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ARTICLE

How to Try Cases on Board and Management Liability After a Financial Crisis

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Since Denmark had not had the principle of the business judgment rule finally confirmed within the financial sector confirmed, a judgment from the Danish Supreme Court on this matter was anticipated with great anxiety: whether the principle would be confirmed, and if so, how the further details of the principle would be drawn up.

Keywords: tort law, business judgment rule, financial sector, Danish law

not even banks' boards or managers are to be considered 'professional', but remain under the protection of the 'business judgment rule', holds Danish Supreme Court, and rightly so

1. INTRODUCTION

In Denmark, as well as other countries, the courts have had to deal with judicial reckoning on the field of tort law in regards to the board members and directors of collapsed banks. As a consequence of the government seizing control of collapsed banks, almost all of the civil law trials are proceeded by a special public undertaking, Finansiel Stabilitet (Financial Stability).

The Danish reckoning generally confirms that also in this field of tort law – corporate and financial tort liability – traditional tort law doctrines prevail.

Since Denmark had not had the principle of the business judgment rule finally confirmed within the financial sector confirmed, a judgment from the Danish Supreme Court on this matter was anticipated with great anxiety: whether the principle would be confirmed, and if so, how the further details of the principle would be drawn up.

The answer is now available, and the business judgment rule – i.e. the courts' restraint from trying a management's business-related assessments – has been confirmed by the Danish supreme court.

At the same time, it underlines when the business judgment rule does *not* apply. This is especially the case in incidences where the basis for making the business decision has been insufficient, as well as incidences where irrelevant considerations – e.g. considerations to members of the board's personal financial interests – have been taken into account.

In situations where the business judgment rule does *not* apply, contrary to regular tort law, the burden of proof is reversed, and it is up to the board members concerned to attempt prove that the interests of the bank were being safeguarded.

With the judgment from the Danish Supreme Court in *UfR 2019.1907 H*, Capinordic Bank, the so-called 'business judgment rule' was recognized, a rule after which a commercial decision by the board and management generally would be accepted by the courts, even though the decision turned out to have caused a loss.

The most important premises of the judgment can be transformed into a line of questions and – clear and operative – answers from a unanimous Supreme Court, and the questions and answers run as follows (in each case with my added emphasizes).

2. IS THE LIABILITY FOR THE MANAGEMENT OF A BANK A SHARPENED VARITION OF CULPABILITY?

No, it is the regular culpability that applies, including the possibility of pleading individual mitigating circumstances, in spite of the fact that the business of the board in a bank is probably one of the most regulated, on both EU and national level.

The Supreme Court holds the following:

> Of the, then in force, company law Act section 140, § 2, it appears that board members and directors, who during fulfillment of their office intentionally or negligently have caused loss to the company, are liable to compensate the loss.
>
> The legislative text which, with minor linguistic adjustments, has been continued in the company law Act section 361, § 1, 2nd point, establishes *regular culpability*. There are not sufficient grounds in the legislation, or in case law, to determine that a sharpened degree of liability for board or directors in a bank should apply.

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3. CAN THE BOARD OF A BANK BE HELD ACCOUNTABLE FOR THE ENTIRE COLLAPSE OF THE BANK?

No, there is not a general responsibility for the organization and operating of the bank; a concrete assessment of the individual granting of a loan or a guarantee.

The Supreme Court holds:

> The Supreme Court does not find it proven that the bank has been organized and ran in a way which in itself encumbers liability for [board members B1 og B2] or [director D] for the losses on the [xx] loan commitments. Whether they can be determined liable, relies on an assessment of the individual loan commitments.

4. IS THERE *A MARGIN OF ERROR* FOR BUSINESS-RELATED ASSESSMENTS – AND THEREBY A POSSIBILITY FOR AN ASSESSMENT EXEMPT FROM LIABILITY AND ERRORS OF ASSESSMENT WITHIN THE BOUNDARIES OF A BUSINESS ASSESSMENT?

Yes, as well as we recognize the margin of assessment within administrative law, we also recognize a margin of assessment in business, in which the courts shall not try. This been recognized by courts in decades in non-financial trials, at least since the judgment on the *Havemann* department stores in the 1970s, and it is now determined that this margin of assessment *also applies in liability cases after the collapse of financial institutions.*

The Supreme Court holds the following [my italics]:

> A decision to grant a loan relies to a great extent on a business assessment, primarily based on a credit rating of the borrower. This assessment must be performed on justifiable grounds. In the credit rating, it shall be included, among other things, the purpose of the loan, the borrower's financial status, the securities/guaranties provided, as well as the borrower's ability to run its business, including the impact of the general financial conjuncture. Which requirements need to be set in order for a loan approval to be regarded justifiable, will rely on an overall assessment in the individual cases. *The Supreme Court holds that courts should show restraint when it comes to overriding the business assessment made by the bank's board and direction in granting a loan.*

However, this margin of assessment does *not* apply in situations where irrelevant considerations have been at steak, e.g. where loans, guarantees, etc., *have been granted for the gain of a member of the board or direction or persons related to members.*

The Supreme Court holds the following [my emphasize and addings]:

> The same restraint [when contemplating to override the business assessment] shall *not* be shown, if it is to be presumed that a granting of a loan or any other disposition in this regard, *has not solely been made due to business-related considerations of the bank, but have also included considerations irrelevant to the operation of the bank.* The Supreme Court holds that in these incidences s*harpened requirements must be set, in order to assure that the interests of the bank have not been breached.* In that regard it must be noted, that in the law of financial activities section 78, rules have been set up in order to prevent conflicts of interest in relation to directors and officers.

This is *not* a matter of strict liability, or any other form of 'automated' (objective) liability. Rather, it is a matter of a *reversed burden of proof*, contrary to the otherwise straightforward burden of proof in tort law. The directors or officers in question must prove that they, in spite of ineligibility, etc., weren't breaching the interests of the bank.

It might be added that this counter-proof is not *per se* hopeless to conduct; in the till now largest Danish case, the *EBH Bank Case*, where judgment in the first instance (the Western High Court) was pronounced on 31 January 2020, two directors (including the chairman of the board) and the CEO, who were all three personally interested in a specific loan decision, but failed to inform the other board members about their personal interest in the case, succeeded to convinced the high court that the same decision would have been taken by the board of directors, even if it had been duly informed of their personal interest in the case, and had been sent outside the board room during the debate and decision in this case. I was the lawyer representing the said chairman during all 149 days in court.

5. WHICH POINT IS TIME IS DETERMINATIVE FOR THE COURTS ASSESSMENT OF JUSTIFIABILITY AND IS THERE A RESPONSIBILITY TO GATHER ADDITIONAL INFORMATION IF SUCH IS REQUIRED?

The answer is, that the time of the decision is determinative, and that it *is* required, if necessary, to gather additional information for assessment.

The Supreme Court states the following:

> The assessment of whether a granting of a loan has been justifiable, must be done on the basis of the informations available at the time of the granting. Emphasis must be placed on the knowledge available to the individual board member at the time. Furthermore it is of importance whether the directors or management––if possible––have made sure that additional necessary information was being gathered before the loan was granted.

These premises show that hindsight is not relevant, e.g. a subsequent financial crisis throwing away all calculations. It is the knowledge and the basis of the decision present at the time of granting the loan, that is determinative. If a sensible board member believed that additional information was required in order to properly make a decision, such additional information must be gathered before making the decision.

6. DOES IT *PER SE* TRIGGER LIABILITY IF LEGISLATIVE PROVISIONS HAVE BEEN VIOLATED, SUCH AS SECTION 70 OR 71 IN THE DANISH LAW ON FINANCIAL ACTIVITIES? (LOV OM FINANSIEL VIRKSOMHED, FIL)

No, actual or potential violations of FIL-provisions regarding the organization and operation of the bank can be violated without the *per se* occurrence of liability. The determining element in the assessment of liability is a concrete assessment of whether the granted loan was justifiable or not.

The Supreme Court holds:

> Banks are subject to an extensive regulation in the Act of financial activity. […] In section 70 of the Act, it is required that the board, in regards to the bank's most important areas of activities, must draw up written internal guidelines, outlining the division of work between the board and management. In section 71, requirements are established for the board's general and strategic functions, as well as requirements for effective types of business management. Section 71 states that each financial institution must consider which measures shall be taken in order for the requirements to be met. The Financial Inspection has described its practice in relation to section 71 in an instruction.
>
> The legislative provisions in section 70 and 71 in the Act on financial activities sets requirements to the organizational and operational aspect of banks. The Supreme Court holds that the provisions do not possess such a nature that an infringement will *per se* be sufficient to consider a director or a manager of a bank liable. As to other provisions in the financial institution, it will depend on the considerations and purposes of the provisions whether an infringement could be decisive for a liability for a managing member in a bank.

7. DOES IT *PER SE* TRIGGER LIABILITY IF THE BANK'S INTERNAL SET OF RULES HAS BEEN VIOLATED, E.G. THE MANDATORY SECTION 70 INSTRUCTION ABOUT WORK AND COMPETENCE DIVISION BETWEEN THE BOARD AND MANAGERS?

No, even such violations do *not per se* trigger a liability. The determining element in the assessment of liability is and will be a concrete assessment of whether the granted loan or security was justifiable or not.

The Supreme Court holds:

> The granting power of a bank is vested with the board which – wholly or partly – within the boundaries of the detailed framework, can delegate its granting power to managers, cf. the Act of financial activities section 70. The board establishes the guidelines for this delegation in the *credit instruction*, and determines the guidelines for granting credit for the employees of the bank in the *credit policy*. If the managers act contrary to the credit instruction, or to the credit policy, the individual manager is responsible towards the board. The board can deviate from its own guidelines, as well as give permission to deviate from the guidelines to the extent that such deviation is not violating any legislation, or otherwise must be considered unjustifiable.
>
> The Supreme Court holds that the circumstances under which a board deviates from its own guidelines, or accepts a such deviation performed by managers, is not *per se* liable. Liability will require that such deviation was unjustifiable, according to a concrete assessment.

Thus is it also under these circumstances a concrete assessment of justifiability that is determining for the question of liability. *It is the substance, not the many formalities surrounding it, we must care about.*

8. DOES IT AFFECT THE ASSESSMENT OF LIABILITY THAT THE AUDITORS OF THE BANK (EXTERNAL AND – IF RELEVANT IN THAT BANK – INTERNAL) HAVE APPROVED OF THE COMMITMENT, I.E. JUDGED THAT THERE WERE NO OBJECTIVE INDICATIONS FOR VALUE ADJUSTMENT ('OIV')?

The answer is yes, it *does* affect the assessment, in the sense that it is part of the overall assessment of whether the granted loan and/or security was justifiable. A negative assessment from auditors does not necessarily mean that liability *can* be confirmed; and a positive assessment from the auditors does *not* necessarily mean that liability can *not* be confirmed.

The Supreme Court holds the following:

> The Supreme Court sustains that auditors' assessments of a loan commitment and the need for depreciation can be part of the courts' assessment whether the granting of a loan has been justifiable.

9. IS THE CEO EXEMPT FROM LIABILITY IF THE BOARD HAS APPROVED HIS OR HERS RECOMMENDATION TO GRANT A LOAN OR SECURITY?

No, the manager who recommends an unjustifiable loan will *not* be exempt from liability, just because of the board's approval. The manager holds an independent responsibility (if necessary in solidarity with the approving board members).

The Supreme Court states the following:

> In instances where (a manager of a bank) has recommended to the board the granting of a loan, and where the recommendation is unjustifiable, the board's approval does not exempt the the manager from liability.

So the manager cannot evade liability due to the board's approval of his or her recommendation. Whether the individual member of the board can be held liable or not, depends on an individual assessment of whether the board members decision to approve the recommendation was unjustifiable.

10. CAN ONE MAKE A SUMMARIZING EVALUATION OF THE SUPREME COURT'S ASSESSMENT OF THE BANK BOARD'S AND MANAGEMENT'S LIABILITY AFTER THE CAPINORDIC-RULING?

Yes you can, namely as follows:

(1) There is no general liability for the board or management, not even board and management of a financial institution. Liability must be assessed in relation to each individual granting of a loan, based on its justifiability – respectively the lack of such.

(2) Courts should show restraint when judging upon a business assessment (and even an error of assessment!) made by board and management of a bank, except in cases where irrelevant interests of e.g. board members' own interests have gone into the assessment. Even then, a strict liability cannot be constituted, but the burden of proof will be reversed in such situations: The board member in question must be able to prove that the interests of the bank was being attended to in the given decision. The rent ruling from the Western High Court (31 January 2002) in the EBH Bank case demonstrates, however, that such counter-proof *is* possible.

(3) The determining element in the assessment of liability is an assessment of *justifiability* of the granted loans (as well as the justifiability of the basis on which the loans were granted).

(4) A potential violation of formal legislation, internal regulations, guidelines of the bank etc. is less important in the material assessment of justifiability. The substance in the case is what matters (again: justifiability).

These basic principles of the elements of assessment of liability in financial institutions undoubtedly carries relevance – *mutatis mutandis* – to the assessment of liability issues in other types of professional legal units.