

Client information

Regional Court Munich: Compliance is task of entire board

The Regional Court of Munich recently sentenced a former board member due to the defective establishment of compliance system and insufficient monitoring to pay damages running into millions (Regional Court of Munich, decision of 10 December 2013, file no. 5 HK O 1387/10, “*Siemens*” – case / decision published end of March 2014).

The key messages of the sentence are:

- The establishment of a functioning compliance system is the task of the whole board.
- The compliance system must offer risk control and loss prevention.
- The board is liable for damages if the compliance system is defective.
- As tasks of the board the organization of the compliance system and the examination of its appropriateness cannot be delegated.
- A board member cannot absolve himself/ herself from the accusation of failure to establish or control the compliance system by arguing a lack of department responsibility.

The decision of the Regional Court of Munich is not final and subject to appeal. Nevertheless, the principles on board duties outlined by the Regional Court of Munich in the area of compliance are likely to give direction to the requirements imposed on board members. The principles follow the previous court practice, which has more and more strict demands on the standard of due care for actions of the board and the fulfillment of the overall responsibility (duties of supervision and monitoring).

Furthermore the decision contains statements on further relevant points of manager liability (compensation of lawyer’s fees for internal investigations, the beginning of the

period of limitation in case of failure to act, entry into settlement negotiations by reference to D&O insurers).

1. BACKGROUND OF THE DECISION

In the case in question, a globally active company brought an action for compensation against a former member of the board due to a breach of duty.

Employees of the plaintiff had created and managed so called “black accounts”. The money had been used for bribe payments abroad, totalling several millions. These payments led i.a. to a supervisory proceeding subject to stock exchange law in the USA and to a criminal proceeding against the plaintiff in Germany. At home and abroad, fines running into billions have been imposed on the plaintiff. For the internal investigations on the system of black accounts, the plaintiff engaged a law firm after its discovery.

The plaintiff justified its claim for compensation by stating the board (negligently) breached its duty to ensure a lawful behaviour of the company. The defendant as board member did not ensure that the company establishes an efficient compliance system with preventive effects, which is actually applied and controlled.

The board member defended himself against the claim for damage i.a. on the ground that the compliance system was not part of the board department under his responsibility. He had adopted for his department corresponding directives to prevent dubious payments. Division managers were responsible for the practical implementation.

The court accepted the arguments of the applicant company. The court sentenced the board member to pay compensation in the amount of in total EUR 15 m. including lawyers’ fees in the amount of EUR 12.85 m. although the board member concerned neither knew the system of black accounts nor knew the corrupt payments and was just one of ten board members at that time.

2. DECISION OF THE REGIONAL COURT OF MUNICH

The Regional Court of Munich stated the following in its decision:

2.1 Compliance organization is the task of the whole board

Within its legality duty a board member has to ensure that there is a suitable compliance system within the company, which is constantly supervised and which prevents infringements.

Ensuring the observance of the principles of legality and thus the establishment of a functioning compliance system is an overall task of the board.

A board member fulfills its organizational duty in case of a corresponding potential threat only if he/she establishes a compliance system aimed at risk control and damage prevention. The company's type, size and organization, the provisions to be complied with, the geographical presence as well as suspected cases in the past are crucial for the extent of the compliance system in detail.

2.2 Internal organizational duty and no release by departmental responsibility

Depending on the company's type and risk situation the board is obligated to create a clear responsibility for compliance within the board.

The departmental responsibility of one board member does not, however, release the (remaining) board members of their overall responsibility to ensure the observance of the principles of legality. All board members are obligated to clarify reported infringements, to keep themselves informed about occurrences, to verify the existing compliance system and to establish a corresponding efficient structure.

2.3 No release from responsibility through delegation of tasks

According to the Regional Court of Munich the board may not delegate the implementation of the compliance system in detail to a lower level ("division managers"). The board must check out for itself whether and how the compliance system is implemented and whether it is appropriate and functional. In this respect the Regional Court of Munich states that the delegation of this central task of the corporation's statutory organ "board" to employees on a lower level constitutes a breach of duty.

In the context of its monitoring duty it is the responsibility of each board member to ensure that a functioning compliance system is resolved by the board.

2.4 Duty to document and escalate

Furthermore, a board member may not absolve her/ himself from tis responsibility by using the excuse that the remaining board did not follow her/ his ideas for the implementation of a compliance system in accordance to the applicable legislation.

Indeed, an outvoted board member must participate in good faith in implementing the board's resolutions. This does however not apply if the resolutions do not comply with legal requirements. If the board members' proposals for improvement of the compliance system have not been taken into account by his board colleagues, the board member has to submit an appropriate counter response to its colleagues and, if necessary, to inform the supervisory board.

2.5 Lawyers' fees are damages eligible for compensation

According to the court the whole lawyer's fees incurred by the company due to internal investigations in the amount of EUR 12.85 m. are damages eligible for compensation.

The involvement of a specialized law firm was caused by the breach of duty (lack of establishment of the compliance system) and was necessary to investigate accusations or to avoid or to reduce sanctions against the company.

The court examines the appropriateness of the fees incurred neither by their amount nor the hours worked or the lawyers involved. According to the court there exist no doubts with respect to the legality and entitlement of payments of lawyers' fees. The scope of the lawyer's invoices corresponded to the relevant agreements. The internal audit attested this fact on the invoices. The lawyers' fees can also be assigned to breaches of duty by the board because the entries in the invoices refer to them.

2.6 Beginning of the period of limitation in case of omissions

The limitation period of claims for compensation begins strictly in the moment the claim arises. According to the court's evaluation the beginning of the limitation period cannot be prior to the termination of the breach of duty. If the actions omitted can still be taken at a later point of time (implementation of an efficient compliance system, adequate control of the systems effectiveness), the breach of duty will not be terminated when the last action to prevent an infringement could have been taken. Rather the breach of duty terminates in the moment the action cannot be made up any more.

That means that the court extends the period of limitation for claims due to failure to act. Concerning the establishment of a functioning compliance system this would mean that the period of limitation due to possible breaches of duty e.g. starts to run when the member leaves the board because only then the member in question cannot take appropriate measures any more. It is questionable whether this extension of the beginning of the limitation period will be upheld by the court of appeal.

4. Interruption of the limitation period by reference to D&O insurers?

According to the court the board member engaged himself to enter into negotiations with the company because he responded to the company's claim and the proposed starting of discussions not unambiguously and with a clear rejection of the liability claim made.

According to the court it was enough to assume the entering into settlement negotiations that the board member or his lawyers referred in their reply to the claim to discussions with D&O insurers and their mandatory involvement. In this context the rejection of the asserted (liability) claim occurred only to fulfill obligations under the insurance contract. This does not constitute an unambiguous rejection of discussions. Especially, there is no unambiguous rejection of the claim, according to the court's opinion, if the manager (defendant), to whom the claim is made, requests a specification of the alleged breaches of duty. This view of the court seems doubtful.

3. CONSEQUENCES IN PRACTICE

For managers, action is needed. A German court has clarified for the first time that the establishment and the monitoring of compliance systems is the central task and duty of the whole board. Managers must examine whether the internal organization of their company meets the specified requirements and act if necessary. The organization of the compliance system and the scope of its monitoring depend on the individual company. In case a compliance system is not established, the establishment is defective or in case of inadequate monitoring of the compliance system compensation claims may arise.

Exculpation from the accusation of defective compliance will be more difficult for board members in the future. They will have to prove that they actively have taken measures for a proper compliance system and its monitoring.

Since the court deduces the obligation for establishing a compliance system from the board's duty to legality, the decisions might be transferable to other company types (limited liability company).

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