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Certainty, Justice and the Law of Agency in the Chinese Civil Code: A View from England

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Abstract: The new Chinese rules on agency do not impose broad "fiduciary" duties on agents—instead, there are a number of specific provisions designed to protect the principal against particular abuses to which it is peculiarly vulnerable in the principal/agent relationship. Chinese law, thus, deliberately refuses to follow the lead of English law, which imposes very strict and wide-ranging fiduciary duties on agents. This paper argues that this is probably wise. English law has to be seen against a matrix of a system of commercial law which was forged on the anvil of international trade and commodity supply contracts, leading to a set of rules that prefer certainty of outcomes (and the avoidance of litigation) overachieving particular justice in individual cases (such as might have been achieved by subjecting English law to an overarching "good faith" principle). English commercial law is adversarial, not cooperative. This explains why, in a relationship that is characterized by cooperation, such as the principal/agent relationship, the general rules of English commercial law are replaced by wide, justice-oriented rules. A system that is already based on cooperation, for which Chinese law is almost paradigmatic, is likely much more adept at applying the general rules to the agency relationship than English law would be.

Keywords: agency, English commercial law, agent's duties to principal, fiduciary duties

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Introduction

English commercial law is characterized by its uncompromising and unapologetic adversarial nature. It is not necessarily designed to promote justice but certainty.① Commercial parties need to know where they stand, and for that, they need clear rules and bright lines, reducing the incidence of judicial discretion to a bare minimum. Promoting certainty reduces litigation, and the theory goes: If the parties know what the rules are, they or their legal advisers can apply them to the problem at hand and accurately assess their chances in court. This emphasis on certainty is one reason, as is often claimed, why "English commercial law is chosen around the world by commercial counterparties to govern their contracts, even when neither they nor the subject matter has any connection with England."② A function of the focus on certainty is a rejection of a general principle of good faith: English lawyers claim that they do not know what "good faith" means③ and fear that it will serve to inject discretionary justice into commercial law, thus undermining the very foundation of its success. Commercial law, and indeed contract law more broadly, is regarded, by the English lawyer, as adversarial in nature, each party having to look after itself, and this concern has been held to render even a contractual agreement by which the parties purported to bind themselves to good faith negotiations void for uncertainty.④

Legal systems that locate themselves in the Civilian tradition are committed to a generally more collaborative approach. Contracts are not seen as contests, not as competition, but as relationships that impose an imperative on both parties to work out a solution to their differences. This is, of course, particularly pronounced in the Chinese tradition going back millennia: Disputes are better resolved by negotiation and mutual understanding, if need be, by mediation; going to court is considered an evil in itself and certainly a last resort.⑤ The goal—avoiding litigation and the social strife that this brings—is the same, but the approach is fundamentally different.

This article considers some of the provisions relating to the law of agency in the new Chinese Civil Code (*Civil Code of the People's Republic of China*, hereinafter the *Civil*

① *Cf.* Lord Mansfield's famous dictum in *Vallejo v Wheeler* (1774) 1 Cowp 143 at 153: "in all mercantile transactions the great object should be certainty: and therefore, it is of more consequence that a rule should be certain, than whether the rule is established one way or the other. Because speculators in trade then know what ground to go upon."

② Lord Briggs in *Manchester Ship Canal Co Ltd v Vauxhall Motors Ltd* [2019] UKSC 46, [2020] 2 All ER 81, [2019] 3 WLR 852, at [41]. This is, of course, not uncontroversial. There are many reasons, other than its supposed superior quality and the expertise of those who apply it, why English law may have the popularity it undoubtedly possesses. Language is, I would argue, the most important of these. While Mandarin Chinese is the language with the most native speakers (English only makes the third place, after Spanish, in that list), it is by a wide margin the most commonly spoken second language in the world: "Summary by language size." Ethnologue. Retrieved 12 March 2019.

③ *Cf.* Ewan McKendrick, *Goode and McKendrick on Commercial Law*, LexisNexis (London), para 3.75 (2020).

④ *Walford v Miles* [1992] 2 AC 128.

⑤ *Cf.* Konrad Zweigert and Hein Kötz, *Einführung in die Rechtsvergleichung auf dem Gebiete des Privatrechts*, Mohr (Tübingen), at 282–286 (1996).

Code) from an English perspective. Agency is an interesting area of the law because its division into internal and external relationships lays bare a fundamental tension in the English "style" of commercial law: externally, i.e., in the context of the principal—third party relationship, the same (harsh) rules obtain that characterize English commercial law generally (it is seen as adversarial), the internal relationship between principal and agent is recognized as collaborative. Principal and agent are "on the same team," and therefore, need to be able to trust one another. English law has long recognized that, by giving an agent authority to bind him, a principal is, to some extent, at the mercy of the agent. If the relationship was an adversarial one, this simply would not work: If the agent was "in it for himself," he would not be able to do what he was appointed to do, namely, to represent the principal and to protect the principal's best interests.① English law is conspicuously emphatic when it comes to signaling this change in emphasis: The agent is made subject to "fiduciary obligations" that are so strict that one might call them draconian in nature. They certainly go well beyond the more specific exhortations that can be found in Arts. 164 and 168 of the Chinese *Civil Code*.

The underlying argument made in this article is that it is not at all uncommon for English law to temper its "bright line" approach focusing on certainty rather than equity by going to the other extreme where the "bright line" approach simply fails to work or manifestly produces injustice. A system of private law which, from the start, is less adversarial and more cooperative in nature and style may thus be well advised not to emulate the English approach.

Certainty v Justice in English Private Law

English commercial law, and indeed much of English private law generally, has been developed in the context of international trade and commerce and can only be understood against that background. English law students will quickly become familiar with case names that are simply the names of ships—these are some of the most important cases that they will have to study and learn. Thus, the rule that pure economic losses cannot be recovered in a tort action was first authoritatively laid down by the House of Lords, then the highest court in the land, in The Aliakmon;② the Court of Appeal in The Hong Kong Fir③ laid down a typology of contractual terms, adding the category of "innominate"

① It is remarkable, but not surprising, that English law did not, by itself, appreciate that, apart from the principal needing protection against exploitation by the agent, the converse was also the case. Thus, an agent who had built up a distribution network, goodwill, or a customer base on behalf of the principal had no recourse if the principal, at this point, decided to dismiss it while taking advantage of the fruits of the agent's labors. It took the intervention of EU law, in the form of Directive 86/653/EEC (implemented in the UK by the Commercial Agents (Council Directive) Regulations 1993, so far surviving the departure of the UK from the European Union), to remedy this.

② *Leigh & Sillavan Ltd v Aliakmon Shipping Co Ltd* [1986] AC 785. The House of Lords approved and applied another shipping case, decided by the Commercial Court, in *The Wear Breeze* [1969] 1 QB 219.

③ *Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26.

terms to the well-established "conditions" and "warranties".④ The Albazero,⑤ affirming, though distinguishing, another shipping case, *Dunlop v Lambert*,⑥ deciding more than a century previously that a contracting party may, in some circumstances, recover losses incurred not by itself but by the transferee of the property affected. The "rule in the Albazero" was subsequently applied in a long line of construction cases involving defective building work, starting with the House of Lords decision in Linden Gardens① and culminating in the controversial decision, by the same court, in *Alfred McAlpine Construction Ltd v Panatown Ltd*,② which is required reading for any contract law student given its fundamental significance for the meaning of loss in English contract law. The original problem in *Dunlop v Lambert* was caused by the strict English rule that only a party to a contract can sue on it, the rule of "privity," a rule that proved to be a particular nuisance in shipping cases, so that the leading cases on privity arose, again, in the context of international trade.③ It is in the nature of international trade in general, and the trade in commodities in particular, that "time is money" and that the parties value certainty above everything. The premium that is put on certainty can lead to results that are, to the non-specialist, surprising and counterintuitive. Thus, in the case of *Gill & Duffus SA v Berger & Co Inc (No 2),*④ the House of Lords held that even where it was clear that beans that had been bought under a c.i.f. contract were of the wrong quantity (which would ordinarily justify rejecting them), the buyer had to pay against conforming documents. This makes sense within the context of the c.i.f. contract, but the point I am trying to make here is that frequently English commercial law, and indeed English contract law, seems designed to facilitate the commodity trader at the expense of the small business owner or consumer, and this is because its rules were hammered out on the anvil of international trade law.

The emphasis on certainty is pervasive in the core statute in English commercial law, the Sale of Goods Act 1979, and in the way in which its provisions have been interpreted. S. 35 SGA may serve as an example. As already mentioned, a breach of condition entitles the innocent party to terminate the contract. In the context of the sale of goods, the innocent buyer is, upon the seller's breach of condition, entitled to reject the goods. The most obvious condition that might be breached by a seller is implied into the sale contract by s. 14(2) of the Act, to the effect that the goods must be of satisfactory quality. This is widely defined in the section—even slight breaches—slight defects—entitle the buyer to reject

④ A breach of condition entitles the innocent party to suspend its own performance and terminate the contract from that point onwards, whereas an action for breach of warranty sounds in damages only—ironically, the shipping case Hong Kong Fir obscured that bright line, otherwise so typical for English commercial law, by introducing a third category of term, where the consequences of its breach determine whether the innocent party is entitled to terminate: the more serious they are, the more likely the innocent party is entitled to walk away.

⑤ *Albacruz (Cargo Owners) v Albazero (Owners)* [1977] AC 774.

⑥ *Dunlop v Lambert* (1839) 6 Cl & F 600.

① *Linden Gardens Trust Ltd v Lenesta Sludge Disposals Ltd* [1994] 1 AC 85.

② *Alfred McAlpine Construction Ltd v Panatown Ltd* [2001] 1 AC 518.

③ *Scruttons v Midland Silicones* [1962] AC 446; *New Zealand Shipping Co Ltd v Satterthwaite, The Eurymedon* [1975] AC 154; *The Mahkutai* [1996] 3 WLR 1.

④ *Gill & Duffus SA v Berger & Co Inc (No 2)* [1984] AC 382.

and receive a full refund of the price. Rather than requiring a buyer who chooses to reject having used the goods for a time to account for the use value made of the goods, following the controversial case of *Rowland v Divall*,⑤ English law simply ignores this issue. Instead, s. 35 SGA temporarily restricts the right to reject, giving the buyer only a very small time window within which the remedy of rejection can be exercised.⑥ Commercial law prefers certainty over justice—it would rather not get involved with the tedious and expensive inquiry into how much the buyer's use of the goods over a period of time would be worth in the market.①

The preference of English law for certainty over justice, at least up to a certain point, can also be demonstrated by examining the foundational rule of English contract law: freedom of contract. It is one of the most basic tenets of English contract law that the courts will not inquire into the adequacy of the consideration. In other words, they will not adjust the parties' bargain so as to make it "fair."② This general rule is even left untouched by consumer protection legislation, in that the Consumer Rights Act 2015, in s. 64, excludes "core" terms of the contract, i.e., those that determine the subject matter of the contract and the price, from the general assessment of fairness that all other terms are subject to. Yet the unconcern with the justice of the bargain comes to an abrupt end once the parties agree that, should it breach, one party shall pay a penalty to the other. In its original form, the penalty jurisdiction struck down any clause which required one party to pay to the other a sum of money upon breach which was not a genuine pre-estimate of the loss that would be suffered as a result of such a breach.③ While the scope of the jurisdiction has recently been somewhat reduced, under the influence of administrative law,④ it is undeniable that English law dramatically restricts the parties' freedom of contract when it comes to their secondary obligations, i.e., the obligations that obtain once the contract has been breached rather than performed. It is intriguing to note that most civilian legal systems do not have similar rules. One explanation for this may be that they tend to rely on orders for specific performance as the primary remedy for breach of contract, while English courts, in the exercise of their equitable jurisdiction, will only order one party to perform where damages are an inadequate remedy, and even then only in carefully circumscribed circumstances. This remedial regime would be undermined

⑤ *Rowland v Divall* [1923] 2 KB 500.

⑥ The high point of this strict approach was reached in *Bernstein v Pamson Motors Ltd* [1987] 2 All ER 220, in which Rougier J held, albeit only at first instance, that use of a car over a three-week period barred the remedy of rejection when a defect was discovered. It has since been somewhat relaxed: *Truk Ltd v Tokmakidis* [2000] 1 Lloyds Rep 543; *Clegg v Olle Anderson* [2003] 2 Lloyds Rep 32.

① It is ironic and makes my point rather well that, for consumers, to whom the Sale of Goods Act 1979 applied, subject to the Unfair Contracts Terms Act 1977, in its full rigor until then, English law was changed in 1994 following an EU Council Directive (93/13/EEC, now superseded by Directive 1999/44/EC), leading to much more nuanced, but much less certain, provisions of the Consumer Rights Act 2015 in ss. 19–24, giving the consumer buyer the option to have the goods repaired or replaced, or to reject them against a refund reduced by an appropriate amount to reflect the use made of them. The Directive, of course, was very much influenced by the civilian tradition, in particular by German law.

② *See*, for many, *Gaumont-British Pictures Corp v Alexander* [1936] 2 All ER 1686; *Langdale v Danby* [1982] 1 WLR 1123; *Brady v Brady* [1989] AC 755.

③ *Dunlop v New Garage* [1915] AC 79.

④ *Cavendish Square Holding BV v El Makdessi, ParkingEye Ltd v Beavis* [2015] UKSC 67, [2016] AC 1172.

if the parties were allowed to agree that, in the event of non-performance, extortionate penalties were to be payable. However, a more convincing explanation is simply that most civilian systems allow courts to regulate the parties' bargain to a greater or lesser extent, setting aside extortionate bargains or even rewriting the parties' agreement to make it fairer. As this can be done with all the terms of the contract, there is no need for a special rule when it comes to secondary obligations. Again, a pattern emerges of a hands-off, adversarial attitude to contracting that hits a hard wall where freedom of contract is perceived to go too far.

There are some situations in which the adversarial approach of English law is simply not appropriate. These include cases in which the parties are clearly of unequal bargaining strength—be it because one of them is a consumer, be it because one of them is inherently disadvantaged by being put under duress or by being in a relationship with the other that English law characterizes as a "relationship of influence." But even where the parties can negotiate at arm's length, the nature of the relationship or of the tasks that one of them is supposed to undertake on behalf of the other, calls for a different, more collaborative approach. The obvious example is the contract of employment. Clearly, while prospective employers and employees may drive a hard bargain until the contract is formed, once it is, they both owe duties to one another that are absent from ordinary contractual relationships. It is thus very well established that an employee owes a duty "to serve his employer loyally and not to act contrary to his employer's interests."[①] This is because the contract of employment cannot reasonably be performed in any other way. Once the employee has decided to accept employment, he is on the "employer's team" and is expected no longer to behave in an adversarial way vis-à-vis the employer.

Some employees, of course, are agents of their employers, but this is not true of all employees. Conversely, not all agents are employees: They may be acting under an independent contract or under no contract at all. Before we can usefully discuss the role that fiduciary obligations play in the law of agency, it is necessary to give a short overview of the English law of agency. This will be done in the next section of this paper.

Overview of the English Law of Agency

The institution of agency is fundamental to any advanced economy. It mainly allows commercial people to delegate the task of entering into contracts at scale or at a distance to others. At the heart of agency lies the concept of authority. Authority allows the agent to affect the legal position of the principal, most commonly by entering into a contract with a third party. Before we turn to the "agency triangle"," that is, the three distinct

① *Malik v Bank of Credit and Commerce International SA* [1998] AC 20.

relationships arising in an agency situation, a few words must be devoted to peculiarities of English law, namely, the surprising lack of formality requirements for the appointment of agents and the, even more surprising, lack of a requirement that the agent be openly acting on behalf of a principal, the so-called doctrine of the undisclosed principal.

Formalities

There is no general formality requirement when it comes to the appointment of agents: They can be appointed orally (even impliedly), in writing, or in a deed (when their authority will normally be known as a "power of attorney.") In contrast to many civilian legal orders, English law does not require the appointment of the agent to follow the same formalities as those that are required for the transaction that the agent is meant to enter into on behalf of the principal. Thus, while s. 2 of the Law of Property (Miscellaneous Provisions) Act 1989 requires that contracts for the disposition of land be in writing and signed, it allows for the signature to be executed by agents that is not required to be authorized in writing.② There is one notable exception to this general rule: Only agents authorized by deed are able to execute a deed on behalf of the principal.① The deed is the strongest formality requirement known to English law, yet to civilian lawyers, its requirements are surprisingly weak: In the modern law, all that is required for a deed to be validly executed is that it says that it is executed as a deed, signed and witnessed by one witness, and delivered to the donee. Deeds are only rarely required in English law for a transaction to be binding; they are useful for making binding gift promises; that is, promises unsupported by consideration, and, technically, are required to grant leases for more than three years under ss. 52 and 54(2) Law of Property Act 1925.②

Where authority is given in the form of a deed, this will normally take effect as a "power of attorney." What a "power of attorney" actually means is not defined in English law, but it can be taken to refer to the grant of a formal power, especially where that power is very wide. The Powers of Attorney Act 1971 s.1(1), as amended by the Law of Property (Miscellaneous Provisions) Act 1989, requires that instruments creating powers of attorney be executed as deeds. The authority thus conferred may be exhaustive, entitling the attorney to do everything the principal can do himself (the only exception appears to be the contraction of marriage), or it may be limited to certain defined objects. For the most part, however, it is not necessary for an agent to be invested with a power of attorney in order to have a perfectly good and valid authority so that any acts within that authority are binding on the principal. In practice, however, the power of attorney provides the

② *McLaughlin v Duffill* [2008] EWCA Civ 1627; [2010] Ch.1.
① Powers of Attorney Act 1971 ss.1 and 7.
② In practice, however, where a lease for more than three years is granted otherwise than by deed, it will nevertheless take effect in equity: *Walsh v Lonsdale* (1882) 21 Ch D 9.

agent/attorney with a document defining the extent of his authority, which he can produce as evidence to the third parties with whom he is to deal.[③]

The Undisclosed Principal Doctrine

The doctrine of the undisclosed principal allows an agent to enter into contracts with third parties ostensibly on his own behalf, however, in reality, on behalf of his undisclosed principal. It is well established that the principal will be able to sue the third party directly on such contracts and vice versa. This result has been called "surprising" (Watts & Reynolds, 2021, para 8-071). in that it does not sit at all well with the general rules of contract law: The third party never makes any promise to the supposed principal, nor does the principal ever express his intention to be bound to the third party. Many have tried and failed to explain the doctrine as part of the law of agency.[④] I would suggest that an undisclosed agency be mainly used in order to protect the principal and third party against the insolvency of an intermediary who would otherwise be directly liable on the relevant contract. The language and conceptual framework of the agency are convenient tools to bring about a reallocation of insolvency risks and very little more. That this is so follows from an examination of the practical goals of undisclosed agency, of its historical development, and its current rules.[①]

There are essentially two situations in which there will be a commercial need to hide the fact that the intermediary is acting on behalf of somebody else:[②] The principal may wish to enter the market without this being known (for a variety of reasons—frequently because he places a premium on goods which would be reflected in the price were his identity known); similarly, the intermediary may wish to avoid that the third parties he is dealing with will in future deal with the principal directly, cutting him out of the transaction. These goals could be achieved by a chain of contracts (P-A-T), with each party being liable and entitled to the person next to him in the chain only, and this is the solution adopted in civilian jurisdictions under the heading "indirect representation" or "commission agency." These legal systems then provide rules which, to a greater or lesser extent, make the third party directly liable to the principal if the intermediary becomes insolvent, so that the difference between those systems and the common law is not as

③ There are a number of specialized powers of attorney which afford the attorney more far-reaching powers than those possessed by an ordinary agent: first, a trustee (himself a fiduciary) is generally barred from sub-delegating his powers but is nevertheless able to grant powers of attorney in certain circumstances; secondly, the Mental Health Capacity Act 2005 introduced the "lasting power of attorney" (replacing the so-called "enduring" power of attorney available between 1986 and 2005). This power survives the principal's incapacity (in contrast to an ordinary agent's authority, which lapses when the principal, for example, becomes of unsound mind), and enables natural persons to entrust their affairs to an attorney of their choice (as long as they still have the capacity to do so), also extending to decisions about their welfare and medical treatment.

④ *See, e.g.,* Randy E. Barnett, *Squaring Undisclosed Agency Law with Contract Theory*, 75 California Law Review, 1969 (1987) (he does not really square it at all); W. Müller-Freienfels, *Comparative Aspects of Undisclosed Agency*, 18 Modern Law Review, 33 (1955).

① *See* Thomas Krebs, *Some Thoughts on Undisclosed Agency*, in Louise Gullifer and Stefan Vogenauer eds. *English and European Perspectives on Contract and Commercial Law: Essays in Honour of Hugh Beale*, Hart Publishing (Oxford), at 161–182 (2014).

② *See* Peter Watts and F. M. B. Reynolds, *Bowstead & Reynolds on Agency*, Sweet & Maxwell (London), para 8-073 (2021).

great as may, at first sight, appear (Kötz, 1996, p. 367; Watts & Reynolds, 2021, p. 377). Historically, the undisclosed agency doctrine appears to have been developed to deal with precisely the insolvency of an intermediary who had been acting in his own name but on somebody else's account (Stoljar, 1961, pp. 203–211). The modern doctrine bends over backward to protect the third party from nasty surprises, so that its rules are a long way removed from the rules applicable to disclosed agency scenarios. Thus, the undisclosed principal is barred from ratifying contracts entered into by the agent in excess of his authority—had the agency been disclosed, he would be able to do so.③ In addition, the agent does not "drop out"—he remains liable and entitled alongside the principal. The third party can avail himself of any defenses—including set-off—which he would have against the agent. Finally, the contract may, by its express or implied terms, exclude the possibility of an undisclosed principal. It is thus arguable that undisclosed agency has rather more in common with assignment than it does with agency proper. Indeed, when they were consulted on the doctrine by the drafters of the then-nascent Unidroit Principles of International Commercial Contracts, the two foremost experts on the common law of agency, Professors Francis Reynolds of Oxford University and Deborah Demott of Duke University, thought that nothing of great value would be lost if undisclosed agency were not included in the new international code.

Still, the practical problems which might arise in commission agency transactions where the agent becomes insolvent having been put in funds by either principal or third party might nevertheless be thought to call for the law's intervention. If the commission agent is regarded as a mere conduit pipe between the principal and the third party, there are arguments why the parties to the transaction should not be exposed to a greater insolvency risk than if they had been dealing directly with each other: Though not acting in his principal's name, the commission agent is acting on his principal's account; he is not taking any risks with his own money and is, as the name implies, paid by way of commission rather than by generating profits from the transaction for himself. On the other hand, of course, the principal is using the commission agent for a reason, knowing that he may fail and choosing to use him anyway, while the third party does not even know that the commission agent is not acting on his own account. Preferring the principal and/or third party in the intermediaries' insolvency is not a foregone conclusion. In other words, the arguments are finely balanced.

The problem arises most acutely when the commission agent enters into a contract with the third party and fails before the third party performs. The trustee in bankruptcy cannot necessarily be relied on to enforce the contract on the principal's behalf and may, in fact, seek to retain any payments made by the third party for the benefit of the bankrupt estate.

③ *See* below.

Conversely, if the third party grants the intermediary credit, while the principal may well be able to reap the benefits of the third party's performance, the third party will be hard-pressed to get his money from the principal and may, for that reason, be unwilling to deal with the intermediary.

Some jurisdictions tackle this problem by statutory rules by which the principal and the third party are brought into a direct contractual relationship in such cases. One example of this can be found in the Principles of European Contract Law (PECL). Where an intermediary has become insolvent (or it is clear that he will not perform for some other reason), the principal may exercise any rights acquired by the intermediary against the third party on his behalf (Art. 3:302). By the same token, the third party may proceed directly against the principal and exercise any rights which he has acquired against the third party (Art. 3:303). In both cases, this is, of course, subject to defenses, which the third party could have relied on. These provisions are modeled on similar rules, which may be found in a number of jurisdictions, in particular the Netherlands, Belgium, Denmark, Sweden, Italy, and Portugal.[①] A common law system, developing organically, cannot easily put in place similar rules. The common law, therefore, solved the problem by developing, very early on, a doctrine by which a contractual relationship between the undisclosed principal and the third party is brought about directly. The practical results will generally be indistinguishable from those reached in other jurisdictions.

The new Chinese *civil code* does not subscribe to the undisclosed agency doctrine. Instead, it follows the Principles of European Contract Law in denying a direct nexus between the (undisclosed) principal and the third party unless and until something goes wrong. Thus, Art. 162 clearly expresses the "publicity principle": The agent's act will only bind the principal where it is carried out "in the name of the principal." Art. 925 modifies this to some extent, in that it puts in place a presumption in favor of agency where the third party knows that the person he is dealing with is another party's agent. While this moves the law a little bit in the direction of the undisclosed agency, it is, in reality, no more than an interpretative guide. Art. 926, on the other hand, is a novel provision which allows the principal or the third party whose only nexus is the engagement with a commission (i.e., indirect) agent to intervene in the commission agent's contract where the other, that is, the principal or the third party, has prevented the commission agent from performing. In English law, the direct nexus would arise at a prior point through the undisclosed agency doctrine. The Chinese solution is, however, also narrower than the solution adopted by the PECL, in that it does not cater to the situation, in which the agent does not perform for reasons related solely to himself.

① *See* Ole Lando and H. G. Beale eds. *Principles of European Contract Law: Parts I and II*, Kluwer Law International (The Hague), at 222 (2000).

The "Agency Triangle"

The three relationships involved in agency form the so-called "agency triangle," which results in a binding, bilateral contract between the third party and the principal. They are principal/agent, agent/third party, and principal/third party. We will briefly examine each in turn before then examining the principal/agent relationship in more detail, given the focus on the fiduciary nature of the relationship adopted by this paper.

Principal and Agent.

The relationship between the agent and the principal may (and usually is) but need not be contractual. The peculiarly common law doctrine of consideration, which insists on a counter-performance, or the promise thereof, to support a promise, means that it is entirely possible for an agent to act on behalf of a principal without being contractually obliged to do so. His failure to act, where he has undertaken to act without being promised anything in return, might, of course, lead to losses being incurred by the principal—however, the agent's liability would, in such a scenario, be tortious only.

It is a fertile source of confusion to equate the contract the principal might have with the agent with the scope and extent of the agent's authority. The two are analytically and logically distinct. The principal, in asking the agent to act, will tell him, expressly or impliedly, what the extent of his authority is to be. This is entirely independent of the contract, if any, between the principal and the agent. Should the agent then exceed his authority in a way that exposes the principal to liability (on which more below), that may be a breach of contract, if a contract between principal and agent exists, or expose the agent to liability in tort (for negligence, a duty of care arising from his voluntary assumption of responsibility, on which more below).

The agent will also be expected, of course, to execute his mandate, in other words, to do what he undertook to do vis-à-vis the principal. Where he is in a contractual relationship with the principal, the default position is that he will only be liable if his failure to achieve the desired outcome is due to his failure to carry out his mandate "with reasonable care and skill,"[①] although it is, of course, entirely possible for an agent to agree to bring about a certain result, failing which he incurs liability.

In English law, it is seen as fundamental to the relationship between principal and agent that the agent acts in a "fiduciary" capacity, subjecting the agent to sweeping and not necessarily well-defined duties accompanied by draconian remedies. We will look at this in detail below. For now, we should note that such a broad label is conspicuously missing from the Chinese *Civil Code*. It is also remarkable that the agent is made to such sweeping and unforgiving duties within the context of a legal system that normally avoids

① Supply of Goods and Services Act 1982, s. 13.

the use of wide principles of this sort, most obviously, of course, the refusal of the English law of contract to recognize a general principle of good faith.

The justification for making the agent a fiduciary is that, by granting authority to bind him in transactions with others, the principal is putting himself, to an extent (to be precise, to the extent of the authority granted to the agent or represented to third parties) at the mercy of the agent. The adversarial model explored above is no longer appropriate, and the pendulum swings the other way dramatically. Agent and principal are on the same team, and as such, the agent is not supposed to be acting in his own interests and against the interests of the principal, but exclusively in the interests of the principal. All temptation to do otherwise is removed by making the agent accountable with respect to all profits, over and above commission earned from the principal, that the agent may have derived from his agency in breach of his fiduciary duties.

Agents are not the only fiduciaries in English law. In fact, the paradigm fiduciary is the trustee. The institution of the trust is generally regarded as the crowning achievement of the Court of Chancery and the legal system that, for centuries, co-existed with the common law: equity. Put at its simplest, one person (the settlor) transfers property to another (the trustee) who agrees to hold it on behalf of a third (the beneficiary). While civilian systems, with greater or lesser success, try to achieve a similar result by using the law of obligations, maybe supplemented by tweaking the rules applying should the trustee become insolvent, English law treats the beneficiary as the owner, in equity, of the trust property, while the trustee has the "legal" title—he is the owner "at common law," but can be ordered by courts of equity to transfer the property to the beneficiary in appropriate circumstances. While the two systems co-existed separately until 1877, they have, since the Judicature Acts 1877, been administered by the same courts, and this adds a complication to the study of English law that many foreign exchange students are unprepared for. The reason why the trust is mentioned here is that it raises similar concerns to agency: the trustee is endowed with the legal title, a title that, should he decide to abuse the "trust" placed in him, he could validly pass to others (so long as they are unaware of the trust). Like an agent, the trustee is therefore required to subordinate his own interests to those of the beneficiary—he is subject to fiduciary duties. These duties were developed by courts of equity over centuries and could easily be transplanted into the agency relationship. In fact, an agent is often treated exactly as if he were a trustee.

Legislative intervention by the European Union and with a long history in civilian legal systems has recently introduced rules into English law that recognize that while the principal may, to some extent, be at the mercy of the agent, the converse is also the case. Say an agent is employed to seek out customers for the principal, using his existing relationships, his knowledge of a given market or his peculiar skills, to build up a customer base in a given market. Once this has been achieved, the principal dismisses

him and takes over the customer base directly, cutting out the "middle man," as the cliché goes. English law traditionally did not see this as a problem—the parties were dealing at arm's length, and if the agent did not protect his position by the terms of the contract, he only had himself to blame. Civilian legal systems saw this differently, recognizing parallels between what they termed "commercial agency" and employment relationships, and since the European Union took a dim view of divergent rules in different member states, it sought to harmonize the position in Directive 86/653/EEC (coordination of the laws relating to self-employed commercial agents), and this was implemented in England by the Commercial Agents (Council Directive) Regulations 1993. The fate of these Regulations hangs in the balance following the United Kingdom's withdrawal from the EU, but for now, they remain part of English law and require a principal who wishes to terminate his relationship with a "commercial" agent to "indemnify" or "compensate" him. Unlike the agent's fiduciary duties, these cannot be contracted out.[①]

Agent and Third Party.

In most cases, the agent will not end up in a legal relationship with the third party: He "drops out" of the picture. There are two exceptions to this. The first involves situations in which the agent exceeds his authority, with the result that the third party does not, in fact, end up in a contractual relationship with the principal. The agent may, in such a scenario, be liable to the third party for breach of his "warranty of authority," the precise scope and legal nature of which is still subject to some doubt in English law.[②] The second is more straightforward: The agent agrees to be liable to the third party and is entitled to enforce the contract alongside the principal. If neither of these applies, the agent indeed "drops out" as far as the third party is concerned.

Principal and Third Party.

The whole point of the agency is to bring the principal into a contractual relationship with a third party. The legal mechanism by which this occurs is referred to as authority. An agent's authority gives him the power to bind the principal. So how is the agent endowed with the principal's authority, and why does authority matter?

There are a number of different ways, in which the different ways, in which an agent can be clothed with authority, can be categorized. In English law, these tend to cut across

① Morland J explained the policy behind the Directive and the Regulations implementing it as follows: "It might take years for an agency to be developed to a state of profitability. If then terminated the commercial agent loses his livelihood. The resources and effort put into the development of a profitable agency are lost to him whereas the principal gains a valuable asset." (*Ingmar GB Ltd v Eaton Leonard Inc* [2001] CLC 1825 [33]. The Directive left it to the Member States whether to focus on the agent's loss or the principal's (unjust) enrichment, but, to the chagrin of legal advisers, the UK Parliament left both options open. Anecdotally, the most frequent question I am asked when giving talks to practitioners on agency is how the Regulations can be avoided!

② It could be explained as a claim on a genuine "warranty," i.e., a collateral contract by which the agent agrees to indemnify the third party against the consequences of any lack of authority on his part, or it could be seen as a tort claim based on the agent's misrepresentation to possess authority he does not, in fact, possess. The problem with the former is that imputing an intention to create legal relations (between himself and the third party) may be difficult, while the problem with the latter is that normally English law does not hold parties strictly liable for the veracity of their statements, requiring some lack of care on the part of the agent before holding him liable, while breach of warranty of authority does not depend on fault: *Collen v Wright* (1857) 7 E & B 301. An additional problem with the tort analysis is that it is well established that the third party's expectation interest is protected. *See* further F. M. B. Reynolds, *Breach of Warranty of Authority in Modern Times*, 1 Lloyd's Maritime and Commercial Law Quarterly 189 [2012].

one another: We speak of actual and apparent, express, implied, and usual authority. This can be quite confusing. Leaving usual authority to one side (it overlaps with all four other kinds of authority), we shall focus on actual and apparent authority, both of which can be founded expressly and impliedly. Finally, even where the agent is entirely unauthorized, the principal may have the power to cure this lack of authority by ratifying the agent's unauthorized act (as is also the case in Chinese law, of course).

Actual Authority. The term "actual" authority is misleading. It implies that other forms of authority are not "actual," and are not "actually" effective. And yet it is undeniable that a principal will end up liable to a third party who contracts with an agent clothed with merely "apparent" authority. What the law means by the label "actual" is, therefore, something else. Where the agent has actual authority, his power to affect his principal coincides with his right to do so. Both power and right must be gleaned from what the principal said to and did vis-à-vis the agent, and this can only be done by a process of interpretation and construction. This process may be very straightforward and clear, as when the principal tells the agent to buy 100mt of a certain grade of grain on the commodities market at a certain price. But even then, of course, the language used by the principal is being interpreted, and the process of interpretation is easy. In such cases, we refer to "express actual authority." But as the language used is less clear, less certain, where, perhaps, the agent is given a task (such as "get me a good deal on the grain"), much more work is done by the process of interpretation, and aspects of the agent's authority will be implied. It is in such cases that we talk in terms of "implied actual authority." The process of construction is the same as in the general law, with one important and easily overlooked difference: As the principal's interlocutor is the agent, and not directly the third party with whom he will end up in contractual relations, the process of interpretation is carried on by the agent and from the agent's point of view, with his, the agent's knowledge of the surrounding facts and on the basis of any course of dealing principal and agent, and not principal and the third party, might have had.①

One more point needs to be made under this heading. The agent knows that he is employed to act on his principal's behalf and in the principal's best interests. Any act that the agent undertakes that the agent knows to be not in the principal's best interests is, by definition, not covered by the agent's actual authority. This principle was set out by O'Connor J in *Lysaght & Co Ltd v Falk*:② "Every authority conferred upon an agent, whether express or implied, must be taken to be subject to a condition that the authority is to be exercised honestly and on behalf of the principal. That is a condition precedent to the right of exercising it, and, if that condition is not fulfilled, then there is no authority, and any act

① *Cf.* to the same effect, Howard Bennet, *Principles of the Law of Agency*, Hart Publishing (Oxford), at 40 (2013).
② *Lysaght & Co Ltd v Falk* (1905) 2 CLR 421, 439.

purporting to have been done under it unless in dealing with innocent parties, is void." The qualification "unless dealing with innocent parties," may give us pause for thought. It is generally thought③ that this refers to the agent's apparent authority, and we shall return to it in that context. An example of the principle can be seen in the Australian case of *Sweeney v Howard*:④ there, a power of attorney conferred very wide-ranging authority on the agent. The agent used it to borrow money secured by a mortgage on his principal's land, intending all along to lend it on for the agent's purposes. This was held not to be covered by the terms of his actual authority: The agent knew he had no business exercising his authority for his own ends.① In such cases, the focus shifts to the agent's "apparent" authority.

Apparent Authority. Where the agent's power to bind the principal is not matched by a corresponding right to do so, the law speaks of "apparent" authority. This is analogous to Art 172 of the *Civil Code,* which provides that an "act of agency" will nevertheless be valid even where the agent has no "power of agency." "Power" seems to refer to the concept of authority because if the act is valid, it seems clear that the agent did, in fact, have the necessary "power"—he just was not, as between himself and his principal, permitted to use it. The validity of the (unauthorized) act depends on the third party having "a good reason to believe that the actor has the power of agency." The protection afforded to the third party, however innocent, seems excessive. English law is rather more conservative. It is well-established that there must be a representation by the principal for the principal to be exposed to liability for the agent's unauthorized acts.② This may, of course, consist of the simple act of putting the agent into a certain position, a position, that is, that would normally be assumed to be accompanied by a certain level of authority.③

English law insists on representation because it regards the basis of apparent authority to be the doctrine of estoppel. An estoppel is basically a rule of evidence that prevents a party from leading evidence that contradicts a statement he himself made to the other party that was then relied on by that party: He cannot show, by evidence, that he was, on that occasion, a liar. The American Restatement of Agency eschews this complexity,④ and rightly so, as I have argued elsewhere: in the context of a law of contract that looks to objective manifestations of consent, it is not necessary to use the artifice of estoppel (Krebs, 2010, pp. 205–224). Yet English cases seem committed to this idea,⑤ with the

③ *Cf.* Peter Watts and F. M. B. Reynolds, *Bowstead & Reynolds on Agency*, Sweet & Maxwell (London), para 3-012 (2021), where the above passage is cited and commented on.
④ *Sweeney v Howard* [2007] NSWSC 852.
① *See* also *Hopkins v TL Dallas Group Ltd* [2004] EWHC 1379; [2005] 1 BCLC 543 [89].
② *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480.
③ This is where the label "usual authority" is sometimes encountered, although, it is suggested, the label should be avoided as it is inherently imprecise: it can refer to both apparent and implied actual authority, depending on the circumstances.
④ American Law Institute, *Restatement of the Law Third*, Agency, American Law Institute (St. Paul), § 2.03, Comment (c) (2006).
⑤ *Rama Corp Ltd v Proved Tin & General Investments Ltd* [1952] 2 QB 147, 149; *Freeman & Lockyer v Buckhurst Park Properties (Mangal) Ltd* [1964] 2 QB 480, 504–505. It is difficult, however, to find a case in which the estoppel analysis is necessary to justify the decision, leaving an objective interpretation within interpretative reach.

consequence that, in contrast to Art 172 of the *Civil Code*, any act by the agent that is covered by his apparent authority is binding on the principal only—without more, the principal does not derive any rights against the third party from the agent's act. However, the practical effect of this should not be overstated, given that the principal will normally be able to ratify the agent's unauthorized act, thus bringing about a bilateral contract between himself and the third party.

Both American and English law do, however, require a contribution of the principal that gives rise to the third party's belief that the agent is authorized, and here they are both narrower than Chinese law appears to be. Again, however, the representation in question can be express or implied. While it is unusual to speak of "express apparent authority" or "implied apparent authority," such a distinction would be useful to distinguish between direct communications of the scope or breadth of the agent's authority (which are, however, contradicted by internal restrictions placed on the agent's actual authority) and implied statements made, for example, by placing the agent in a position in which it would be usual for the agent to possess the sought-for authority.

This becomes clear in the so-called "self-authorization" cases. The first in this line of cases is The Ocean Frost,[①] another shipping case. Both contracting parties were represented by utterly corrupt agents. They both knew that the one acting for the buyer of a ship had no authority whatsoever to commit his principal to a three-year, rather than a one-year, time charter of the ship. The House of Lords acknowledged in the course of the judgment that it was possible for an agent to be authorized to communicate the extent of authority possessed by another agent and averted to "rare and unusual" cases in which an agent, lacking authority to enter into a certain transaction, might be authorized to communicate the principal's representation that he had been authorized to enter into that self-same transaction. This was not so in the case itself, and the argument that the corrupt agent had been able to "self-authorize" in this manner was rejected. However, some seven years later, the Court of Appeal came to decide the case of *First Energy (UK) Ltd v Hungarian International Bank Ltd*[②] on the basis of the "rare" principle set out by the House of Lords in The Ocean Frost. A Hungarian merchant bank had a head office in London and a further office in Manchester. The manager of the Manchester office had dealt with the third party throughout the transaction on behalf of the bank, and the third party knew that it went beyond his authority to grant loans above a certain amount. When he approved a loan on behalf of the bank, assuring the third party that he had received the requisite one-off authority to do so, the Court of Appeal held that he had been able to make a representation that gave rise to his own apparent authority. The crucial aspect of the case

① *Armagas Ltd v Mundogas SA* [1986] AC 717.
② *First Energy (UK) Ltd v Hungarian International Bank Ltd* [1993] 2 Lloyd's Rep 194.

is that, normally, a branch manager of a bank would have the authority to approve loans, and that the third party only knew about his lack of authority because he had told them. Having taken away his own apparent authority, he was in a position to reinstate it. The case is nonetheless not uncontroversial and has not been followed in Canada③ and Singapore.④

This is as far as English law is prepared to go when it comes to "self-authorization." It is not enough for the agent to claim to be authorized, however respectable or trustworthy he may appear to be. English law takes a stance that is rather less forgiving than the Chinese *Civil Code* in Art. 172, unless that provision is interpreted restrictively so as to require a causal link of some sort between the principal and the "good reason" to believe the agent's authority on the part of the third party.

There are some cases where it is doubtful if an English court would find the requirements of apparent authority to be made out. Say an agent is issued with visiting cards by his principal, showing him as a "senior buyer" of the principal. Clearly, any transaction that would normally be within the ambit of a "senior buyer's" authority will be covered by his apparent authority, even if he exceeds the scope of his "actual" authority, the requisite representation by the principal being present in the form of the visiting card. Would and should it make a difference, then, if the agent ordered the cards himself, as long as his title of "senior buyer" was correct? A case that might help in that sort of situation, but which has long been doubted in the literature, is *Hambro v Burnand*.① There, an agent, writing insurance, exceeded his authority by acting in his own, not his principal's best interests. His authority, however, had been reduced to writing, and he would have been able to present this to the third party, thus clothing himself in apparent authority. The court did not draw a clear distinction between actual and apparent authority in holding the principal bound to the third party. The reason for this might well have been a reluctance to insist on a direct representation that would normally be required for apparent authority in circumstances where an appearance of authority could have been created by asking the agent to show his credentials. Again, a court applying Art 172 would probably reach a similar result; however, much of this is criticized in English law.

Ratification. Ratification allows a principal to adopt the transaction of an unauthorized agent. He can thus take the benefits of that transaction, clothing the agent with authority retrospectively. In practice, the need for ratification may arise in a variety of circumstances. The agent may not realize that he is exceeding his authority, or that he has no authority at all.② It may also be that, though aware of his lack of authority,

③ *British Bank of the Middle East v Sun Life Assurance Co of Canada (UK) Ltd* [1983] 2 Lloyd's Rep 9.
④ *Skandinaviska Enskilda Banken AB v Asia Pacific Breweries (Singapore) Pte Ltd* [2009] SGHC 197.
① *Hambro v Burnand* [1904] 2 KB 10.
② It is the object of the rule in *Ireland v Livingston* (1871–72) LR 5 HL 395 to prevent this, but the rule is said to be of limited applicability in modern times, given the increased technological scope for referring back to the principal: *see* e.g. *European Asian Bank AG v Punjab and Sind Bank (No 2)* [1983] 1 WLR 642, 655.

the agent believes that the transaction is in his principal's best interests, so the principal would have conferred the requisite authority on the agent had he been aware of the circumstances. Finally, the agent may enter into the transaction knowing full well that it is not covered by his authority, and that it would be against the principal's likely wishes. Particularly in the first two situations, the usefulness of the doctrine of ratification is apparent: It enables the principal to take advantage of the agent's transaction without needing to enter into a new contract; if the third party seeks to take advantage of the agent's alleged lack of authority in order to escape from a bad bargain, the principal may seek to put the matter beyond doubt by ratifying the transaction.

One important limit of ratification is that the agent must have been acting on behalf of another—in other words, the undisclosed agency is excluded. The reason given for this rule by the House of Lords in the leading case, *Keighley, Maxsted & Co v Durant*,③ is that "civil obligations are not to be created by, or founded upon, undisclosed intentions."④ The editors of Bowstead & Reynolds on Agency criticize this reasoning, and the unavailability of ratification, as inconsistent with the very idea of the undisclosed agency, which has as its foundations precisely the agent's undisclosed intentions (Watts & Reynolds, 2021, para 2-061). I am going to put forward two counter-arguments, one on a practical and one on a conceptual level. The first argument, which was clearly strongly influential on the House of Lords in *Keighley v Durant*, is the danger of ex post fabrication. Granted, this danger exists in the context of undisclosed agency as well, and the whole doctrine of the undisclosed principal can be criticized on this ground. However, where an undisclosed agent acts with prior authority, any evidence that such authority was actually granted will clearly be more reliable than in the case of subsequent ratification. It will involve some sort of communication between the principal and the agent, possibly even in writing. On the other hand, the adoption of the contract by the principal in cases where the agent lacked authority at the time of the contract will be possible as long as the agent can credibly assert that, when entering into the contract, he intended to do so on the principal's account. This seems a much lesser burden than that of establishing antecedent authority, so that the danger of fabrication is correspondingly greater, with the result that the law would, in the words of Lord Shand, "give one of two contracting parties in his option, merely from what was passing in his own mind and not disclosed, the power of saying the contract was his alone or a contract in which others were bound with him."①

Reynolds finds it surprising that the rule applies even where it is sought to hold the ratifying principal liable, in other words, where obligations are imposed rather than

③ *Keighley, Maxsted & Co v Durant* [1901] AC 240.
④ *Keighley, Maxsted & Co v Durant* [1901] AC 240, at 247 (Lord Macnaghten).
① *Keighley, Maxsted & Co v Durant* [1901] AC 240, at 250.

rights conferred on him.② *Keighley v Durant* was itself such a case: The seller of wheat unsuccessfully sought to recover damages for non-acceptance from the alleged principal, who had privately agreed with the agent to take the contract on a joint account a day after it had been concluded in the agent's name alone, and in excess of the price at which he was authorized to buy on the joint account. The Restatement 3d relies on a number of US cases which appear to contradict this result, but none of these appear to be a particularly strong authority to support a departure from a rule well-established by English authority and accepted by the first two Restatements of Agency.③ Two out of three of these cases involve alleged acts of ratification by undisclosed principals who accepted and retained money originating from the third party, which was paid into their bank accounts.④ The cases cited in the Restatement are, to some extent, consistent with the proposition that an undisclosed principal may well be bound by an act amounting to ratification where his liability arises in tort or unjust enrichment—neither cause of action depends on showing a consensus ad idem of any kind between the principal and the third party. Clearly, where the principal asserts the rights of an owner over property belonging to the third party or retains a benefit at the third party's expense in circumstances which the law considers unjust, it is right and proper that he should be held liable accordingly, be he undisclosed or disclosed. This does not, however, change the general rule that neither he nor the third party will be bound in contract.

Ratification is said to take effect retrospectively—in other words, the law pretends that the agent had authority all along. The practical effect of this is that even when the third partydiscovered the agent's lack of authority and made it clear that he no longer wishes to be bound, the principal is nevertheless free to ratify and bind the third party to the contract. If this is correct, it is difficult to square ratification with ordinary contract doctrine: At no point are the parties "ad idem"; at first, the principal has not expressed his intention to be bound—later on, the third party has expressly disavowed any such intention. The leading English case which is usually cited as authority for the above proposition is *Bolton v Lambert*.① It concerned a contract to take a lease. Lambert wrote to Scratchley, a director of Bolton Ltd, offering to take a lease from the company. Scratchley replied to Lambert, accepting this offer. The very next day, Lambert sought to withdraw from the contract. It appears from the report that he did not at that point know that, in

② Hugh Beale ed. *Chitty on Contracts* (33rd edition), Sweet & Maxwell (London), vol. 2, at 17, fn. 151 (2020).

③ *Coyle v. Smith*, 300 So. 2d 738 (Fla.Dist.App.1974); *Young & Rubicam, Inc. v. Ticket Holder Marketing*, Inc 1989 WL 4210 (N.D.Ill.) and *Acuri v. Figliolli*, 91 Misc.2d 831, 398 N.Y.S.2d 923 (N.Y.Dist.Ct. 1977).

④ In *Young & Rubicam v Ticket Holder*, the proceeds of a bill of exchange drawn on the third party were paid into the alleged principals' bank account. In *Acuri v Figliolli*, the alleged undisclosed agent had sold his mother's car, accepted a number of installments in payment, which he had paid over to the mother, and later repossessed the car for an alleged breach of contract. The third party's claim against the mother was for restitution of the instalments paid, and the action was, in fact, an action for money that had and received.

① *Bolton v Lambert* (1889) 41 Ch D 295.

accepting the offer, Scratchley had exceeded his authority. When Bolton Ltd later sued for specific performance, this circumstance became clear, and Lambert argued that he had, on that ground alone, been entitled to withdraw from the contract. The Court of Appeal disagreed and held that the contract was valid. It, therefore, seems that the rule in *Bolton v Lambert*, to the effect that ratification of a contractual offer or acceptance is retrospective, is binding on English courts up to the Court of Appeal. Cotton LJ appreciated the practical difficulties which the fiction that ratification had retrospective effect might cause, and "how favorable the rule was to the principal, because till ratification he was not bound, and he had an option to adopt or not to adopt what had been done."② He then went on to assert, however, that he was bound to apply the fiction and find in favor of the principal.

The problems with the fiction in *Bolton v Lambert* flow from the fact, recognized by Isaacs J in *Davison v Vickery's Motors Ltd*,③ that the case is simply irreconcilable with the ordinary rules of contract law. Assume R, a rogue, writes to S, offering to buy goods at a certain price and forging the signature of C, a long-standing customer of the company. S writes to C, accepting the offer. It is now, beyond any doubt, following Shogun Finance,④ that there is no contract of any kind in this situation. However, C may well decide to treat S's acceptance as an offer to sell it (C) the goods on the terms set out therein. It is equally clear, however, that S can withdraw that offer at any time until C has actually accepted it. Can it make any difference to this scenario if R, rather than pretending to be C, pretended to be acting on behalf and with the authority of C? The law, it is suggested, cannot possibly reach contradictory results in the two cases.

Modern Chinese law, along with most civilian codifications, the *Principles of European Contract Law*, and the *Principles of International Commercial Contracts*, avoids these difficulties in Art. 171. That provision attempts to maintain a balance between the interests of the principal and the third party by giving the third party a means by which ratification (or refusal to ratify) can be expedited or even forced: The third party can, once he finds out that the agent lacked authority, give notice to the principal asking him to clarify the position within 30 days. More importantly, the danger of creating a unilaterally-binding contract is avoided by allowing the third party to escape from the bargain, pending ratification. It is suggested that these are much more sensible rules than those of English law, but that they are rules that are not easily implemented in common law, case-based system.

② *Bolton v Lambert* (1889) 41 Ch D 295, 307, citing *Hagedorn v Oliverson* (1814) 2 M & S 485, an insurance case in which Lord Ellenborough CJ pointed out that the retrospective effect of ratification meant that a principal could avoid paying an insurance premium where no loss was suffered, while taking the benefit of the insurance in the event of a loss by ratifying his agent's unauthorized entering into the policy on his behalf. However, that situation did not, in fact, arise in that case, and as such, the dicta relied on by Cotton LJ are obiter.

③ (1925) 37 CLR 1.

④ *Shogun Finance v Hudson* [2004] 1 AC 919.

Liabilities of the Agent to the Principal

As already mentioned, English law is still, at least nominally, committed to the doctrine of consideration which, in its truest form, only imposes contractual obligations on a party where the party receives some sort of counter-promise or counter-performance. This used to go hand-in-hand with the notion that there was only very limited scope for imposing private law liabilities outside of contract. This initially hampered the development of the law of tort: In the famous case of *Donoghue v Stevenson*,① well known even outside the common law world, the argument that a manufacturer should not be liable in tort to the ultimate consumer of a defective product (in the actual case, a bottle of ginger beer containing the decomposed remains of a snail) because she had not entered into a contract with the manufacturer and should therefore have no claim against it, almost succeeded in the House of Lords: The appeal was allowed by a bare majority, with Lords Buckmaster and Tomlin dissenting. From that case, it was still a very long road for the law to reach the position where a person can be liable not just for actions but for statements, with the decision in *Derry v Peek*② standing as authority for the proposition that "in the absence of the contract, an action for negligence cannot be maintained where there is no fraud."③ In the seminal case of *Hedley Byrne v Heller*,④ decided by the House of Lords in 1964, 32 years after *Donoghue v Stevenson*, it was, however, put beyond doubt that duty could arise where it was voluntarily assumed. As Professor Edelman (now Edelman J, High Court of Australia) explained in a very important article (to which we will have to refer again) in 2010, "'contract' does not exhaust the category of promises or undertaking having legal effect. Where the issue involves a failure to take care or skill, the only question is whether there has been a voluntary assumption of responsibility to the defendant in the performance or undertaking of a task" (Edelman, 2010, p. 302). In the context of agency, this translates into a position where a person who agrees to act as an intermediary gratuitously will be liable in tort, on the basis of having voluntarily assumed responsibility, if he performs the agreed tasks negligently or not at all, but only to the extent that this has made the principal's position worse. Where the principal can prove, of course, that in the absence of the would-be agent's undertaking, he would have performed the relevant task himself or found someone else to perform it, this will not look very different from the contract measure of damages—though it will, in fact, just be the tort

① *M'Alister (or Donoghue) v Stevenson* [1932] AC 562.
② *Derry v Peek* (1889) L.R. 14 App Cas 337.
③ *Le Livre v Gould* [1893] QB 491 at 498 (Lord Esher MR).
④ *Hedley Byrne & Co Ltd v Heller and Partners Ltd* [1964] AC 465.

measure,[①] putting the claimant in the position he would have been in had the tort (i.e., the voluntary undertaking coupled with a failure to honor it) not been committed.

Where the agent is subject to contractual duties, it is, of course, not necessary to prove reliance on the part of the principal in this way. In the vast majority of cases, the agent will be under a duty to perform his mandate with reasonable care and skill because he contractually undertook to do so.

The orthodox view is that, just by virtue of being an agent, and whether or not his relationship with the principal is contractual, a person becomes the subject of very wide and strict fiduciary duties. The most obvious difference between the *Civil Code* and English law lies in the Code's refusal to subject agents to such very wide duties. Instead, specific duties and liabilities of the agent are provided for: Art. 164 makes an agent liable for "damage caused to the principal due to failure to perform or fully perform duties of agency," and provides for joint and several liability of the agent and the third party where the agent "maliciously conspires with the counter-party to infringe the principal's legal rights and interests." Art. 168 bans self-dealing and, indeed, cross-dealing in situations where an agent represents several principals. The Code is silent on the remedial framework that will apply should those duties be breached.

As we have already seen, English law puts the agent under a more general "fiduciary duty." We shall examine two questions in this context:

(a) How does English law decide on whom fiduciary duties are to be imposed?

(b) What is the content of fiduciary duties imposed on agents?

The Imposition of Fiduciary Duties

The orthodox view in English law appears to be that the imposition of fiduciary duties depends on the characterization of the relevant relationship and the status of the supposed fiduciary. This may not present many problems when it comes to the paradigm fiduciary, the trustee,[②] the picture when it comes to the agency is more complex. I have argued elsewhere (Krebs, 2010, pp. 205–224) that little hinges on the characterization of a person as an agent: While the vocabulary of authority provides useful tools in describing the incidents of the agency triangle, a contract entered into by an "agent" obeys the ordinary rules of offer and acceptance. However, if one consequence of being an "agent" is the imposition of fiduciary duties, that picture changes dramatically. Suddenly, the question of whether someone is an agent or some other form of intermediary, becomes all-important. The problem with this is that English law does not really have a definition of

① *Cf. East v Maurer* [1991] 1 WLR 461.

② At least not where the trust is express. It has long been used as an argument against the imposition of a resulting or constructive trust that thereby the "trustee" might become subject to fiduciary duties he could have known nothing of.

"agent." Unlike civilian systems, it does not draw a clear distinction between a messenger, an agent, and intermediaries in between these two. If the imposition of fiduciary duties is status-based, the label "agent" would suddenly assume exaggerated importance. English law has not developed a clear definition of what makes an "agent." For example, a cashier in a supermarket is clearly able to affect the supermarket's legal position: By ringing items up in the cash register, he will form a contract between the supermarket and the customer. And yet he will have little or no discretion, e.g., in setting the price. And yet it is that discretion, that ability to "sell the principal down the river," that is seen as the main reason for imposing fiduciary duties.

This is one reason why Professor Edelman, in his aforementioned article (Edelman, 2010, p. 302), argues forcefully and convincingly that fiduciary duties arise in the same way as other contractual (and tortious) duties: by implication, depending on the particular circumstances of the relationship. This would mean that, rather than being made subject to the whole barrage of fiduciary duties, only such duties could be implied as were appropriate on the facts.

The locus classicus for fiduciary duties in a commercial context, as Professor Edelman explains (Edelman, 2010, pp. 302, 310), is *Boardman v Phipps*.[①] A solicitor to a trust and one of its beneficiaries noticed that the trust held a minority shareholding in a company that was being run in a way that they found sub-optimal. They thought that the company should be taken over, but the trust could not afford to bid for a majority stake. The solicitor and beneficiary joined forces and, using their own funds, took over the company. They turned the company's business around and made it much more profitable, which also benefited the trust. Nevertheless, they were held liable to account for their profits, having breached their fiduciary duties to the trust by not obtaining its fully informed consent. Why did the solicitor and the beneficiary become subject to fiduciary duties? All the courts deciding the case focused on the supposed agency relationship between the trust and the defendants, even though it was fairly clear that they had not been appointed as agents to represent the trust. True, they had purported to represent the trust in shareholder meetings, but, as we have seen above, a person cannot appoint himself as an agent. Professor Edelman argues, rightly, that the reason why the fiduciary duties were imposed was not a pre-existing agency relationship (which was very doubtful), but the fact that the defendants had voluntarily assumed responsibility for the trust's affairs. The reasoning of the courts leads to two problems: Rather than considering whether an implication of fiduciary duties is appropriate, the courts spend a lot of time and mental energy in deciding whether or not the relationship between the parties is properly characterized as agency, and then, having affirmed that question, impose very wide-reaching, arguably too

① *Boardman v Phipps* [1967] 2 AC 46.

wide-reaching, fiduciary duties.

The Content of Fiduciary Duties

As we have seen above, in the general law of contract, English law refuses to recognize that the parties should conduct themselves in a way that accords with a general duty of good faith towards one another. The reason why this is said is that the supposed duty is too diffuse, too poorly defined, so that it might give rise to a "palm tree," i.e., discretionary, justice. Yet when it comes to fiduciary duties imposed on agents, it seems to have no such qualms. Here, English law seems to start with a general principle and then derive from these specific rules that govern the relationship between principal and agent. At the bottom, these turn out not to be so very different from the more precise rules set out in the Chinese *Civil Code*.

Obligation to Avoid Conflicts of Interest

This duty has two facets, both of which lie at the heart of the formulation in Art. 168 of the Chinese *Civil Code*: The agent must not put himself in a position in which his self-interest conflicts with that of the principal, and he must not put himself in a position in which the duties he owes to other parties, commonly other principals, conflict with the duties he owes to his principal.① Art. 168 focuses, rather more narrowly, on self-dealing and cross-dealing—the duty in English law is wider but Art. 168 is certainly capable of being interpreted analogously.

Obligation Not to Profit

Boardman v Phipps itself② is the best example of this obligation and, at the same time, demonstrates its breadth. The defendants would not have come across the opportunity they took advantage of were it not for their involvement with the affairs of the trust, and that causal link alone sufficed to make them disgorge them to the trust, which thereby received a windfall.

One way to look at this, of course, is as a sub-rule of the previous rule, to avoid conflicts of interest. But I would suggest it takes that rule very far indeed. After all, the trust would not have had the means to pursue the opportunity the defendants had identified—the prophylaxis against conflicts of interests, even of a theoretical nature, is a worthy goal, but it is very arguable that this is one example of it going too far. *Boardman v Phipps* is very far removed from the clearer case of profiting from one's agency, namely situations in which the agent takes a bribe or makes some other form of "secret" profit. Where an agent, having to decide to which the third party to commit his principal, takes a bribe from one of the third parties, it is very arguable that the amount of the bribe would

① *Swain v The Law Society* [1982] 1 WLR 17, 36.
② [1967] 2 AC 46.

have accrued to the principal had the agent not been dishonest.

Obligation to Act in the Beneficiary's Best Interests

Professor DeMott, now the reporter of the American Restatement of Agency (3d), suggests that "the fiduciary's duties go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's interests" (DeMott, 1988, pp. 879, 882). It is surprising to find such a vague duty in a system that eschews the recognition of a general duty to act in good faith precisely because it considers it too vague! And, indeed, unused to general principles, the application of this duty has led to surprising results. Thus, in *Fassihi v Item Software (UK) Ltd*,[③] the Court of Appeal decided that it was in the best interests of a company for a director to disclose his own wrongdoing—a decision which contradicted the well-established House of Lords decision in *Bell v Lever Bros*,[①] fundamental to the law relating to a mistake in contract, which held the opposite, namely that a company director did not have to disclose his own breaches of duty. Lord Atkin had, in that case, argued that the adversarial principle prevailed in such a case, arguing that "to imply such a duty would be a departure from the well-established usage of mankind and would be to create obligations entirely outside the normal contemplation of the parties concerned."[②]

Obligations to Act in Good Faith

What the courts mean when they refer to this fiduciary duty is more than a mere duty of honesty (which is well-established to exist throughout the law). What precisely is meant by it, beyond the three more (or less) concrete duties listed above, is not entirely clear. It has indeed been described as "incapable of precise definition."[③]

It is striking that it is this precise duty of good faith which English law refuses to recognize as a general principle. Professor Edelman argues that this is, in fact, not correct and that English law does recognize such a principle, but one which will manifest itself in different ways depending on the situation to which it is argued to apply (Edelman, 2010, pp. 302, 324). This is in keeping with his general argument by which fiduciary duties are implied in the agent's undertaking to the principal, to no greater or lesser extent than is necessary, to make the relationship work. While agreeing with the general argument, I would argue that the inclusion of the very wide and diffuse obligation to act in good faith within the fiduciary obligations attributed to agents is simply a recognition that, in contrast to the general law of contract, the principal/agent relationship is not adversarial, but collaborative.

③ *Fassihi v Item Software (UK) Ltd* [2004] EWCA Civ 1244; [2004] BCC 994, cited by James Edelman, *When Do Fiduciary Duties Arise?*, 126 Law Quarterly Review, 302, 321 (2010).
① *Bell v Lever Bros* [1932] AC 161.
② *Bell v Lever Bros* [1932] AC 161, 228.
③ *Wallace v United Grain Growers Ltd* [1997] 3 SCR 701 at [98].

Conclusion

I have sought to show in this article that English law, once it switches from adversarial to collaborative relationships, imposes greater (and less certain) duties than would be required in a legal system that takes a less adversarial stance throughout. A system like the Chinese law of contract, which expects the parties to collaborate more rather than simply pursue their own self-interests without regard to the interests of their counterparties, is therefore not obliged to follow the lead of English law in imposing very wide-ranging and ill-defined fiduciary duties.

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Fiduciary Duties in Company Law: A German Perspective

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Abstract: As Chinese practitioners and scholars ponder the scope of fiduciary obligations under the country's company law, this paper offers a comparative perspective from German law. Although German corporate law has not rejected legal transplants, the common law trust has never been accepted as an organizational device for administering third-party funds or doing business. Nonetheless, the German judiciary has developed a sophisticated concept of fiduciary obligations where the statutes remain silent. This paper explores the application of fiduciary obligations to limited partnerships, limited liability companies, and stock corporations. It takes a membership perspective to ascertain the legal relationships between a corporation and its shareholder-members and among fellow-shareholders, as business entities evolve from personalistic to capitalistic settings. Fiduciary obligations also inform the relationship between the corporation and its directors and corporate officers. Although German law does not classify directors and corporate officers as the shareholders' direct trustees, shareholders stand nonetheless to benefit from the way directors and corporate offices discharge their duties towards the respective corporate entities. Moreover, criminal law rules on embezzlement operate to protect the corporation and the monies it administers from overly risky business projects.

Keywords: German company law, limited liability companies, stock corporations; directors' duties of loyalty and care, criminal law liability for embezzlement

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Introduction

Fiduciary Concepts

China's Company Law imposes obligations of fidelity and diligence on directors, supervisors, and senior managers: Art. 149 (8) admonishes directors or senior managers not to commit acts inconsistent with the obligation of fidelity.① *The Code of Corporate Governance of Listed Companies* issued by China's Securities Regulatory Commission extends this concept to controlling shareholders or actual controllers: They shall assume fiduciary duties towards the company and the other shareholders.② Art. 147 et seq. of China's Company Law have been characterized as the "proclamation of orthodox corporate fiduciary duties,"③ although skepticism remains whether the practice will readily follow suit④: Courts are expected to encounter difficulties in accommodating a legal transplant that has its origins in common law jurisdictions.⑤ As fiduciary duties and the business judgment rules make their way into China's civil law system it will be useful to reflect on their intellectual underpinnings and to offer a comparative survey from a jurisdiction which has used fiduciary concepts to transgress the limitations of statutory law.

Fiduciary duties in corporate law have their origins in trust law.⑥ Modern trust cases call for an inquiry into whether fiduciary duties indicate the existence of a (legal) relationship, point to the availability of a remedy where contract law does not help.⑦ The duties of loyalty and care stand for a principal-agent relationship⑧ which goes beyond common law notions of agency.⑨ Principal-agent relationships are notorious for incomplete contracting and hidden information problems.⑪ But trust law and corporate law have come to broaden trustee and manager activities by conditioning them on the observance of fiduciary principles.⑪ "Modern fiduciary duties" are understood as crucial for managing

① *See* Art. 147 of China's Company Law. The following English version has been used: https://www.ilo.org/dyn/natlex/docs/ELECTRONIC/92643/108008/F-186401967/CHN92643%20Eng.pdf).

② Art. 63 of *The Code of Corporate Governance for Listed Companies* (Announcement No. 29 [2018] of the China Securities Regulatory Commission—*Code of Corporate Governance of Listed Companies [2018 Revision]* [Effective]). On the role of the CSRC's enforcement practice in fleshing out the concept of loyalty and diligence, *see* Guangdong Xu/Tianshu Zhou/Bin Zeng/Jin Shi, Directors' Duties in China, 14 *Eur. Bus. Org. L. Rev.* (EBOR) 57–95 (2013) (p. 84 et seq.).

③ Nicholas C. Howson, Fiduciary Principles in Chinese Law. In: Criddle/Miller/Sitkoff (eds.), *The Oxford Handbook of Fiduciary Duties* (Oxford 2019), 603–622 (at p. 613).

④ Jiangyu Wang, : Huang/Howson, (eds.), *Enforcement of Corporate and Securities Law–China and the World* (Cambridge 2017), 185–206 (at 191 et seq.)

⑤ *See* Xu/Zhou/Zeng/Shi, 14 *Eur. Bus. Org. L. Rev.* (EBOR) 57–95 (2013) (at pp. 61 et seq.).

⑥ For a survey *see* Julian Velasco, in: Criddle/Miller/Sitkoff, *Handbook*, 61–78 (at p. 64 et seq.).

⑦ *See* the analysis, in: Jonathan Garton/Rebecca Probert/Gerry Bean, *Moffat's Trust Law–Texts and Materials* (7th ed. Cambridge 2020), at p. 740 et seq., 748.; *see* also: Alexander Styhre, What we talk about when we talk about fiduciary duties: the changing role of a legal theory concept, 13 (2) *Management and Organizational History*, 113–139 (2018) (at p. 118 et seq.) on fiduciary duties as an instrument to define non-contractual responsibilities of directors and managers.

⑧ For a detailed analysis *see*: Robert Cooter/Bradley J. Freedman, The Fiduciary Relationship: Its Economic Character and Legal Consequences, 66 *N.Y.U. L. Rev.* 1045–1075 (1991), at p. 1048 et seq.

⑨ Robert Sitkoff, The Economic Structure of Fiduciary Law, 91 *Boston U. L. Rev.* 1039–1049 (2011), at p. 1040 et seq.

⑩ Ibid., at p. 1041 et seq.

⑪ Ibid., at p. 1042 et seq.

investor money for the benefit of beneficiaries and clients with conflicting interests.① Mandatory and default rules operate to establish deterrence mechanisms for the agent not to neglect the best interests of the principals.②

Historically, remedies for the breach of fiduciary duties were based in equity to restore the plaintiff to his rightful position.③ Fiduciary duties have evolved into providing beneficiaries with a remedy where they would have been unable to claim specific performance since they were not privy to the contract.④ When Pistor Xu assessed the importance of fiduciary duty concepts for transition countries, they noted that under Delaware's corporate law and its extensive default rules, fiduciary duties operate to contain the impact of the freedom of contract enjoyed by other shareholders.⑤ Conversely, German company law, with its extensive set of mandatory rules for corporations, was considered to instrumentalize the equivalent of fiduciary duties to alleviate the perceived or real harshness of mandatory rules.⑥ On the other hand, traditional fiduciary duty concepts have made substantial inroads into German corporate law, as the courts clarify the notion of the duty of care owed by corporate officers.⑦ This suggests that duties of loyalty and care operate as a flexible instrument to both substitute and expand legislative concepts and to stimulate the evolution of legal rules through case law where the statute is silent.⑧ Nowadays, fiduciary concepts determine the relationship between the company and the shareholder, and among shareholders themselves.⑨ Moreover, they supply shareholders with remedies for specific performance, damages, or disgorgement of profits where traditional concepts of contract law are of no avail. Fiduciary concepts also inform the relationship between a company and its corporate officers.⑩ Although German Company Law does not qualify corporate officers as the shareholders' trustees, corporate officers are under a fiduciary obligation towards their corporate entity as they administer and invest third-party monies.⑪ Moreover, corporate officers must be mindful of the fiduciary obligations which the company owes to its shareholders.⑫ The board of directors and corporate officers must protect shareholder interests if they want to escape censure from the shareholders and the supervisory board.⑬

German partnership law and the corporate law rules for limited liability companies and stock

① *See*: UNEP Finance Initiative/Principles for Responsible Investment, *Fiduciary Duty in the 21st Century–Final Report* (October 2019), at p. 21 et seq. (available at https://www.unepfi.org/publications/investment-publications/fiduciary-duty-in-the-21st-century-final-report/).

② Sitkoff, at p. 1043.

③ *See* the "catalog of fiduciary remedies" in: Samuel L. Bray, in: Criddle/Miller/Sitkoff, *Handbook*, , 449–467 (at p. 451 et seq.).

④ Thilo Kuntz, Transnational Fiduciary Law: Spaces and Elements, 5 *UCI J. Transn'tl. & Comp. L.* 47–83 (2020) (at p. 78 et seq.), *Cf.* Paul B. Miller, Justifying Fiduciary Remedies, 63 (4) *University of Toronto Law Journal* 570–623 (2013), at p. 604 et seq.

⑤ Katharina Pistor/Chenggang Xu, in: C. Milhaupt (ed.), *Global Markets, Domestic Institutions–Corporate Law and Governance in a New Era of Cross-Border Deals* (New York, 2003), 77–107 (at p. 78 et seq.)

⑥ Ibid., at p. 94 et seq.

⑦ *See* Mathias Janke, *Gesellschaftsrechtliche Treuepflicht* (Frankfurt/Main 2003), at p. 33 et seq., 199 et seq.

⑧ For a comparative survey *see* Kuntz, 5 *UCI J. Transnat'l. & Comp. L.* 47–83 (2020) (at p. 79 et seq.).

⑨ For a survey *see* Maximilian Mann, *Abdingbarkeit und Gegenstand der gesellschaftsrechtlichen Treuepflicht* (Berlin 2018), p. 26 et seq.

⑩ Michael Hoffmann-Becking (ed.), *Münchener Handbuch des Gesellschaftsrechts Band 4–Aktiengesellschaft* (5th ed. 2020) (-Rieckers), § 17 19 et seq.

⑪ Hoffmann-Becking (-Hoffmann-Becking), § 25 38.

⑫ Lutter/Hommelhoff, *GmbH-Gesetz* (20th ed. 2020) (Kleindiek), Anh. zu § 6 18 et seq., BGH, judgment of 22 September 2020, *NZG* 2020, 1343 et seq., Oberlandesgericht (OLG, Regional Appellate Court) Rostock, judgment of 21 April 2006, OLG-NL 2006, 250 (251), Hoffmann-Becking (-Hoffmann-Becking), § 25 38 et seq.

⑬ *See* Hoffmann-Becking (Hoffmann-Becking), § 29 28 et seq.

corporations do not presume the existence of a trust-like relationship as such.[1] Rather, they assess whether an existing legal relationship generates scenarios where a "heightened duty of care" (*gesteigerte Treuepflicht*) is apposite.[2] This allows for a flexible approach as normal duties of care under a bilateral private law contract gradually intensify on their trajectory from long-term relationships to corporate settings. The doctrinal starting point for ascertaining the scope of potential fiduciary obligations is "membership."[3] "Membership" triggers specific fiduciary obligations among the members of a corporate entity, between the corporate entity and its members and vice-versa, and members stand to benefit from the discharge of such duties as corporate officers owe to their corporation. In the context of "membership," fiduciary obligations present a highly flexible concept. They may vary according to the type of the corporate form.[4] Fiduciary obligations supply workable standards where—as in closed or family companies[5]—the disciplinary effect of the market for corporate control is ineffectual or nonexistent.[6] If a corporate entity has strong "capitalistic" elements, an analogy with large corporations with dispersed shareholders is appropriate.[7]

In exploring directors' duties, German law makes a distinction between the duty of legality and the duties of loyalty and "heightened care" (or care with fiduciary elements).[8] The duty of legality focuses on the prohibition of misappropriations and conflicts of interest. Directors must prevent the corporation from committing breaches of law. In discharging their duties of loyalty and care, directors will be judged based on the business judgment rule.[9] Directors' fiduciary obligations arise in the context of the duty of loyalty and care. This "heightened duty of care" (or duty of care with fiduciary elements) is conditioned on factual scenarios and is mostly judge-made.[10]

This paper will survey the relevant statutes for corporate activities and will then focus on the "membership" notion as a starting point for analyzing fiduciary elements among members, between members and their corporate entity and vice versa. The analysis will then assess the scope of fiduciary obligations owed by the directors to their respective entities when they invest monies put at the disposal of the corporation. A section on tort law and criminal law liabilities of directors concludes.

Codified Law

Statistics

Analyzing fiduciary concepts of German Company Law requires an exercise in statistics. Businesses which have chosen the corporate form include family-controlled entities, and corporations

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① For a subtle distinction between contractual duties and fiduciary liability *see* Miller, 63 (4) *University of Toronto Law Journal* 570–623 (2013), at p. 604 et seq.
② *Cf.* Hüffer/Koch, *Aktiengesetz* (München 15th ed. 2021) (-Koch), § 93 28.
③ *See* BGH, judgment of 22 January 2019, *NZG* 2019, 702 (703). *See* infra sub II.
④ Baumbach/Hopt, *Handelsgesetzbuch* (München 40th ed., 2021) (-Roth), § 109 23.
⑤ *See* Lorenz Holler/Maximilian Mann, Die gesellschaftsrechtliche Treuepflicht in der Familiengesellschaft, *NZG* 2021, 402 et seq.
⑥ *Cf.* Brigitte Haar, *Die Personengesellschaft im Konzern–Privatautonomie zwischen Vertrag und Organisation* (Tübingen 2006), 95 et seq., 101 et seq.
⑦ *See* BGH, judgment of 19 November 1984, *NJW* 1985, 972 (973).
⑧ *See* Hoffmann-Becking (-Hoffmann-Becking), § 25 31 et seq., Lutter/Hommelhoff (-Kleindieck), § 43 10 et seq., 19.
⑨ Marcus Lutter, Die Business Judgment Rule und ihre praktische Anwendung, *ZIP* 2007, 841 (842 et seq.); Lambertus Fuhrmann et al., Gesetzliche Beurteilungs- und Ermessensspielräume als "spezial-gesetzliche Business Judgment Rule", *NZG* 2020, 1368 et seq.
⑩ For a detailed analysis *see* Holger Fleischer/Frauke Wiedemann, Kodifikation und Derogation von Richterrecht, *AcP* 209 (2009), 597–627.

listed on the stock exchange with dispersed shareholders. The impact of court-designed rules hinges on the economic relevance of specific corporate forms and their contribution to the German GDP. Stock corporations figure prominently among the country's enterprises with the highest turnover.[①] However, when it comes to analyzing the total turnover of German companies, family-controlled businesses take a share of 52 percent,[②] employing 58 percent of the country's workforce.[③] As of January 1, 2020, 14,193 stock corporations (*AG's–Aktiengesellschaften*) and 363 partnerships limited by shares (*KGaG's–Kommanditgesellschaften auf Aktien*) did business.[④] But they were by far outnumbered by 1,329,277 limited liability companies (*GmbH's–Gesellschaften mit beschränkter Haftung*).[⑤] During the past decade (2010–2020), the total number of stock corporations declined by 19.3 percent;[⑥] that of limited liability companies increased by 30.8 percent[⑦] and that of limited partnerships by 17.7 percent.[⑧] The share of stock corporations listed at a stock exchange has been declining.[⑨] Forty percent of the corporations listed at the stock exchange are either family-owned or controlled.[⑩] Seventy-eight percent of the limited liability companies are family-owned.[⑪]

Statutory Concepts

The German legal divide is between private and public business entities. German law does not operate with a unitary statutory instrument for business activities with corporate elements. Planning for business activities takes place in the context of the *Commercial Code* (*Handelsgesetzbuch*)[⑫] for (limited) partnerships, the *Limited Liability Companies Act* (*GmbH-Gesetz*)[⑬] and the *Stock Corporation Act* for listed and non-listed corporations (*Aktiengesetz*).[⑭] In view of the prevalence of family-owned companies and non-listed stock corporations the crucial question is whether the case law has succeeded in replicating market-oriented standards for tightly-knit structures.[⑮]

Legal doctrine has not dispensed with the emphasis on personalistic elements of partnerships.[⑯] Historically, shareholders of stock corporations were classified as members of an entity which

① *See* Größte deutsche Unternehmen nach ihrem weltweiten Umsatz im Geschäftsjahr 2019/2020 (available at https://de.statista.com/statistik/daten/studie/12917/umfrage/rangliste-der-500-groessten-unternehmen-deutschlands/).

② Stiftung Familienunternehmen, *Die volkswirtschaftliche Bedeutung von Familienunternehmen* (5th ed. 2019) at p. 6. (available at https://www.familienunternehmen.de/media/public/pdf/publikationen-studien/studien/Die-volkswirtschaftliche-Bedeutung-der-Familienunternehmen-2019_Stiftung_Familienunternehmen.pdf).

③ Holger Fleischer, Vergleichendes Familiengesellschaftsrecht am Beispiel abberufener Familiengesellschafter-Geschäftsführer, *GmbHR* 2021, 113–120 (at p. 113).

④ Udo Kornblum, Bundesweite Rechtstatsachen zum Unternehmens- und Gesellschaftsrecht (Stand 1.1.2020), *GmbHR* 2020, 677, 678.

⑤ Ibid.

⑥ Ibid., at p. 687.

⑦ Ibid., at p. 686.

⑧ Ibid., at p. 685.

⑨ Institut der Deutschen Wirtschaft Köln, Unternehmensfinanzierung–Was sind die Gründe für die rückläufigen Börsengänge? *IW-Trends* 3. 2017 (available at https://www.iwkoeln.de/fileadmin/publikationen/2017/363282/IW-Trends_2017-03-05_Demary_Roehl.pdf).

⑩ Stiftung Familienunternehmen, *Börsennotierte Familienunternehmen–Bedeutung, Merkmale, Performance* (2019), at p. 57 (available at https://www.familienunternehmen.de/media/public/pdf/publikationen-studien/studien/Boersennotierte-Familienunternehmen-in-Deutschland_Studie_Stiftung-Familienunternehmen_2019.pdf).

⑪ Ibid., at p. 12.

⑫ For an English translation *see*: https://www.gesetze-im-internet.de/englisch_hgb/englisch_hgb.pdf.

⑬ For an English translation *see*: https://www.gesetze-im-internet.de/englisch_gmbhg/.

⑭ For an English translation *see*: https://www.gesetze-im-internet.de/englisch_aktg/.

⑮ *Cf.* Haar, at p. 96 et seq.

⑯ *See* Haar, at p. 95 et seq., also for closed companies with personalistic structures: Walter Bayer, Empfehlen sich besondere Regelungen für börsennotierte und geschlossene Gesellschaften? Gutachten E zum 67. *Deutschen Juristentag* (München 2008).

shielded from outside risks.① As a corollary, membership in a listed corporation did not necessarily imply comprehensive protection against the encroachment of shareholders' financial interests.② Nonetheless, the judicial focus on quasi-fiduciary structures has evolved into reading extensive duties of care with fiduciary elements into the law of stock corporations, both listed and unlisted.③ This suggests a potential for a fiduciary dynamic which is finely tuned to the organizational features of the respective business entity. There are (personalistic) limited liability companies with tightly-knit family structures which resemble limited partnerships. Conversely, limited partnerships may assume the capitalistic structures of a public (listed) company so that an analogy with the law for limited liability companies or elements of stock corporation law is apposite.④ It is now common ground that fiduciary elements operate as a constraint on the abuse and encroachment of membership rights in stock corporations.⑤

Fiduciary Elements in Partnership Law. Under German law, civil code and commercial law partnerships stand for the most basic, rudimentary form of business organizations. At the outset, these partnerships remain faithful to traditional notions of contract law. Partners, including general and limited partners, conclude a partnership contract for the duration of the partnership. It is instructive to trace the line of cases in Germany's jurisprudence of the past century when it came to explaining why fiduciary concepts in a partnership setting are different from the contractual duty of good faith under the law of obligations (S. 242 of the *German Civil Code* ["*Treu und Glauben*"]).⑥ The predecessor of the current German *Bundesgerichtshof*,⑦ the *Reichsgericht*, recognized more than 100 years ago, that the partners of a civil code partnership may not place their personal interests over those of the partnership, which takes precedence.⑧ The partners were found to be under a duty to refrain from taking actions detrimental to the partnership.⑨ The language of the *Reichsgericht's* reasoning is still couched in the good faith language of S. 242 of the *Civil Code*. But it is clear that the *Reichsgericht* was ushering in an emancipation from traditional law of contract concepts when it referred to a "heightened" duty of loyalty and care in a partnership scenario.⑩ German standard legal doctrine now classifies the corporate duty of loyalty and care with fiduciary elements as customary law, although the exact

① From the perspective of legal history: Andreas Dieckmann, *Gesamthand und juristische Person* (Tübingen 2019), 131 et seq.

② For the historic development of shareholder rights and litigation *see*: Karsten Schmidt, *Gesellschaftsrecht* (Köln 3rd ed. 1997), 602 et seq., Mathias Habersack, Die Aktionärsklage–Grundlage, Grenzen und Anwendungsfälle, *DStR* 1998, 533 et seq.; Theodor Baums/Astrid Keinath/Daniel Gajek, Fortschritte bei Klagen gegen Hauptversammlungsbeschlüsse? Eine empirische Studie, Frankfurt, *Zeitschrift für Wirtschaftsrecht* 2007, 1629 (1639 et seq.), Theodor Baums/Florian Drinhausen/Astrid Keinath, Anfechtungsklagen und Freigabeverfahren, Eine empirische Studie, *Zeitschrift für Wirtschaftsrecht* 2011, 2329 (2332 et seq.).

③ *See* infra sub II.2.

④ *See* BGH, judgment of 11 September 2018, *NZG* 2018, 1226 et seq., OLG Celle, judgment of 26 August 1998, *NZG* 1999, 64 (65).

⑤ *See* Wolfgang Richter, Der Kapitalmarkt und sein Gesellschaftsrecht–Überlegungen zu einem kapitalmarktgemäßen Gesellschaftsrecht börsennotierter Gesellschaften –, *ZHR* 172 (2008), 419–457 (432 et seq-). *Münchener Kommentar zum Aktienrecht* (München 5th ed. 2021) (-Schäfer), § 243 AktG 53 et seq., Bürgers/Fett, *Kommanditgesellschaft auf Aktien* (München 2nd ed. 2015) (-Wieneke/Fett), § 10 39.

⑥ Section 242 (Performance in good faith): "*An obligor has a duty to perform according to the requirements of good faith, taking the customary practice into consideration*" (English translation available at https://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p0731).

⑦ The Bundesgerichtshof (BGH) is the country's highest court in private and criminal law matters.

⑧ RG (Reichsgericht) judgment of 13 April 1912, *LZ* 1912, 545.

⑨ RG, judgment of 16 January 1913, *JW* 1913, 429 (430).

⑩ RG, judgment of 7 February 1930, *RGZ* 128, 1 (16): the principles of good faith apply to company law with an exceptional degree, accord: judgments of 11 November 1933, *RGZ* 142, 213 (216) and of 8 April 1943, *RGZ* 171, 51 (54) (also a relationship of mutual confidence between partners).

confines remain unclear.① Nonetheless, this is a workable definition as long as courts and legal theory reject a contractual opt-out of this corporate duty with fiduciary elements.②

Limited Liability Companies—The Statutory Model. S. 2 of *the Limited Liability Company Act* still requires a contract between the founding shareholders for the establishment of the company.③ But it is obvious that the contract for the establishment of a limited liability company attains a legal quality different from that of a bilateral contract under the law of obligations: The interpretation of the contract for the establishment of a limited liability company (i.e., the articles of association) will have to observe objective standards; the intent of the founding shareholders is normally irrelevant.④ *The Limited Liability Act* allows for freedom of contract. But due to the fact that many limited liability companies are family businesses, many articles of association and shareholder agreements limit the free transferability of shares.⑤ *The Limited Liability Statute* provides for a catalog of minimum rights that shareholders enjoy, e.g., minority rights, rights to receive information, and the right of first refusal if legal capital is raised. But generally, the statute is silent on duties of loyalty and care which shareholders might owe to the company or to other fellow-shareholders. There is no provision for procedural rights to challenge a decision of the general meeting of shareholders before a court of law. Practitioners have resorted to so-called side contracts, establishing a complicated relationship between the law of obligations and company law.⑥ The director (*Geschäftsführer*) of a limited liability company must discharge his duties towards the company with the care of a prudent businessman.⑦ This entitles a *Geschäftsführer* to a certain degree of discretion, similar to the US business judgment rule.⑧ On the other hand, the *Geschäftsführer* of a limited liability company must file for insolvency, once he has become aware of the company's illiquidity or over-indebtedness: Failure to do so will expose the director to personal liability, making it difficult to negotiate rescuing plans in the vicinity of

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① *See* the analysis in Mann, 26 et seq.

② *See* Mann, at p. 105 et seq., *cf.* Baumbach/Hopt (-Roth), § 109 23 for (limited) partnerships.

③ Section 2 of the *Law on Limited Liability Companies (Form of articles of association):*
"(1) The articles of association require a notarial form. They must be signed by all the shareholders.
(1a) The company may be formed under a simplified procedure if it has no more than three shareholders and one director. The model protocol provided in the Annex must be used to form a limited liability company under the simplified procedure. No further provisions which derogate from the law may be laid down. The model protocol also serves as the list of shareholders. In all other respects, the provisions set out in this Act concerning the articles of association shall apply mutatis mutandis to the model protocol.
(2) The articles of association may be signed by authorized representatives only on the basis of a power of attorney established or authenticated by a notary."
Section 3 of the Law on Limited Liability Companies (Content of articles of association):
"(1) The articles of association must stipulate the following:
1.The company's business name and the place of its registered office,
2.The purpose of the enterprise,
3.The amount of the share capital,
4.The number and nominal values of the shares to which each shareholder subscribes against payment of the capital contribution into the share capital (original capital share).
(2) If the enterprise is to be formed for a specific term or if other obligations vis-à-vis the company are to be imposed on the shareholders in addition to payment of a capital contribution, these provisions must also be included in the articles of association."

④ BGH judgments of 16 December 1991, *BGHZ* 116, 359 (364), 27 September 2011, *NZG* 2011, 1420, Lutter/Hommelhoff, GmbH-Gesetz (20th ed. 2020) (-Bayer), § 2 19 et seq.

⑤ *See* Heribert Heckschen/Jannick Weitbrecht, Überfremdungsschutz im GmbH- und Aktienrecht, *NZG* 2019, 721 et seq.

⑥ *See* Peter Ulmer, Verletzung schuldrechtlicher Nebenabreden als Anfechtungsgrund im GmbH-Recht? *NJW* 1987, 149 et seq., Hartmut Wicke, Schuldrechtliche Nebenvereinbarungen bei der GmbH–Motive, rechtliche Behandlung, Verhältnis zum Gesellschaftsvertrag, *DStR* 2006, 1137 et seq.

⑦ *See* s. 43 (1) of the *Limited Liability Company Act*: "*The directors shall conduct the company's affairs with the due care of a prudent businessman.*"

⑧ Lutter/Hommelhoff (-Kleindiek), § 43 23 et seq.

insolvency.①

Stock Corporation Act—Legislative Assumptions. The organizational model which informs the *Stock Corporation Act* is still the stock corporation listed at a stock exchange. The traditional listed corporation is two-tier, with the supervisory board policing executive officers for breaches of liability.② Contrary to US corporate statutes, German law conditions the organizational benefits of a stock corporation with legal personality on severe restrictions of the freedom of contract.③ An opt-out of mandatory law is virtually impossible.④ But family and mid-size businesses are exempt from the listing regime and certain accounting rules.⑤

The *Stock Corporation Act* refrains from specifying extensively the scope of fiduciary duties owed in the context of a corporation. Contrary to the *Limited Liability Company Act*, there are, however, some provisions which might be read as a reference to a fiduciary scenario which needs to be fleshed out by the courts. S. 53a of the *Stock Corporation Act* enshrines the non-discrimination principle for the benefit of shareholders which is supplemented by situation-specific fiduciary obligations.⑥ S. 117⑦ provides for a duty to pay damages to the corporation and to shareholders if members of the board of directors or the supervisory board acted under undue the influence on the corporation, thereby causing

① *See* s. 64 of the *Limited Liability Companies Act* (Liability for payments following illiquidity or over-indebtedness): "*The directors shall be obligated to compensate the company for payments made after the company has become illiquid or after it is deemed to be over-indebted. This shall not apply to payments which, after this point in time, are compatible with the due care of a prudent businessman. The directors shall be under the same obligation in regard to payments to shareholders if these led to the company becoming illiquid, unless this was not recognizable whilst observing the due care referred to in the second sentence. Section 43 (3) and (4) shall apply mutatis mutandis to any claim for compensation.*"

② *See* ss. 76 et seq., 95 et seq. of the *Stock Corporation Act*.

③ The courts will recognise, however, side-agreements under the law of obligations: BGH, judgment of 22 January 2013, *NZG* 2013, 220 (221) (reviewing the case law).

④ *See* s. 23 (5) of the *Stock Corporation Act*: "*The by-laws may deviate from the regulations of the present Act only where this has been expressly permitted. Supplementing the by-laws by additional determinations is permissible unless the present Act provides conclusively for the matter.*"

⑤ *See* Peter Kindler, Die Aktiengesellschaft für den Mittelstand Das Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts, *NJW* 1994, 3048 et seq., Bernd Bösert, Das Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts -–Ein Überblick über Hintergrund und Inhalt –, *DStR* 1994, 1423 et seq., Andreas Lohner, *Die „kleine AG" im Aktiengesellschaftsrecht* (Regensburg 2002), at p. 56 et seq.

⑥ S. 53a *Stock Corporation Act* (Equal Treatment of Shareholders): "*Subject to the same pre-requisites being given, stockholders are to be treated equally.*"

⑦ S. 117 *Stock Corporation Act* (Obligation to provide compensation for damages):
"(1) Anyone who intentionally compels, by exploiting his influence on the company, a member of the management board or of the supervisory board, an officer of the company vested with full commercial power of attorney (Prokurist), or an authorised agent to act to the detriment of the company or its stockholders shall be under obligation to provide compensation to the company for the damage it has suffered as a result. Such party shall also be under obligation to compensate the stockholders for the damage they have suffered as a result, insofar as they have suffered damage above and beyond the damage that has been caused them by the damage caused to the company.
(2) In addition to that person, the members of the management board and of the supervisory board shall be liable as joint and several debtors if they have acted in dereliction of their duties. Where it is in dispute whether they have exercised the due care of a prudent manager faithfully complying with his duties, the onus of proof shall be upon them. The obligation of the members of the management board and of the supervisory board to provide compensation shall not arise vis-à-vis the company and also not vis-à-vis the stockholders if the action taken is based on a lawful resolution adopted by the general meeting. The fact that the supervisory board has endorsed the action does not preclude the obligation to provide compensation.
(3) In addition to that person, furthermore, those parties shall be liable as joint and several debtors who have obtained an advantage by the action causing damage, should such parties have intentionally instigated the influence being exerted.
(4) Section 93 (4), third and fourth sentences, shall apply mutatis mutandis to the release from the obligation to provide compensation vis-à-vis the company.
(5) The company's claim to compensation may also be asserted by its creditors inasmuch as they are unable to obtain satisfaction from the company. The company's waiving its claims to compensation, or concluding a compromise regarding these claims, shall not serve to release it from the obligation to provide compensation to the creditors, nor will it be so released from this obligation by the fact that the action is based on a resolution adopted by the general meeting. Where insolvency proceedings have been opened for the company's assets, the insolvency administrator or the insolvency monitor shall exercise the right of the company's creditors for the duration of said proceedings.
(6) The claims governed by the present regulations shall become statute-barred within five (5) years.
(7) The above regulations shall not apply if the member of the management board or of the supervisory board, the officer of the company vested with full commercial power of attorney (Prokurist), or the authorized agent has been compelled to take the action causing damage by either of the following being exercised:
1. The power of direction based on a control agreement, or
2. The power of direction of a principal company (section 319) into which the company is integrated."

damage to the corporation. Similarly, a controlling shareholder may not cause a dependent corporation to undertake a disadvantageous business transaction unless the corporation receives compensation for the disadvantages caused (S. 311 et seq.).

S. 93 of the *Stock Corporation Act* is the core norm for fleshing out directors' duties.① The members of the board of directors have to discharge their duties with the care of a prudent businessman when they take action for the benefit of the corporation. From the perspective of legal theory, members of the board of directors are under a double set of duties. They have to observe a catalog of statutory duties of legality and of loyalty and care. In addition, the judge-made law on a "heightened duty of care" imposes a specific set of fiduciary obligations, tailored to the respective corporate business situation. S. 161 of the *Stock Corporation Act*② requires listed corporations to comply with the *German*

① S. 93 *Stock Corporation Act* (Duty of the members of the management board to exercise skill and care, liability and responsibilities):
"(1) In managing the affairs of the company, the members of the management board are to exercise the due care of a prudent manager faithfully complying with his duties. No dereliction of duties shall be given in those instances in which the member of the management board, in taking an entrepreneurial decision, was within his rights to reasonably assume that he was acting on the basis of adequate information and in the best interests of the company. The members of the management board are to respect the secrecy of any confidential information and secrets of the company, particularly trade secrets or business secrets, of which they have become aware in the context of their activities in the management board. The obligation set out in the third sentence shall not apply vis-à-vis an audit and enforcement panel recognized pursuant to section 342b of the Commercial Code (HGB) in the context of an audit performed by this panel.
(2) Members of the management board acting in dereliction of their duties are liable as joint and several debtors to compensate the company for any damage resulting therefrom. Where it is in dispute whether or not they exercised the due care of a prudent manager faithfully complying with his duties, the onus of proof shall be on them. Where the company has taken out insurance to protect a member of the management board against risks arising from his professional activities for the company, the insurance policy is to provide for a deductible of at least ten (10) percent of the damage, up to a minimum of one hundred and fifty (150) percent of the annual fixed remuneration of the member of the management board.
(3) The members of the management board shall be under obligation to provide compensation, particularly, in these instances in which, in contravention of the present Act,
1. Contributions are restituted to the stockholders,
2. Stockholders are paid interest or participate in the profits,
3. Treasury shares of stock in the company or in some other company have been subscribed to, purchased, accepted in pledge, or redeemed,
4. Shares of stock are issued prior to the issue price for them having been fully paid in,
5. The company's assets are distributed,
6. Payments are made in contravention of section 92 (2),
7. Remunerations are granted to the member of the supervisory board,
8. Loans are granted,
9. Shares of a new issue are issued in the context of the conditional capital increase, and this is done outside of the purpose specified therefor or prior to the equivalent value having been fully paid.
(4) The obligation to provide compensation shall not arise vis-à-vis the company where the action taken is based on a lawful resolution adopted by the general meeting. The fact that the supervisory board has endorsed the action does not preclude the obligation to provide compensation. The company may waive its claims to compensation, or conclude a compromise regarding these claims, only once three (3) years have elapsed since the arisal of the claim, and only in those cases in which the general meeting approves this being done and no minority, the aggregate of whose shares is at least equivalent to one tenth of the share capital, raises an objection and has it recorded in the minutes. The limitation in time shall not apply where the party obligated to provide compensation is unable to pay his debts as they become due and concludes a compromise with his creditors in order to avert insolvency proceedings or if the compensation obligation is provided for in an insolvency plan.
(5) The company's claim to compensation may also be asserted by its creditors insofar as they cannot obtain satisfaction from the company. However, this shall apply in cases other than those governed by subsection (3) only in those instances in which members of the management board have grossly violated their duty to exercise the due care of a prudent manager faithfully complying with his duties; subsection (2), second sentence, shall apply mutatis mutandis. The obligation to provide compensation shall not be canceled vis-à-vis the creditors by a waiver by the company or by its concluding a compromise, nor shall the fact that the action is based on a resolution adopted by the general meeting cancel this obligation. Where insolvency proceedings have been opened for the company's assets, the insolvency administrator or the insolvency monitor shall exercise the right of the company's creditors against the members of the management board for the duration of said proceedings.
(6) The claims governed by the present regulations shall become statute-barred, in the case of companies that were listed on a stock exchange at the time at which the dereliction of duties occurred, after ten years; in the case of other companies after five years."

② S. 161 of the *Stock Corporation Act* (Declaration pursuant to the Corporate Governance Code):
"(1) The management board and the supervisory board of a company listed on the stock exchange shall declare annually that the recommendations of the Government Commission on the German Corporate Governance Code published by the Federal Ministry of Justice and Consumer Protection (BMJV) in the official section of the Federal Gazette (Bundesanzeiger) have been and are being complied with, or which of the Code's recommendations have not been applied or are not being applied and the reasons therefor. The same shall apply to the management board and the supervisory board of a company which has exclusively issued other securities than shares of stock for trading on an organized market in the sense of section 2 (11) of the Securities Trading Act (WpHG) and the issued shares of stock of which are traded, on the company's own initiative, only via a multilateral trading facility in the sense of section 2 (8), first sentence, no. 8 of the Securities Trading Act
(2) The declaration shall be permanently made accessible to the public on the company's website."

Corporate Governance Code,[1] or, alternatively, explain why such code is not observed. Principle A.I.4. of the latest *German Corporate Governance Code* expects the board of directors to establish internal control procedures and appropriate risk management systems. Principle E.19.1 addresses potential conflicts of interest. Directors must declare an interest, subscribe to a non-compete clause, and refrain from asserting business opportunities due to the corporation. It remains to be seen how the courts will translate this catalog of not formally mandatory rules into fiduciary obligations. The members of the board of directors have to be mindful of the criminal law prohibitions against embezzling shareholder funds. Ultimately, this will translate into a prophylactic (fiduciary) obligation not to engage in high-risk projects without a proper risk assessment.[2]

Breach of Fiduciary Obligations—Statutory Remedies

In supplying remedies for breaches of fiduciary obligations, German law maintains the doctrinal divide between partnerships and business entities with legal capacity, i.e., limited liability companies and stock corporations. Partnerships with a personalistic character may sue a partner in breach of fiduciary obligations towards the partnership.[3] If a majority of partners disregard minority rights, the partnership can be sued to set aside a vote of the partners.[4] Damages can be envisaged once the principle of non-discrimination has been infringed.[5] The courts have recognized a so-called *actio pro socio*, where a partner can sue a managing partner for breach of his duties towards the partnership,[6] provided that the action will require the managing partner to make a payment of damages to the partnership.[7] It should be noted that litigation in closely-knit ownership structures in family businesses is likely to provoke the end of activities which crucially depend on cooperative behavior of participants.

Traditionally, German law has been reluctant to facilitate shareholder empowerment through litigation. The statute on limited liability companies is silent on remedies to redress breaches of the duty of care with fiduciary elements, leaving it to the courts to flesh out rules for fiduciary remedies.[8] This is also applied to (limited) partnerships which resemble limited liability companies or stock corporations.[9] Over the years, courts have instrumentalized the corporate duty of care (*Treuepflicht*) to expand shareholders' rights.[10] Statutory remedies under the *Stock Corporation Act* are available by analogy to limited liability companies and to (limited partnerships) with capitalistic features,[11]

① *German Corporate Governance Code* (16 December 2019) (available at https://www.dcgk.de//files/dcgk/usercontent/en/download/code/191216_German_Corporate_Governance_Code.pdf).

② *See* infra sub IV.

③ *See* OLG Karlsruhe, judgment of 16 December 2005, *BeckRS* 2006, 2269. For an assessment of the current status quo and the obstacles that had to be overcome in developing a concept for judicial protection of partners: Jens Koch, Empfiehlt sich eine Reform des Beschlussmängelrechts im Gesellschaftsrecht?, Gutachten F zum 72. *Deutschen Juristentag* (München 2018), F 74 et seq. For a comment on the judicial acknowledgment of partners' rights to sue, *see* Haar, 97 et seq.

④ *See* OLG Düsseldorf, decision of 10 December 1982, *OLGZ* 1983, 191 (193 et seq.), judgment of 23 November 2017, *RNotZ* 2018, 191 (193 et seq).

⑤ Baumbach/Hopt, (-Roth), § 109 *HGB* 36.

⑥ Nonetheless, an *actio pro socio* will be abusive and hence, a breach of fiduciary obligations owed towards co-partners, if it infringes their membership status: BGH, judgment of 22 January 2019, *NZG* 2019, 702.

⑦ BGH judgments of 17 June 1953, *BGHZ* 10, 91 (102 et seq.), 27 September 1957, *BGHZ* 25, 47 (50 et seq.), Baumbach/Hopt (-Roth), § 109 *HGB* 32 et seq.

⑧ Walter Beyer/Sven Möller, Beschlussmängelklagen de lege lata und de lege ferenda, *NZG* 2018, 801 (806 et seq.), Hartmut Rensen, *Beschlussmängelstreitigkeiten in der GmbH* (Baden-Baden 2014), 25 et seq. *See* also: Koch, at p. F 70 et seq.

⑨ BGH, judgment 11 September 2018, *NZG* 2018, 1226 et seq.

⑩ *See* the detailed analysis by Holger Fleischer, Mitgliedschaftliche Treuepflichten: Bestandsaufnahme und Zukunftsperspektiven, *GesRZ* 2017, 362 et seq.

⑪ *See* Koch, supra FN 8, at F 74 et seq.

including the *actio pro socio*.[①] Moreover, the legislator has cautiously moved to expand shareholders' rights under the *Stock Corporation Act*.[②]

Under S. 245 (1) of the *Stock Corporation Act*, a shareholder can apply to the court to have a vote of the general meeting set aside or declared null and void. The action for a declaration of nullity or for setting aside a vote must be directed against the corporation.[③] Nullity may be invoked if substantial procedural requirements have been disregarded, or the vote conflicts with the essentials of a stock corporation, rules on creditor protection, or public policy (S. 241 of the *Stock Corporation Act*). A shareholder may challenge a resolution which is the result of an agreement between the dominant shareholder and the board of directors.[④] A dominant shareholder may not fabricate a shareholder resolution as an instrument of self-dealing.[⑤]

S. 148 of the *Stock Corporation Act* is reminiscent of a derivative suit mechanism, but overly burdensome for the individual shareholder:[⑥] Shareholders who own one percent of the legal capital of a corporation or a total of shares of € 100,000 or more, may apply to the court for permission to file a claim for damages against a member of the board of directors or the supervisory board on behalf of the corporation irrespective of whether the general meeting of shareholders has passed a resolution in favor of litigation.[⑦]

To provide for fiduciary remedies for limited capitalistic partnerships, practitioners have resorted to writing the procedural requirements of stock corporation law into the respective contracts for the establishment of such limited partnerships.[⑧] The courts have condoned this, but have shied away from allowing a general analogy with the shareholder litigation remedies under stock corporation law.[⑨] Instead, one of the procedural remedies available to partners who argue about the scope of fiduciary obligations in a capitalistic partnership is an application for a declaratory judgment that the vote taken disregarding the dissenting partner is valid (or not).[⑩] A declaratory judgment will not issue, however, if the majority plans to infringe the core of membership rights of a minority partner.[⑪]

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① OLG Köln, judgment of 5 November 1992, *NJW-RR* 1994, 616 et seq., Lea K. Kumkar, Die actio im GmbH-Recht, *NZG* 2020, 2012 et seq., Lutter/Hommelhoff (-Bayer), § 13 51. Filing an *actio pro socio* is, however, subject to fiduciary constraints: *see* BGH, judgment of 22 January 2019, *NZG* 2019, 702.

② *See* Gerald Spindler, Haftung und Aktionärsklage nach dem neuen UMAG, NZG 2005, 865 et seq., Beyer/Möller, supra FN 85, NZG 2018, 801 (802 et seq.).

③ If shareholders sue, the corporation will be represented by the board of directors and the supervisory board. If the board of directors or an individual director sue, the supervisory board will represent the corporation. The board of the directors will represent if the action has been brought by a member of the supervisory board (s. 246 (2) of the *Stock Corporation Act*). The right to have a vote of the general meeting of shareholders quashed or declared null and void extended to resolutions appointing members of the supervisory board (s. 250 (1) of the *Stock Corporation Act*). A declaration for nullity will be issued where the resolution disregards mandatory provisions of codetermination or stock corporation laws. This includes, *inter alia*, a resolution which appoints a member who already holds a total of ten posts on supervisory boards of corporations under a statutory duty to establish such a board (s. 250 (1) (4) of the *Stock Corporation Act*). With respect to actions against resolutions appointing members of the supervisory board, shareholders, members of the board of directors and the supervisory board or the boards as an entity, workers' councils or trade unions represented in the corporation or a dependent enterprise have standing (s. 250 (2) of the *Stock Corporation Act*).

④ BGH, judgment of 1 February 1988, *NJW* 1988, 1579 et seq.

⑤ *Cf.* Pierre-Henri Conac/Luca Enriques/Martin Gelter, Constraining Dominant Shareholders‘ Self-Dealings, The Legal Framework in France, Germany and Italy, 4 *Eur. Comp. & Fin. L. Rev.* 491 (514) (2007).

⑥ Klaus Ulrich Schmolke, Die Aktionärsklage nach § 148 *AktG, ZGR* 2011, 398 (410).

⑦ On this *Klagezulassungsverfahren* ("lawsuit admission procedure"): Pierre-Henri Conac/Luca Enriques/Martin Gelter, 4 *Eur. Com. & Fin. L. Rev.* 491 (507) (2007).

⑧ BGH, judgment of 19 October 2009, *DStR* 2009, 2495-

⑨ *See* BGH, judgments of 17 July 2006, *DStR* 2006, 1711, and of 19 October 2009, *DStR* 2009, 2495.

⑩ BGH, decision of 26 March 2007, *NJW-RR*, 2007, 1477 (1478). *See* Lutter/Hommelhoff (-Bayer), Anh zu § 47, 30 et seq., 40 et seq.

⑪ *Cf.* BGH judgment of 24 November 2008, *BGHZ* 179, 13 (21) (*Schutzgemeinschaftsvertrag II*).

The Membership Perspective: Duties of Loyalty and Care with Fiduciary Elements

From Beginnings in Partnership Law to Limited Liability Companies

As members of a partnership have pooled money to engage in joint business activities, they are mutually dependent, and owe each other a heightened degree of confidence which transcends the standard of care and good faith under a normal bilateral contract. The heightened degree of mutual confidence in a partnership results in specific behavioral duties of advancing the business purpose of the partnership,[1] but also to refrain from actions that might be detrimental to the interests of another partner.[2] At this stage, the notion of duty of care with fiduciary elements kicks in. German partnership law recognizes a core of membership rights of the partner which neither the partnership nor the other members may infringe.[3] Conversely, a partner may be required to approve steps undertaken to advance the interests of a partnership, although the envisaged measure may be detrimental to his own financial interests.[4] The *Bundesgerichtshof* has relied on an analogy to extend these principles to limited liability companies. Although established as an entity with judicial capacity, the personalistic structure of a limited liability company frequently replicates the tightly-knit structure of a (commercial) partnership where members play an active role in determining the business strategy of their enterprise. Thus, the shareholders of a limited liability company owe a heightened duty of care and loyalty (or a duty of care with fiduciary elements) not only to the company as an entity with legal capacity, but also to their fellow member-shareholders.[5] This may translate into a duty to not block business measures supported by a majority of shareholders for the benefit of the company even though the minority shareholders may suffer financially. However, the imposition of any such a duty to take action is predicated on a proportionality assessment.[6] A breach of this duty may give rise to a claim for damages which the affected shareholder can initiate in his individual capacity.[7] This would also be the case when the statutory balance between shareholder rights and management powers has been disregarded, resulting in an unjustified salary for a shareholder-manager.[8]

Stock Corporations

Originally, the capitalistic structure of stock corporations was believed to exclude any shareholder duties of specific care and consideration for fellow-shareholders.[9] Moreover, the judicial emphasis

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① BGH, judgment of 8 May 1989, *NJW* 1989, 2687 (2688).
② *See* BGH, judgment of 22 January 2019, *NZG* 2019, 702 (703).
③ BGH, judgment of 10 October 1994, *NJW* 1995, 194 (195 et seq.), *cf.* Haar, at p. 96 et seq.
④ BGH, judgment of 10 October 1994, *NJW* 1995, 194 (195 et seq.).
⑤ BGH, judgment of 5 June 1975, *BGHZ* 65, 15 (19).
⑥ Oberlandesgericht (OLG, regional court of appeal) München, judgment of 28 July 2008, *NZG* 2009, 25 (26 et seq.), *see* also Jens Koch, Empfiehlt sich eine Reform des Beschlussmängelrechts im Gesellschaftsrecht? Gutachten F zum 72. *Deutschen Juristentag* (München 2018), F 92 et seq.
⑦ *See* BGH judgments of 14 May 1990, *NJW* 1990, 2627 (discriminatory measures), 30 September 1991, *DStR* 1992, 150 et seq. (hidden distribution of profits).
⑧ BGH, judgment of 11 December 2006, *NZG* 2007, 185 (186).
⑨ *See* on the history of the action to set aside a resolution of the shareholders' meeting: Markus Emmerich, *Die historische Entwicklung von Beschlussverfahren und Beschlusskontrolle im Aktienrecht im Gesellschaftsrecht der Neuzeit unter besonderer Berücksichtigung des Aktienrechts* (Berlin (2000), 131 et seq. For a survey of the development of German cases: Marcus Wandrey. *Materielle Beschlusskontrolle im Aktienrecht–Eine Untersuchung der beweglichen Schranken des Aktionärsstimmrechts* (München 2012), 54 et seq.

on the personalistic structure of the limited liability and the closely-knit web of overlapping business between its shareholders seemed to foreclose an extension of the fiduciary analogy to stock corporations.① Nowadays, courts and scholars acknowledge that shareholders owe a heightened duty of care (or a duty of care with fiduciary elements) to the corporation and other fellow-shareholders.② From a comparative law perspective, it is interesting to see how this interpersonal duty of care to fellow-shareholders was deduced. In a first step, courts noted that if a corporate body had a specific internal structure, it could not be convincingly argued that a legal form should dominate the substance of identical governance structures. Thus, a heightened duty of care (or a duty of care with fiduciary elements) between shareholders of the small corporation with tightly-knit structures came to be recognized.③ Once the shareholders in small, personalistic corporations had become exposed to a heightened-duty analysis, the courts began to reflect upon the legal and economic situation of individual shareholders, especially minority shareholders in larger corporations. The heightened duty of care was so construed as to protect the core rights of minority shareholders. The leitmotif of minority protection via a heightened duty of care (or a duty of care with fiduciary elements) is to protect the financial interests of shareholders who might otherwise be exploited by maneuvers of the majority and an obedient board of directors.④ Over the years, this re-defined duty with fiduciary elements has become a flexible instrument, which can also be adjusted to the specific economic situation of a stock corporation⑤ or a limited liability company,⑥ so that minority shareholders may also owe a comparable duty to the majority in a situation of financial distress.⑦

Fiduciary concepts now operate to clarify the relationship between shareholders, especially between majority and minority shareholders. The corporate entity is under a fiduciary obligation to ensure that a shareholder of a limited liability company or stock company can exercise his or her membership rights.⑧ On the other hand, fiduciary obligations are frequently invoked in order to compel shareholders into acceptance of restructuring plans for a corporate entity in financial distress.⑨

Corporate Membership Duties and Self-interest

Basics

In determining the exact scope of a shareholder's fiduciary obligation towards his or her corporation, German corporate law doctrine makes a distinction between the exercise of altruistic (i.e., corporation-related) and self-interested membership rights. The exercise of the latter serves the personal business interests of the latter, unrestrained by the business purpose and the focus of the corporation⑩. Self-

① *See* e.g., BGH, judgment of 16 February 1976, *BeckRS* 1976, 31115257.
② *See* Janke, at p. 229 et seq.
③ BGH, judgment of 1 February 1988, *BGHZ* 103, 184 (190 et seq.).
④ BGH judgments of 25 November 2002, *NZG* 2003, 280 (281) (Macotron) and 25 November 2002, *NZG* 2003, 216 (219) (Hypobank).
⑤ BGH judgment of 5 July 1999, *NZG* 1999, 1158 (1159) (Hilgers); OLG Stuttgart, judgment of 23 July 2003, *NZG* 2003, 1025 (1027).
⑥ BGH, judgment of 12 April 2016, *NZG* 2016, 781 (782) (Media-Saturn).
⑦ BGH, judgment of 20 March 1995, *BGHZ* 129. 136 (151 et seq,).
⑧ *See* BGH, judgments of 19 September 1994, *BGHZ* 127, 107 (111 et seq.) (BMW), of 9 June 1954, *BGHZ* 14, 25 (38), 1 February 1988, *BGHZ* 103, 184 (194).
⑨ *See* infra sub II.3.b.
⑩ *See* Hoffmann-Becking (-Rieckers), § 17 24 et seq.

interested membership rights will only conflict with general fiduciary obligations towards the corporation if they are exercised in a gross, abusive manner.[①] This may be the case if a majority shareholder attempts to change the agenda of the general meeting of shareholders to engineer the appointment of a new board of directors likely to implement a business measure which is detrimental to the corporation and the minority shareholders.[②] Likewise, blocking the general meeting of shareholders by asking an excessive number of questions[③] or filibustering can constitute a breach of a fiduciary obligation.[④]

These principles also apply to limited liability companies. Although corporations and limited liability companies observe the majority rule,[⑤] the personalistic structure of a limited liability company triggers fiduciary obligations to the extent that shareholders must take positive action for the benefit of the corporate entity.[⑥] The *Bundesgerichtshof* has accepted that the prohibition not to compete with a partner's partnership (S. 112 of the *Commercial Code*[⑦]) can be extended by analogy to the personalistic structure of a limited liability company.[⑧] But it seems that this analogy is subject to an important qualification: A shareholder of a limited liability company is under a fiduciary obligation not to compete with their company only if he or she holds a majority position or has the means to control the company.[⑨] Moreover, the majority or controlling shareholders breach the fiduciary obligation not to compete if they acquire a majority holding in a competitor; a mere investment in a minority participation is insufficient.[⑩]

It cannot be overlooked that the personalistic origins of the duty of care with fiduciary elements inject an element of uncertainty into the legal analysis of corporations with dispersed shareholders, where the interconnectedness of personal business interests is less important.[⑪] This advises caution whenever a fiduciary obligation is argued to establish a positive duty to take action.[⑫] Thus, a duty of care with fiduciary elements predominantly translates into limitations on the exercise of membership rights. A majority shareholder may not infringe on the core shareholder rights of the minority.[⑬] In such a scenario, the corporation has to ensure that minority shareholders can exercise their membership

① Ibid., at § 17 25.
② Kammergericht (Regional Appellate Court) Berlin, ruling of 3 December 2012, *NZG* 2003, 441 (443 et seq.) (Ampere).
③ Landgericht (District Court) München, judgment of 28 May 2010, *WM* 2010, 1699 (1701 et seq.). *See* also s. 131 (2) of the *Stock Corporation Act* which allows for a stipulation in the corporate charter to avert an abusive exercise of the shareholder's right to obtain information and BGH, judgment of 8 February 2010, *NJW* 2010, 1604 (1605 et seq.).
④ Hoffmann-Becking (-Rieckers), § 17, 25.
⑤ OLG Hamm, judgment of 9 December 1991, *DStR* 1992, 992.
⑥ BGH judgment of 5 June 1975, BGHZ 65, 15 (19), OLG Hamm, *DStR* 1992, 992; OLG Köln, judgment of 9 March 1999, *NZG* 1999, 1167)
⑦ S. 112 of the *Commercial Code*:
"(1) Without the consent of the other partners, a partner may neither conduct any business in the partnership's branch of commerce nor participate as a general partner in another similar commercial partnership.
(2) Consent to participation in another partnership shall be deemed to be granted if the other partners know at the time of entering the partnership that the partner is participating as a general partner in another partnership and nonetheless do not expressly stipulate that he give up such participation."
⑧ BGH, judgment of 5 December 1983, *BGHZ* 89, 162 (166).
⑨ Lutter/Hommelhoff (-Bayer), § 14 39.
⑩ Ibid.
⑪ *See* the cautious approach in: BGH, judgment of 16 February 1976, *BeckRS* 1976, 31115257 (Audi/NSU) and the balancing analysis in the BGH's judgment of 1 February 1988, *BGHZ* 103, 184 (194 et seq.).
⑫ Hoffmann-Becking (-Rieckers), § 17 21.
⑬ *See* the observations in the BGH judgment of 1 February 1988.

rights properly.[1] Minority shareholders are entitled to receiving qualified information on the protocols of a shareholder meeting as far as their own questions and the answers of board members are concerned.[2] As a corollary, the majority may not instrumentalize the general meeting of shareholders to appoint a specific accountant who appears to be biased with respect to the scrutiny of the annual statement.[3] On the other hand, a minority shareholder may not abuse quorum requirements for the sheer sake of blocking. Below this threshold, however, there is no duty to protect fellow-shareholders from a negative fall-out from their membership in the corporation.[4] The (economic) scope of membership rights is defined by the business activities and the purpose of the corporation which the shareholders have associated with by buying shares.[5]

Financial Distress Scenarios

The courts have been frequently asked to clarify the scope of fiduciary obligations for shareholders in a situation of financial distress or in the vicinity of insolvency which could be averted by implementing a restructuring plan (including additional financial contributions).[6] The courts decline to impose a general (fiduciary) obligation to "save" a corporate entity in a distress scenario.[7] Moreover, there is no duty of care to consider financial problems of fellow-shareholders unless they translate into direct negative effects for the corporate entity and its activities as stipulated in the corporate charter.[8] Nonetheless, dissenting shareholders have been found to be under a fiduciary obligation to support a restructuring plan submitted by the majority of their fellow-shareholders. The duty to accept and support a restructuring plan for an ailing corporate entity has been deduced from the fiduciary obligations owed to fellow-shareholders. At the outset, such a duty will only be triggered if the restructuring plan is not too speculative[9] and promises a realistic chance of a recovery.[10] A minority shareholder is entitled to project-related information from fellow-shareholders; but their fiduciary obligations do not justify a "fishing expedition" for limitless information[11]. The focus is on the economic survival of the corporation, not on potential insolvency creditors and their claims against an insolvency estate.[12]

The *Bundesgerichtshof* has held that the impending, foreseeable illiquidity of a property fund organized as a capitalistic partnership justifies the preparation of a restructuring plan.[13] The fiduciary obligation of a dissenting partner is triggered if the injection of additional capital (as requested by a

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① BGH, judgment of 9 June 1954, *BGHZ* 14, 25 (38).
② BGH, judgment of 9 September 1994, *BGHZ* 127, 107 (111) (BMW).
③ BGH, judgment of 22 November 2002, *NZG* 2003, 216 (219) (Hypobank).
④ BGH, judgment of 16 February 1976, *BeckRS* 1976, 31115257 (Audi/NSU).
⑤ BGH, judgment of 22 June 1992, *NJW* 1992, 2167 (2171) (IBH).
⑥ *See* list of cases in Lutter/Hommelhoff (-Kleindiek), § 43 36 and Hoffmann-Becking (-Rieckers), § 17 29.
⑦ Accord: Lutter/Hommelhoff (-Kleindiek),
⑧ BGH, judgment of 22 June 1992, *NJW* 1992, 3167 (3171) (IBH).
⑨ *See* BGH, decision of 2 July 2007, *NZG* 2007, 860 (assessing the fiduciary obligations of a limited partner in a situation of financial distress of a limited partnership); for limited liability companies with a personalistic structure BGH, judgment of 25 September 1986, *BGHZ* 98, 276 (280 et seq.).
⑩ *See* OLG Köln, judgment of 9 March 1999, *NZG* 1999, 1166.
⑪ Kammergericht Berlin, judgment of 2 January 2001, *NZG* 2001, 508 (509).
⑫ BGH, judgment of 14 February 2019, *NJW* 2019, 1289 (1291).
⑬ BGH, judgment of 9 June 2015, *DStR* 2015, 2188 (2190).

majority of partners) is a more appealing venue of action than the dissolution of the partnership due to a shortage of fresh funds.① In such a scenario, the dissenting partner is under a duty not to block the vote which requires a minimum quorum of accepting partners for an injection of fresh funds. If the dissenting partner fails to oblige, his or her (negative) vote cast will be deemed void.② Conversely, if the corporate entity does not face severe economic disadvantages which dominate personal motives of the shareholders, a dissenting shareholder is under no fiduciary obligation to accept the restructuring plan or give reasons for rejecting it.③

Under *Stock Corporation Law*, minority shareholders have been admonished not to frustrate rescue plans with a reasonable chance of success,④ if the alternative is the commencement of insolvency proceedings.⑤ In such a scenario, the shareholder's duty of care (with fiduciary elements) towards the corporation in distress does not require a positive approval of the (dissenting) shareholder. Abstention in the general meeting of shareholders is sufficient.⑥ Votes cast in breach of fiduciary obligations are void.⑦ On the other hand, rescue plans prepared by the majority of shareholders may not operate to infringe membership rights of minority shareholders and their position in the restructured corporation: If the general meeting of shareholders accepts both, a reduction of the legal capital and a subsequent increase, the issue of new shares must enable minority shareholders to maintain the previous distribution ratio among the majority and minority.⑧ Thus, a restructuring of the legal capital should not be instrumentalized to deliberately weaken the voting power of the minority or eject minority shareholders *de facto*.⑨

Controlling Shareholders and Fiduciary Obligations

Below the threshold of tort law, the German law on conglomerates does not impose a general duty on the parent company to compensate for losses which arise within its conglomerate.⑩ But the law provides for some protection in the aftermath of business decisions of the controlling shareholder which ignore the interests of his (minority) fellow-shareholders⑪: S. 311 of the *Stock Corporation Act*⑫ addresses a scenario where the controlling shareholder of a corporation or a partnership limited by shares undertakes a transaction or measures, disadvantageous to the dependent corporate entity. In

① BGH, judgment of 19 October 2009, *DStR* 2009, 2495 (2497 et seq.) ("Restructure or Leave").
② BGH, judgment of 21 July 2008, *NZG* 2008, 783 (785) (limited liability company).
③ BGH, judgment of 12 April 2016, *NZG* 2016, 781 (782) (Media-Saturn).
④ *See* OLG München, decision of 16 January 2014, *BeckRS* 2014, 3022.
⑤ BGH, judgment of 20 March 1995, *BGHZ* 129, 136 (151) (Girmes).
⑥ *See* OLG München, decision of 16 January 2014, *BeckRS* 2014, 3022.
⑦ Hoffmann-Becking (-Rieckers), § 17 31.
⑧ BGH, judgment of 5 July 1999, *NZG* 1999, 1158 (1159) (Hilgers).
⑨ *Cf.* Kammergericht Berlin, judgment of 9 March 2020, *DNotZ* 2021, 231(235).
⑩ *See* OLG Stuttgart, judgment of 4 August 2020, *BeckRS* 2020, 33585, Holger Fleischer/Stefan Korch, Okpabi v Royal Dutch Shell und das deutsche Deliktsrecht in Konzernlagen, *ZIP* 2021, 709 (712 et seq.).
⑪ *See* generally: Hoffmann-Becking (- Krieger), § 70 17 et seq.
⑫ S. 311 *Stock Corporation Act* (Limitations restricting the exertion of influence):
"(1) Where no control agreement exists, a controlling enterprise may not use its influence to instigate a controlled stock corporation or public partly limited partnership to enter into a legal transaction detrimental to it, or to take or refrain from measures resulting in a disadvantage, unless the disadvantages are compensated.
(2) Where the compensation has not in fact been provided in the course of the financial year, then it must be determined at the latest at the end of the financial year in which the controlled company suffered the disadvantage when and by which advantages the disadvantage is to be compensated. The controlled company is to be granted a legal claim to the advantages determined to serve as compensation."

fleshing out quasi-fiduciary obligations for controlling shareholders, S. 311 of the *Stock Corporation Act* requires the controlling shareholder to refrain from such activities unless the resulting disadvantages are compensated. A transaction is disadvantageous under S. 311 of the *Stock Corporation Act*, if it reduces or jeopardizes the assets or returns of a corporate entity due to its dependence on the controller shareholder-enterprise.① These requirements are met *inter alia*, if the controlling shareholder causes the dependent corporation to assume the risks of prospectus liability from an offer of shares previously held by the controlling shareholder. The financial loss sustained by the dependent corporate entity is the *de facto* repayment of legal capital without receiving any compensatory benefits.② Similarly, the controlling shareholder-enterprise is liable to minority shareholders if a merger has been so engineered as to encroach upon minority shareholder rights abusively.③

A breach of the obligations under S. 311 *Stock Corporation Act* does not nullify the transactions undertaken by the controlling shareholder. Instead, the controlling shareholder has to remedy the disadvantages until the end of the current business year. According to S. 317 *Stock Corporation Act*,④ a duty to pay compensation is only triggered if the disadvantages have not been remedied until the end of the current business year. The right to compensation against the controlling shareholder-enterprise can be enforced by the dependent corporate entity, but also by its shareholders, provided they have suffered individual losses, independent of those indirectly sustained through the losses of their dependent corporate entity. If the dependent corporate entity decides to commence litigation against the controlling shareholder-enterprise, an individual shareholder is not barred from bringing a separate suit.⑤ The controlling shareholder-enterprise and its statutory representatives are jointly and vicariously liable for compensating the dependent corporate entity and its shareholders. S. 317 (2) of the *Stock Corporation Act* exempts from the duty to compensate if the business judgment rule has been observed: If a manager of an independent corporate entity would have taken the same measures or entered in to the respective transactions by observing the standard and care of a prudent businessman, there is no duty to compensate.⑥

The jurisprudence on S. 317 of the *Stock Corporation Act* reflects the evidentiary problems of both,

① BGH, judgment of 31 May 2011, *BGHZ* 190, 7 (15 et seq.).
② Ibid.
③ OLG Köln, decision of 14 December 2017, *NZG* 2018, 459 (463) (Strabag).
④ S. 317 *Stock Corporation Act* (Liability and responsibilities of the controlling enterprise and its legal representatives):
"(1) Where a controlling enterprise instigates a controlled company, with which no control agreement is in place, to enter into a legal transaction causing a disadvantage to it, or to take or refrain from taking a measure and this causes a disadvantage to the controlled company, without the controlling enterprise in fact compensating it for this disadvantage by the end of the financial year or granting to the controlled company a legal claim to an advantage intended to serve as compensation, then the controlling enterprise is under obligation to compensate the company for the damage resulting therefrom. The controlling enterprise shall also be under obligation to compensate the stockholders for the damage they have suffered as a result insofar as they have suffered damage above and beyond the damage that has been caused them by the damage caused to the company.
(2) The obligation to provide compensation shall not arise where even a conscientious manager faithfully complying with his duties of an independent company would have also entered into the legal transaction or would have taken, or refrained from taking, the measure.
(3) Besides the controlling enterprise, those of the legal representatives of the enterprise shall be liable as joint and several debtors that have instigated the company to enter into the legal transaction or to take the measure.
(4) Section 309 subsections (3) to (5) shall apply mutatis mutandis."
⑤ BGH judgment of 30 June 2020, *NZG* 2020, 1025 (1027).
⑥ *See* BGH, judgment of 3 March 2008, *MMR* 2008, 392 (393): the ex-ante perspective is decisive for determining whether the business judgment rule has been observed.

the dependent corporate entity and an individual minority shareholder to document their claims against the controlling shareholder. It is sufficient that they establish a *prima facie* case against the controlling shareholder.①

The Executives' Perspective on the Duty of Loyalty and Care with Fiduciary Elements

The Managing Director (*Geschäftsführer*) of a Limited Liability Company

The Statutory Concept

An assessment of the duties owed by a *Geschäftsführer* of a limited liability company cannot be dissociated from empirics: Most limited liability companies in Germany are family-owned with strong personalistic features.② Frequently, the *Geschäftsführer* is both a shareholder and a member of the controlling family. Moreover, under the *Limited Liability Act,* shareholders are entitled to give instructions to the *Geschäftsführer* which must be executed if they are not in clear breach of law.③ In such a scenario, minority shareholders and creditors take a special interest in how the *Geschäftsführer* discharges his duties. Nonetheless, there is general agreement that the *Geschäftsführer* owes duties only to his corporate entity (with legal capacity). He may incur liability towards his corporate entity if he disregards shareholder interests.④ Thus, the shareholders of a limited liability company are only indirect beneficiaries of the *Geschäftsführer*'s lawful discharge of duties. Direct liability to shareholders will only arise if the *Geschäftsführer* is found to be criminally liable or has to accept personal liability under tort law.⑤

The statute classifies the *Geschäftsführer* as the representative of the corporate entity. This corporate law status is usually supplemented by a private law service contract which fleshes out the duties owed under corporate law, adding specific consultations mechanisms when an investment envisaged by the *Geschäftsführer* exceeds a certain threshold.⑥ Thus, even if a *Geschäftsführer* complies with his statutory duties in his capacity as the legal representative of a limited liability company, he may nonetheless be in breach of obligations owed under the private law service contract.⑦ On the other hand, if the meeting of shareholders has recalled a *Geschäftsführer* from his post as the legal representative of the limited liability company, this does not automatically terminate the private law contract for services to be rendered to the corporate entity.

① BGH judgment of 31 May 2011, *Grigoleit, Aktiengesetz* (2nd ed. 2020), § 317 19.
② *See* Stiftung Familienunternehmen, *Börsennotierte Familienunternehmen – Bedeutung, Merkmale, Performance* (2019), at p. 12.
③ *See* Horst Konzen, Geschäftsführung, Weisungsrecht und Verantwortlichkeit in der GmbH und GmbH & Co. KG, *NJW* 1989, 2977 (2984 et seq.)
④ Kammergericht Berlin, judgment of 24 February 2011, *CCZ* 2011, 235 (236 et seq.).
⑤ *See* III.1.e.
⑥ *See* the model contract in Formularbuch Recht und Steuern (München 9th ed. 2019) (-Schwedhelm/Wollweber), A.6.26.
⑦ *See* generally BGH, judgment of 12 June 1989, *NJW-RR* 1989, 1255 et seq.

The Duty of Legality

The statutory language on the duties owed by the *Geschäftsführer* toward the limited liability company is neither comprehensive nor very informative. S. 43 (1) of the *Limited Liabilited Act* requires the *Geschäftsführer* to exercise his function with the due care of a prudential businessman.① Failure to do so will trigger liability towards the limited liability company (S. 43 (2) of the *Limited Liability Act*). According to S. 43 (3) of the *Limited Liability Act*, this liability is for having disregarded the mandatory provisions on legal capital and capital maintenance rules. Legal doctrine classifies the duty imposed by S. 43 (1) of the *Limited Liability Act* as a "duty of legality": it establishes a duty of properly guiding the enterprise.② This is to incentivize the *Geschäftsführer* to advance the business interests of the limited liability company, but it also defines a mandate under which corporate compliance with mandatory law has to be ensured.③

Compliance with the duty of legality requires the *Geschäftsführer* to seek expert opinion to make an informed judgment on an envisaged business transaction.④ The *Geschäftsführer* may not commit a breach of law which—like bribery—might generate financial benefits for the corporation.⑤ It is a breach of the duty of legality if the *Geschäftsführer* were to disregard the statutory distribution of powers in a limited liability company.⑥ In a conglomerate structure of limited liability companies, the *Geschäftsführer* of the controlling holding company has to be mindful of the dependent companies, from the perspective of protecting minority shareholders,⑦ but also for the purpose of avoiding liability for infringing the interests of the dependent company.⑧

The Duty of Care with Fiduciary Elements

The combination of a statutory duty of legality and a duty of care with fiduciary elements has elevated the *Geschäftsführer* to a trustee-like status: Corporate funds and the (economic) well-being of the limited liability company have been entrusted to him, and he has to observe a standard of care higher than the duty of good faith under bilateral contracts.⑨ From a practical perspective, fiduciary obligations provide the limited company (or rather the insolvency administrator or a representative

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① S. 43 *Limited Liability Act* (Directors' Liability):
"(1) The directors shall conduct the company's affairs with the due care of a prudent businessman.
(2) Directors who breach the duties incumbent upon them shall be jointly and severally liable to the company for any damage arising.
(3) In particular, they shall be obligated to compensate where payments have been made in contravention of section 30 from those company assets which are required to maintain the share capital or the company's own shares have been purchased in contravention of the provisions set out in section 33. The provisions set out in section 9b (1) shall apply mutatis mutandis to a claim for compensation. Where compensation must be paid to satisfy the company's creditors, the directors' obligation shall not be abrogated on account of the fact that they acted in compliance with a resolution passed by the shareholders.
(4) The claims based on the aforementioned provisions shall become statute-barred after five years."

② Lutter/Hommelhoff (-Kleindiek), § 43 10 et seq.

③ *See* BGH, judgment of 7 May 2019, *NJW* 2019, 2164 (2165).

④ BGH, judgments of 14 May 2007, *NJW* 2007, 2118 (2120), 27 March 2012, *NZG* 2012, 672 (673 et seq.).

⑤ Cf. OLG Celle, judgment of 21 December 2005, *NJOZ* 2006, 1563 (1565).

⑥ OLG Naumburg, judgment of 23 May 1954, *GWR* 2014, 413.

⑦ This includes limited partnerships and their limited partners, when the limited liability company is the general partner and the *Geschäftsführer* of the limited liability company *de facto* administers the limited partnership: BGH, judgment of 22 September 2020, *NZG* 2020, 1343 (1344 et seq.).

⑧ *See* the factual scenarios in: OLG Düsseldorf, judgment of 8 November 2019, *NJOZ* 2020, 1033, and BGH, judgment of 18 June 2013, *BGHZ* 197, 304, and the comment by Gregor Bachmann, Die Haftung des Geschäftsführers für die Verschwendung von Gesellschaftsvermögen, *NZG* 2013, 1121.

⑨ Lutter/Hommelhoff (-Kleindiek), § 43 10 et seq., BGH, judgment of 23 September 1985, *NJW* 1986, 585 et seq., OLG Naumburg, judgment of 26 March 2013, *BeckRS* 2014, 15053.

for minority shareholders) with a flexible ad-hoc tool to rebalance statutory obligations or fill gaps where the statute is silent. Among these figure prominently the fiduciary obligations not to compete with the limited liability company or to exploit business opportunities which have to accrue to the company, but not to the *Geschäftsführer* in his personal capacity.① It should be noted that the jurisprudence of the *Bundesgerichtshof* relies on a fiduciary argument to deduce a duty not to compete for a *Geschäftsführer*, where stock corporation law relies on a statutory prohibition for members of the managing board of a stock corporation to compete with their company. This technique is particularly relevant for family and closed enterprises where the decision-making structure is more relevant than the legal form.

The duty of care with fiduciary elements is subject to the business judgment rule. The business judgment rule,② now codified in both the *Stock Corporation Act* and the *Limited Liability Act*, was first read by the *Bundesgerichtshof* into the law of stock corporations,③ but is now widely accepted as being authoritative for close corporations and family enterprises organized in the form of a limited liability company.④ The *Bundesgerichtshof* has emphasized that a *Geschäftsführer* can only benefit from the business judgment rule if the decision-making is based on all available information and a proper risk assessment: Thus, if a *Geschäftsführer* plans to restructure the loans of a limited liability company, an assessment of the impacts from volatile interest markets is necessary.⑤ There is, however, a crucial difference between stock corporations and limited liability companies. The entrepreneurial discretion enjoyed by a *Geschäftsführer* may be severely limited by instructions given by the shareholders. To deviate from such instructions would constitute a breach of the (power) structure of a limited liability company.⑥

In an interesting combination between the liability rules for controlling shareholders under stock corporation law and those for the *Geschäftsführer* of a limited liability company, the *Bundesgerichtshof* has extended the business judgment rule to limited capitalistic partnerships. The insolvency administrator of a limited partnership, where a limited liability company was the general partner, had sued the *Geschäftsführer* of the limited liability company for non-compliance with the business judgment rule.⑦ The *Bundesgerichtshof* declined to classify this claim as contractual, resulting from the legal relationship between the general and limited partners. Instead, the court argued that in acting as the representative of the general partner, the *Geschäftsführer* had also to be mindful of the business interests of the wholly dependent limited partnership,⑧ thus clearing the way for fiduciary concepts.

① *See* supra III.1.d.
② *See* BGH, judgment of 4 November 2002, *BGHZ* 152, 280, and Constantin Goette/Maximilian Goette, Managerhaftung: Abgrenzung unternehmerischer Entscheidungen nach Maßgabe der Business Judgement Rule von pflichtverletzendem Handeln, *DStR* 2016, 815 (816 et seq.).
③ BGH, judgment of 21 April 1997, *BGHZ* 135, 244 (253) (ARAG/Garmenbeck).
④ *See* Gerald Spindler/Andreas Seidel, in: Fleischer/Recalde/Spindler (eds.), *Family Firms and Closed Companies in Germany and Spain* (Tübingen 2021), 283 (287 et seq.).
⑤ BGH, decision of 14 July 2008. *NZG* 2008. 751 (752).
⑥ Lutter/Hommelhoff (-Kleindiek), § 43 23.
⑦ BGH, judgment of 18 June 2013, *NZG* 2013, 1021.
⑧ Ibid., at p. 1022.

Business Opportunities

Since the 1980s, the *Bundesgerichtshof* has explored the scope of fiduciary obligations in the context of the prohibition not to compete with the company or corporation.① While the law for limited partnerships and stock corporation law has codified such a duty, the statute on limited liability companies remains silent. In a 1989 case, the *Bundesgerichtshof* specified the extent of the fiduciary duty which the *Geschäftsführer* owes to the limited liability company: The *Geschäftsführer* is precluded from seizing for his own personal benefit a business opportunity which he became acquainted with while serving for the limited liability company.② This applies even if the limited liability company had been unable to raise to necessary funds for undertaking the business transaction. Under these circumstances, the *Geschäftsführer* would have been under an obligation to arrange a credit scheme to supply the company with fresh liquidity. If the *Geschäftsführer*—in appropriating a business opportunity due to the company—had bought a piece of land, the sanction for a breach of the fiduciary is to hand over the real property to the company.③ The fiduciary duty not to seize business opportunities which belong to the corporate entity has been applied to all forms of business activities, whether a partnership, limited partnership, limited liability company, or a stock corporation.④ From an economic point of view, the business opportunities doctrine serves to protect the structure of fiduciary relationships. It protects the distribution of property rights between directors and the company and corporation, thereby reducing control costs for shareholders and the risk of opportunistic management behavior.⑤

Direct Liability for the Geschäftsführer—Shareholders v. The Geschäftsführer

German law does not recognize criminal liability for corporate entities.⑥⑦ Moreover, if the *Geschäftsführer* acted as the representative of the limited liability company, his actions or omissions would normally be attributed to the company which would have to assume private law liability.⑧ Although direct liability might be regarded as pushing the *Geschäftsführer* towards risk-averse behavior, courts have always accepted that *Geschäftsführer* may be directly liable under tort law.⑨ There is, however, the risk that personal tort liability may be instrumentalized to mend those situations where German law does not recognize tortious liability for the corporate entity behind the individual.

In a case decided in 1989, a limited liability company had ordered construction materials as part of

① For a survey *see* Holger Fleischer, Gelöste und ungelöste Probleme der gesellschaftsrechtlichen Geschäftschancenlehre, *NZG* 2003, 985 et seq.

② BGH, judgment of 8 May 1989, *NJW* 1989, 2687 (2688).

③ Ibid.

④ *See* survey in BGH, judgment of 4 December 2012, *NJW-RR* 2013, 363 (365), Holger Fleischer, *Handbuch des Vorstandsrechts* (München 2006) (-Fleischer), § 9 23 et seq., Martin Gelter/Geneviève Helleringer, Opportunity Makes a Thief, Corporate Opportunities as Legal Transplant and Convergence in Corporate Law, 14 (2) *Berkeley Bus. L. J.* 94 (105 et seq.) (2017).

⑤ Fleischer, *NZG* 2003, 985 (992); id., Handbuch des Vorstandsrechts, § 9 25.

⑥ *Münchener Kommentar zum StGB* (-Joecks/Scheinfeld) (4th ed. 2020), Vorbemerkung zu § 25 16 et seq.

⑦ This does not extend to fines for breaches of antitrust law which can be imposed on entities with legal capacity: *See* the factual scenarios in BGH, decisions of 26 February 2013, *NJW* 2013, 1972, and of 9 October 2018, *WM* 2019, 1323, and Krenberger/Krumm, *OWiG* (München 6th es. 2020) (-Bohnert/Krenberger/Krumm), § 30 11 et seq.

⑧ Habersack/Casper/Löbbe, *GmbHG-Großkommentar* (München 3rd ed. 2020), § 35 4 et seq., BGH, judgment of 2 February 1996, *BGHZ* 132, 30.

⑨ *See* the surveys over German cases§ 13 341 et seq. *Münchener Kommentar zum GmbHG* (München 3rd ed. 2018) (-Merkt), Joerg Brammsen/Kathrin Sonnenburg, Geschäftsführeraußenhaftung in der GmbH, *NZG* 2019, 681

a secured transaction.[①] To guarantee the payment of the purchase price, the limited liability company pledged claims against third parties as a security to the seller. The construction materials were built into houses and, in accordance with German property law, the property of the seller had vanished. The limited liability company went bankrupt, and the seller could not obtain payment from the insolvency estate due to a shortage of funds. The seller then decided to sue the *Geschäftsführer* of the now defunct limited liability company for having infringed property rights with respect to the construction materials. The *Bundesgerichtshof* explained that the *Geschäftsführer* had acted under a duty of a guarantor with respect to the property of the construction company. Moreover, as the *Geschäftsführer* of the limited liability company, he was under a tort law duty to so organize the business of the company that third-party property would not be infringed. Failure to do so will trigger hpersonal liability of the *Geschäftsführer*.[②] This holding has been heavily criticized.[③] But its underlying assumptions are still recognized as valid case law. Thus, a *Geschäftsführer* is under a duty to take organizational measures so that on a parking lot—run by the limited liability company—nobody will sustain injuries.[④] In more recent holdings, the *Bundesgerichtshof* has clarified that the personal liability of the *Geschäftsführer* (or a member of the board of directors) may only be invoked if tort law has been infringed[⑤] or special legal protection for the assets of third parties (such as insolvency law rules) have been ignored.[⑥] The *Geschäftsführer* is under no general duty to protect third parties from financial loss.[⑦] Liability under unfair trading law will be triggered if the *Geschäftsführer*'s actions have contributed to unfair trading practices or if the *Geschäftsführer* was under a specific duty towards third parties to abstain from breaches of unfair trading law.[⑧] This is the case when a limited liability company establishes an internet platform. Under these circumstances, the *Geschäftsführer* is under a duty to examine the compatibility with unfair trading law.[⑨] On the other hand, below this threshold, the mere knowledge that the limited liability company might be breaching unfair trading law does not trigger personal liability of the *Geschäftsführer*.[⑩]

The Board of Directors between the Duty of Legality and the Duty of Care with Fiduciary Elements (*Stock Corporation Law*)

Basic Concepts

Directors, in their capacity as statutory representatives, owe specific duties towards the corporation. German stock corporation law distinguishes between a codified duty of legality and (mostly judge-

① BGH, judgment of 5 December 1989, *BGHZ* 109, 297 (302 et seq.).
② Ibid.
③ For an analysis of the literature and subsequent case law *see*: *Münchener Kommentar zum BGB* (München 8th ed. 2020) (-Wagner), § 823 130 et seq., Oppenländer/Trölitzsch, *Praxishandbuch der GmbH-Geschäftsführung* (München 3rd 2020) (-Ziemons), § 24 15 et seq.
④ OLG Stuttgart, judgment of 29 April 2008, *NJW* 2008, 2514 (2515).
⑤ *See* also BGH, judgment of 12 December 2000, *NJW* 2001, 964 (Kindertee).
⑥ BGH, judgment of 7 May 2019, *NJW* 2019, 2164 (2165).
⑦ BGH, judgment of 10 July 2012, *NJW* 2012, 3439.
⑧ BGH, judgment of 18 June 2014, *GRUR* 2014, 883 (884).
⑨ Ibid.
⑩ Ibid.

made) duties of care with fiduciary elements. S. 76 of the *Stock Corporation Act* charges the board of directors with the responsibility of managing the corporation. This includes a duty to establish an efficient business organization, compliance mechanisms, risk assessment procedures, and early warning systems to detect existential dangers for the corporation. S. 93 of the *Stock Corporation Act* reiterates the duty of legality as directors may not engage the corporation in unlawful actions.

Under S. 93 (2) of the *Stock Corporation Act,* directors are jointly and severally liable to the corporation if the standard of care of the prudent businessman has not been observed. In case of doubt, S. 93 (2) places the burden of proof on directors that they have observed the standard of care of a prudent businessman. This is the codification of the business judgment rule. But it should be noted that the business judgment rule does not provide a safe harbor for every action or decision taken by the board of directors.① The business judgment rule only applies where the board of directors had discretion to decide between several alternatives of action.② There has to be a showing that they did exercise their business judgment properly, based on the information and the third-party advice of expert knowledge that did not exist among the board members.③ Therefore, failure to seek expert advice, although necessary, supports the conclusion that discretion was not exercised at all. Although the business judgment rule has been codified in the statute, it is helpful to trace back its origins in German jurisprudence. In a 1997 case, the *Bundesgerichtshof* expressly acknowledged that the board of directors enjoys a substantial amount of entrepreneurial discretion which is not subject to scrutiny by the supervisory board-unless the board of directors disregards its statutory duties.④ If an investment decision is well-founded ex ante, directors cannot be held liable by the corporation if the investment fails to generate any return.⑤ Subsequently, courts and academia have fleshed out the impact of the business judgment resulting in a catalog of procedures which the board of directors has to observe to escape liability. Closer inspection suggests that the scope of the business judgment rule is limited by fiduciary concepts about directors' duties with respect to the corporate assets.

Cases after the turn of the century demonstrate that the criminal law sanction of embezzlement (S. 266 of the *Criminal Code* [*Strafgesetzbuch*]) have the potential of impacting corporate decision-making.⑥ In 2005, the *Bundesgerichtshof* held that the expenditure of corporate funds without receiving compensatory counter-services for the benefit of the corporation might constitute embezzlement under S. 266 of the *Criminal Code*.⑦ If a bank is in financial distress, failure to observe the implications of the business judgment rule constitutes criminal law embezzlement.⑧ Entering into

① Hopt/Roth in *GroßKomm AktG* (Berlin 5th ed. 2015), § 93 70 et seq,

② For a criminal law perspective *see* Schönke/Schröder, *Strafgesetzbuch* (München 30th ed. 2019) (-Perron), § 266 19b.

③ Cf. Münchener Kommentar zum Aktiengesetz (München 5th ed. 2019) (-Spindler), § 93 55 et seq.

④ BGH, judgment of 21 April 1997, *BGHZ* 135, 244 (253) (ARAG/Garmenbeck).

⑤ *See* Matthias Graumann, Angemessene Informationsgrundlage von Prognosen bei unternehmerischen Entscheidungen, ZIP 2021, 16. For the requirements of a proper exercise of business judgment in the context of restructuring plans *see* Drinhausen/Eckstein, *Beck'sches Handbuch der AG* (München 3rd ed. 2018), § 17 27 et seq. *See* also the factual scenarios in BGH, judgment of 22 February 2011, *NZG* 2011, 549 (550 et seq.), and OLG Koblenz, judgment of 23 December 2014, *BeckRS* 2015, 712.

⑥ *See* infra sub IV.

⑦ BGH, judgment of 21 December 2005, *NJW* 2006, 522 (523) (Mannesmann).

⑧ BGH, judgment of 20 October 2016. *NZG* 2017, 116 (117) (HSH Nordbank).

a highly risky financial transaction without proper risk assessment may amount to a refusal to exercise a well-informed business judgment at all, and hence, waste corporate funds.[1] On the other hand, very few business decisions are without risk.[2] It remains to be seen how the business judgement rule and the directors' fiduciary obligations towards managing corporate assets will interact in the future.

Directors' Duty of Care with Fiduciary Elements

Principle 19 of the *German Corporate Governance Code*[3] binds the board of directors and the supervisory board on the best interests of the enterprise.[4] They must abstain from pursuing personal interests or exploiting business opportunities to which the enterprise is entitled. During their appointment, members of the board of directors must observe a comprehensive duty not to compete. Principle 19 is understood to define the fiduciary obligations which the members of the board of directors have to observe while in office. Principle 19 also highlights the specific regulatory technique of the German legislator with respect to fiduciary obligations in stock corporation law. S. 88 of the *Stock Corporation Act* imposes a duty not to compete and provides for a corporation's claim of damages. S. 93 (1) prescribes the duty of confidentiality for any business information on the corporation that has been disclosed to them during their appointment. Beyond these statutory incidences, fiduciary duties are judge-made law; they originate within the specific context of the board of directors representing the corporation. These duties are rooted in trustee-like concepts for the role of the directors: If the supervisory board approves premiums to board members without any legal basis in their respective service contracts or any additional services rendered, there is a breach of the fiduciary obligation to protect and hold the assets of the corporation.[5]

Directors' Tort Liability towards Third Parties

As under the law for limited liability companies, the statutorily defined position of a member of the board of directors does not automatically shield a member from tort liability towards third parties. If a director has breached a law designed for the protection of the shareholders (*Schutzgesetz*), he will be liable under tort law.[6] Although a member of the board of directors does not assume the role of a guarantor for the financial interests of a third party,[7] property rights must be respected[8]: If a member of the board of directors of a bank makes an untrue, televised statement on the creditworthiness of one of its clients, this constitutes an illegal interference with client's business operations and triggers a claim for personal damages against that member.[9] Under tort law, members of the board of directors are

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① Schönke/Schröder (-Perron), § 266 20a.
② *Münchener Kommentar zum StGB* (-Dierlamm), § 266 228 et seq.
③ *German Corporate Governance Code* (as resolved by the Government Commission on 16 December 2019) (English version available at https://www.dcgk.de//files/dcgk/usercontent/en/download/code/191216_German_Corporate_Governance_Code.pdf).
④ A breach of the principles contained in the *German Corporate Governance Code* does trigger a finding of nullity as neither statutory law or the corporate charter have been infringed: BGH, judgment of 9 October 2018, BGHZ 220, 36 (45).
⑤ BGH, judgment of 21 December 2005, *NJW* 2006, 522 (523) (Mannesmann).
⑥ Hüffer/Koch (-Koch), § 93 61 et seq.
⑦ BGH, judgment of 10 July 2012, *NJW* 2012, 3439 (3441).
⑧ BGH, judgment of 24 January 2006, *BGHZ* 166, 84 (106 et seq.).
⑨ Ibid. *See* also Alexander Hellgardt, Die deliktische Außenhaftung von Gesellschaftsorganen für unternehmensbezogene Pflichtverletzungen–Überlegungen vor dem Hintergrund des Kirch/Breuer-Urteils des BGH, *WM* 2006, 1514 (1521 et seq.).

directly liable to a third party if they instrumentalize their corporation to promote an investment project that is fraudulent *ab initio* because there is no realistic chance of a return.①

Controlling Management Behaviour through Criminal Law—Embezzlement

S. 266 of the *German Criminal Code* punishes the breach of a duty to safeguard pecuniary interests of another, if such duty arises inter alia under a fiduciary relationship and its breach has adversely affected the pecuniary interests of those the fiduciary was responsible for.② The statutory sanction of embezzlement has been criticized for its vagueness,③ but it is nonetheless the core norm for assessing the fall-out from problematic business decisions which contribute to losses of corporate funds.④ S. 266 of the *German Criminal Code* protects the enterprise from financial damage which originates from internal business decisions which are taken in exercising managerial discretion.⑤ It is not designed to safeguard the pecuniary interest of the shareholders, but that of the corporate entity as such.⑥ Potential criminal law sanctions come into play once a perpetrator is under a fiduciary obligation to look after the pecuniary interests of others.⑦ These obligations may arise under statutory duties, specific codes of conduct, or a general fiduciary relationship.⑧ A member of the board of directors of a bank is not generally precluded from supporting a decision in favor of a loan which may be risky.⑨ But risk assessment procedures typical for banks and statutory duties under banking law have to be observed,⑩ before a loan of substantial dimensions is paid out.⑪ In exploring a new field for business activities, a profound risk analysis is mandatory which may also include a duty to seek advice from independent experts.⑫ Intent under S. 266 of the *Criminal Code* requires that the perpetrator not only accept a risk, but also approve of the danger that the risk materializes.⑬ S. 266 of the *Criminal Code* is also applicable when a member of the board of directors or the *Geschäftsführer* of a limited liability company disregards the distribution of powers between the general meeting of shareholders and the management. If the articles of association of a limited liability company require an approval of secured

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① BGH, judgment of 10 July 2015, *GWR* 2015, 517.
② *See* the English translation of s. 266 of the *German Criminal Code* (Embezzlement) (available at https://www.gesetze-im-internet.de/englisch_stgb/englisch_stgb.html#p2464):
(1) Whoever abuses the power conferred on them by law, by commission of an authority or legal transaction to dispose of the assets of another or to make binding agreements for another, or whoever breaches their duty to safeguard the pecuniary interests of another which are incumbent upon them by reason of law, by commission of an authority, legal transaction or fiduciary relationship, and thereby adversely affects the person whose pecuniary interests they were responsible for, incurs a penalty of imprisonment for a term not exceeding five years or a fine.
(2) Section 243 (2), sections 247 and 248a, and section 263 (3) apply accordingly.
③ *Münchener Kommentar zum StGB* (München 3rd ed. 2019) (-Dierlamm), § 266 3
④ Gerd Krieger/Uwe H. Schneider (eds.), *Handbuch Managerhaftung* (3rd ed. Köln 2017) (-Krause), § 40.25.
⑤ Ibid. *See* also OLG Celle, judgment of 21 December 2005, *NJOZ* 2005, 1563 (1564).
⑥ Landgericht (LG, District Court) Wiesbaden, judgment of 13 August 2015, *NZG* 2016, 832.
⑦ A breach of s. 266 of the *Criminal Code* may also be committed by an omission or failure to act: OLG Celle, judgment of 21 December 2005, *NJOZ* 2006, 1563 (1565).
⑧ Krieger/Schneider (-Krause), § 40.26.
⑨ BGH, judgment of 13 August 2010, *BKR* 2010, 163 (165) (WestLB).
⑩ BGH, judgment of 27 January 2021, *BeckRS* 2021, 7195.
⑪ Ibid.
⑫ Ibid.
⑬ BGH, judgment of 28 May 2013, *NStZ* 2013, 715 (716).

transaction prior to pledging corporate assets as security, the *Geschäftsführer* commits embezzlement if he fails to do so, and the company subsequently faces losses.① The assumption that a majority of shareholders would have approved will exonerate the *Geschäftsführer*.② Courts have also employed embezzlement sanctions to protect the structure of conglomerates and dependent corporate entities. The board of directors of a stock corporation which controls a conglomerate commits a breach of fiduciary duties (within the meaning of S. 266 of the *Criminal Code*) if he or she engineers a transfer of corporate funds to a dependent enterprise in support of restructuring project, although the restructuring project has already failed.③ A centralized cash management system within a conglomerate triggers criminal law concerns if the funds of dependent companies are completed, thereby causing over-indebtedness.④

Conclusion

As the business judgment rule and the prohibition on seizing business opportunities demonstrate, German Company Law does not resist legal transplants from common law orders.⑤ But as a civil law order, German law has always refused to add the common law trust to the statutory menu of organizational instruments for administering funds or doing business. Nonetheless, German Company Law has brought forth a catalog of "heightened duties" of care or duties of care with fiduciary elements which come very close to fiduciary obligations under Trust Law. Both, the linguistic and doctrinal starting point is the notion of loyalty and fidelity (*Treue*) which is owed under bilateral contracts. As contracts evolve into long-term relationships and rudimentary types of business organizations in the context of partnerships, the standard duty of care is transformed into a duty of care with fiduciary elements. In classifying these fiduciary obligations as a "heightened duty of care," the judiciary and legal doctrine remain faithful to the original trajectory of the duty of loyalty from simple bilateral contracts to sophisticated corporate settings. Closer inspection suggests that the duty of care with fiduciary elements has evolved into a highly flexible instrument which the courts apply to factual scenarios where the underlying statutes remain silent.

Judge-made interpretations of the duty of care with fiduciary elements build on an elaborate notion of membership. A corporate entity owes fiduciary obligations to its members so that the interests of minority shareholders will be protected. Conversely, shareholders, in their capacity as members of a corporate entity, have to respect their fiduciary obligations towards their fellow-shareholders and the respective corporate entity. Directors and corporate officers have to discharge their fiduciary obligations towards the corporation as they administer third-party funds. Although *German Company*

① LG Kleve, decision of 21 October 2010, *BeckRS* 2010, 29946.
② Ibid.
③ BGH, judgment of 22 November 2005, *NJW* 2006, 453 (454) (Kinowelt).
④ BGH, decision of 31 July 2009, *NZG* 2009, 1152 (1153).
⑤ For a detailed analysis of US legal transplants in *German Company Law*, *see* Jan von Hein, *Die Rezeption US-amerikanischen Gesellschaftsrechts in Deutschland* (Tübingen 2008), at p. 199 et seq.

Law does not classify directors and corporate officers as shareholders' trustees with corresponding fiduciary obligations, shareholders stand nonetheless to benefit—somewhat indirectly—from the scrupulous observance of the fiduciary obligations, which directors and corporate officers owe their respective corporate entity. Ultimately, an evolutionary approach towards fiduciary obligations in company law is predicated on the willingness of the judiciary to innovate where the statutes remain silent, while the real world of business calls for the adaptation of established concepts of loyalty and care.

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