a shareholder at the time of the challenged transaction and must maintain that status throughout the lawsuit.[169] This is usually referred to as the "contemporary ownership rule"; the rule has been justified as necessary to prevent the buying of a lawsuit.[170] Yet, there are some exceptions to this rule; the contemporary ownership requirement will not apply where the alleged wrong is occurring at the time the shareholder bought stock even if it began before the shareholder purchased the stock.[171] As for the others standing requirements, the size of plaintiffs' financial stake in the corporation is immaterial.[172] By contrast, Slovak law requires that plaintiff *inter alia* owns at least 5% of company's issued capital.

[165] *See* BAINBRIDGE, *supra* note 2, at 362
[166] *See e.g.*, Geer v. Cox, 242 F.Supp. 2d 1009, 1018 (D.Kan. 2003)
[167] Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A2.d 1031, 1035 (2004)
[168] *Id.* at 1033
[169] *See e.g.*, Lewis v. Anderson, 477 A.2d 1040, 1049 (Del. 1984)
[170] *See* HAMILTON, *supra* note 68, at 388
[171] *See e.g.*, Noland v. Barton, 741 F.2d 315 (10th Cir. 1984)
[172] Subin v. Goldsmith, 224 F.2d 753, 761 (2d Cir. 1955)

Another prerequisite for maintaining a derivative action is the demand requirement. Thus the plaintiff must allege with the particularity the efforts, if any, to obtain the action he desires and the reasons for his failure to obtain the action or for not making that effort.[173] A demand should be made to the board of directors. The courts have not formulated a specific rule as to what constitutes a reasonable response time between a demand and the filing of a derivative action; instead they determine it by examining the complexity of the issues presented by the demand and the surrounding circumstances.[174] In the certain circumstances a demand will be excused; the majority courts recognize it as a 'futility exception', though the formulations of the exception vary[175].

The effect of making demand is to place control of the derivative litigation in the hands of the board of directors.[176] In the response to a demand the board can accept it and sue director(s) or refuse a demand. Where demand is refused, a plaintiff may proceed with the derivative action only if the court is satisfied that the board's rejection of the demand was wrongful; the business judgment rule is used in reviewing a board's refusal to act pursuant to a stockholder demand.[177] The business judgment rule provides that absent evidence of bad faith, fraud, or self-dealing, courts will defer to the decisions of directors.[178]

In the duty of care cases, the plaintiff needs to prove that directors were grossly negligent in making their decisions and courts review the process not the decision. In the duty of loyalty cases, burden of proof is shifted to the directors, who are not protected under the business judgment rule.

[173] *See e.g.*, Cal. Corp. Code § 800(b)(2)
[174] *See* Aronson *supra* note 88, at 147
[175] *Id.* at 150
[176] Spiegel v. Buntrock, 571 A.2d 767,773 (Del. 1990)
[177] *See* Aronson, *supra* note 88, at 168

In sum, there are many obstacles to effective enforcement of shareholders rights. The business judgment rule strongly protects the directors in the case of their duty of care. Another obstacle is that a plaintiff-shareholder must bear a risk and costs of a lawsuit. Yet, if a lawsuit will be successful, the payoff goes to corporation. Some courts[179] are awarding attorney's fees to a plaintiff's counsel who successfully litigates a derivative action.

5.2 Enforcement under Slovak law

Directors are generally liable to the company for damages caused by the breach of any of their duties. The fiduciary duties are similarly to American law owned to the company. This could be justified by the fact that director concluded his contract with the corporation, rather than with the shareholders.

The action seeking enforcement of director's liability could be initiated by the corporation itself. In this case the latter is represented by the member of Supervisory board.[180] Yet, the strict reading of the statute suggest that the latter can act only following the demand of the shareholders owning at least 5% of the registered capital.[181] Thus the board can not act without the shareholders' demand. Yet, this provision does not facilitate the passive behavior of the Supervisory board. I conclude this on the base of two provisions. Firstly, the Supervisory board has the same fiduciary duties of care and loyalty as the directors' of the board of directors. [182] I believe that the passive behavior of the Supervisory board could be interpreted as a breach of their

178 *See*
179 Donner Mgmt. Co. v. Schaffer, 139 Cal. App. 4th 615 (2006)
180 § 182 (1) CC
181 *Id.*
182 § 200 (3) CC

duty to act with the professional care. Secondly, the latter has also the obligation to call the shareholders' meeting whenever the interests of the company so require; thereby initiating the shareholders' meeting where the necessary demand could be exercised.[183]

By contrast to American law, the derivative action in Slovakia has a short history. The regulation is rather brief and the case law has not been developed yet. Under the Slovak law, only shareholder(s) owning at least 5% of the registered capital can initiate a derivative action. [184] Thus, opposite to the American law, this right is not awarded to every shareholder. The law neither addresses other standing requirements.

Similarly to American regulation, the minority shareholders must first make a demand on the Supervisory board to bring the suit for the corporation. However, the law does not recognize any cases when a demand could be excused.

The law sets up a time limit within which the supervisory board should not only respond, but within which the latter should "satisfy the requirement of the shareholders".[185] If the board does not file an action 'without undue delay'[186], the majority shareholders can proceed to file a suit. This formulation corresponds to the one applied by the American courts, both trying to established an objective standard. However, the practice did not show whether this objective standard works well in the Slovak conditions.

By contrast to American law, the Slovak shareholders are not blocked from the pursuing the case if the board refuses to bring an action.[187] Thus unlike the U.S. board of directors, the Supervisory board has less discretionary power if corresponding to the shareholders' request. As

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[183] § 199 CC
[184] § 182 (1) CC, the term 'majority shareholders' will be used throughout this section to describe those shareholders
[185] *Id.*
[186] *Id.* ("*bez zbytočného odkladu*")

a consequence, it seems that the Slovak shareholders' can file a derivative suit easier than their American counterparts. This conclusion is supported by the express provisions of the Slovak Commercial Code, granting to the shareholders the remuneration of the attorney's fees if the corporation was successful in the litigation.

Unlike the American law, the creditors of the Slovak corporation are granted right to sue company in their own name and on their own behalf, provided that the directors breached their duties and a company is hesitant in bringing the claim against its directors.[188] They have this right only if the company's assets are not sufficient to settle creditors' existing claims against the company. The liability for the damages to the creditor shall be extinguished neither by a waiver nor by a settlement between the company and its creditor. The purpose behind is to protect the creditors in the cases when the directors breach their duties and neither a corporation, nor its shareholders proceed with the litigations. However, the possible obstacle of this creditors' protection lies in the fact that the latter must not necessarily have knowledge about such a violation.

[187] *See supra* at 35
[188] § 194 (9) CC

6. Conclusion

Although the American and Slovak corporate law belongs to different legal systems, each system imposes on directors the duties of care and loyalty. The content of the former seems to be similar in the both systems, thereby requiring directors to make a fully informed decision. However, the standard varies and the liability for the breach of the duty ranges from gross negligence standard in Delaware to mere negligence in Slovakia. Moreover, state courts in the U.S. defer to the director's decision making under the business judgment rule so long as the latter acted in the good faith and without the conflict the interest.[189] On the other hand, the business judgment rule does not exist under Slovak law and directors bear the burden of proving that they acted with the professional care. In conclusion, Slovakia imposes a much stricter standard of care for the directors than the U.S. Nevertheless, in the absence of the relevant case law in Slovakia, it is hard to predict how extensively will be this strict standard implemented and interpreted by the judiciary.

The duty of loyalty under both systems requires directors to subordinate their personal interests to those of the corporation if a conflict exists.[190] However, provisions regulating the conflict of interests under Slovak law are rather too specific and do not cover all possible cases where the conflict of interests could occur. Therefore, it would be advisable to adopt more general provision of the U.S. law. The main difference between the both systems is that American law allows interested-director transactions under some specific conditions, while under the Slovak law such transactions are forbidden.

[189] *See* Aronson v. Lewis *supra* note 100

[190] *See* e.g. Lawrence A. Cunningham, *Commonalities and Prescription in the Vertical Dimension of Global Corporate Governance,* 84 Cornell L. Rev. 1133, 1158 (1999)

When considering the limitations of a director's liability, both models insulate directors by using different means. The legal norms in the U.S. largely exclude directors from liability because of the business judgment rule, liability indemnification and immunizations. These devices have functionally sealed off any real exposure to liability for directors of U.S. corporations, other than "red-handed thieves and defrauders".[191] On the other hand, although the Slovak directors do not benefit from the business judgment rule and the elimination of the liability is expressly prohibited, they will not be liable if proving they acted in the good faith and professional care. Moreover, shareholders of Slovak companies may waive or settle a claim against the director for damages.

Under both systems, liability arising from a breach of the duty of care and loyalty runs primarily to the corporations. Thus shareholders can not sue directly to recover damages from these transactions but must bring a derivative suit. One distinct difference between the both systems is who is able to bring a derivative action on the behalf of the company. Under the American system any shareholder can file a derivative action, while Slovak law allows only shareholders holding at least 5% of the outstanding shares. Despite this disadvantage, it seems at least theoretically, that Slovak shareholders can proceed with derivative actions more easily than their American counterparts. However, until now the lawsuits against the board members for breaching their fiduciary duties have been very rare. We will see in the coming years whether Slovak shareholders will become more active and how will Slovak courts interpret the fiduciary duties of the directors'.

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