Summary

Subject of the study

Deciding whether a corporation's board of directors[1] has fulfilled its duties to the corporation is often not an easy task for a court, especially when matters of business judgment are involved. In this study I investigate whether it is possible for the judicial review of director conduct involving the exercise of business judgment to be carried out in a more systematic manner than is presently the case.

With regard to Dutch corporate law, I focus on the right of inquiry (laid down in Book 2, Title 8, Chapter 2 of the Dutch Civil Code (hereinafter: DCC)) and on director liability under Sections 2:9 DCC and 2:138/248 (1) DCC.

In short, the 'right of inquiry' entitles shareholders (and trade unions) to request the Enterprise Chamber of the Amsterdam Court of Appeal to review the course of action followed by, and the affairs of, the corporation. In general, the subject matter of a judicial inquiry is the conduct of the board of directors, the supervisory board and/or the general meeting of shareholders. In the first phase of the inquiry proceedings, one of the central questions is whether there are 'well-founded reasons to doubt the correctness of the course of action followed by the corporation' (Section 2:350 (1) DCC). If the answer to this question is yes, an inquiry may be ordered. In the second phase of the proceedings, the Enterprise Chamber determines upon request, based on the investigator's report, whether the corporation has followed an 'obviously incorrect course of action' (Section 2:355 (1) DCC) and, if so and, upon request, whether measures must be taken to put an end to the 'obviously incorrect course of action' followed by the corporation. The Enterprise Chamber can also, upon request, order – relatively far-reaching – measures in the first phase, although those measures are by definition provisional. The right of inquiry does not involve questions relating to the personal liability of directors, for example vis-à-vis the corporation, for the negative effects of an 'obviously incorrect course of action' which they caused the corporation to follow.[2]

1 The Netherlands has a two-tier board system, consisting of a management board (parallel to the inside directors on a one-tier board) and a separate supervisory board (parallel to the outside directors on a one-tier board). Although every corporation has a management board, not every corporation has a supervisory board. References in this summary to the 'board of directors' are to the management board.

2 See, *e.g.*, Geerts (2004), 333-336 for a more detailed analysis of the mechanism of inquiry proceedings.

> Section 2:9 DCC provides that each member of the board of directors is responsible to the corporation for the proper performance of the duties assigned to him. If a matter falls within the scope of responsibility of two or more board members, each is jointly and severally liable for any shortcoming, unless he proves that it is not attributable to him and that he was not negligent in acting to prevent its consequences.
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> Section 2:138/248 (1) DCC provides that on the bankruptcy of a corporation, each member of the board of directors is jointly and severally liable to the estate for the amount of the liabilities to the extent that these cannot be satisfied out of the liquidation of the other assets, if the board of directors has manifestly performed its duties improperly and it is plausible that this is an important cause of the bankruptcy.

With regard to foreign corporate law, my main source of inspiration is the law of Delaware, the leading corporate law jurisdiction in the United States of America. The analysis throughout the study is based primarily on case law.

Against this background, the study is divided into four parts, each with a different focus. In the first part I discuss the tension between deference to directors' decisions and the scope of judicial review, as well as the way in which the Enterprise Chamber and the Dutch lower courts deal with this tension.[3] In the second part I describe how the Delaware Supreme Court and the Delaware Court of Chancery come to grips with this problem.[4] In the third part I analyze the key legal concepts that play a role in inquiry proceedings.[5] In the fourth part I – based on my findings in the previous three parts – formulate a systematic approach to the judicial scrutiny of director conduct in matters of business judgment, including a Dutch version of the business judgment rule. I then show how this approach functions in the context of inquiry proceedings and apply the result to several Enterprise Chamber rulings.[6] I conclude the study with an analysis of director liability to the corporation based on Section 2:9 DCC, and show how the approach I have developed works in that context as well. Finally, I discuss the relationship between Section 2:9 DCC and Section 2:138/248 DCC.[7]

Synopsis of the study

Part 1

It is generally accepted that the board of directors is the central policymaker within the corporation. The board is under a duty to use its powers properly and to act within their limits. Obviously, the board must also act in accordance with

3 Chapter 1 – numbers 2-4.
4 Chapters 2-4 – numbers 6-22.
5 Chapter 5 – numbers 24-31.
6 Chapters 6-7 – numbers 33-41.
7 Chapter 7 – number 42.

the other duties it has based on – *inter alia* – the law and the articles of association. In matters that involve the judicial scrutiny of a board's business judgments, the central question is normally not whether the board had the power to act but whether it used its powers properly. It can be said that the defining tension in today's corporate governance is primarily one between deference to directors' decisions and the scope of judicial review. These concepts conflict, since greater deference to directors' decisions necessarily results in decreased director accountability in the courts and *vice versa*. The question of where the balance between these competing interests should be struck is the subject of much debate among – *inter alia* – corporate law experts in the Netherlands, Delaware and elsewhere. I believe that a court should defer to a large extent to the board's business judgment unless there are circumstances which justify stricter scrutiny. In the study I explore the rationale for this approach.

In Dutch corporate law, the principle that the board should be allowed a certain degree of discretion is well settled. The limits of that discretion, however, are far less clear. This degree of discretion, and the corresponding limited review by the court, is generally restricted to the substance of the board's business judgments. In this respect, the traditional Dutch position is that the court should review the board's conduct relating to the business judgment only for reasonableness, a test which is still quite vague. Under this test, the court must limit its substantive review to some extent, but is nevertheless allowed to take into account the 'sensibleness'/'desirability' of the board's business judgment, in other words its quality or wisdom, while still showing deference. This basically means that the line between a full and limited review of the substance of the business judgment is rather thin.

A reasonableness test is – at least in theory – stricter than a rationality test, the latter being easier to satisfy since it excludes any consideration of the 'sensibleness'/'desirability' of the board's business judgment. Dutch corporate law is not familiar with the rationality test. In my opinion, it is questionable whether the reasonableness test does sufficient justice to the underlying rationale for judicial deference to a board's business judgments.

One reason for judicial deference is the so-called hindsight bias. Psychological research has shown that people find it difficult, if not impossible, to judge conduct without taking into account – and being influenced by – the negative results of that conduct. Those who are aware of the negative results have the strong tendency to view them *ex post* as relatively inevitable and thus more foreseeable than they in fact were, which in turn makes it easier to consider the conduct under review as wrong (i.e. insufficiently 'sensible'/'desirable'). This also applies to judges. Directors are expected to take risks on behalf of the corporation, risks that can produce profits but also losses, sometimes very large profits or losses. Under an *ex post* reasonableness test, a reviewing court might too often erroneously treat business judgments that turned out badly – because they resulted in a substantial loss – as bad (i.e. wrong) decisions, although *ex ante* the loss was not as predictable as the court thinks it was. This might well have the effect of discouraging directors from making business judgments that are risky but nevertheless in the interest of the corporation and causing directors to be risk averse. There is less room for the effect of the hindsight bias under the rationality test.

Recent case law from the Dutch Supreme Court shows that the Enterprise Chamber does not always succeed in reviewing corporate policy on proper grounds in inquiry proceedings and that courts in Section 2:9 DCC proceedings do not always correctly apply the criteria for deciding whether or not the director is personally liable to the corporation. The Dutch Supreme Court has provided clarification on certain issues, but there is still substantial uncertainty as to how the conduct of the board in matters of business judgment should be judicially reviewed in both inquiry proceedings and Section 2:9 proceedings. In other words, there is no settled method for carrying out the judicial scrutiny of director conduct relating to matters of business judgment.[8]

Part 2

The corporate case law of Delaware could – and in my view does – provide useful guidance. In a number of chapters I discuss the main features of that law, including the fiduciary duties of directors, the concept of the interest of the corporation, the mechanism of the derivative action, and the different levels of judicial scrutiny, including the business judgment rule.

In short, under the Delaware business judgment rule – provided there is no conflict of interests that affects the board – judicial review of the board's business judgments is limited to the issue of gross negligence as far as the preparation of the business judgment is concerned and the lack of subjective good faith (i.e. lack of *any* rational business purpose) as far as the substance of the business judgment is concerned. In this context, the reasonableness of the board's conduct relating to the business judgment does not play a decisive role. In some circumstances, for example when the board is affected by a conflict of interests and there is no neutral decision-maker, it is possible that a stricter standard of judicial review – namely, a reasonableness test or even an entire fairness test – may be applied. These cases, however, are the exception to the rule.[9]

Part 3

Before drawing upon the insights gained from Delaware law to propose a new approach to the judicial review of director conduct in matters of business judgment in the Netherlands, I explore the meaning of – and relationships between – the key legal concepts used in inquiry proceedings. These include 'well-founded reasons to doubt the correctness of the course of action followed by the corporation' (Section 2:350 DCC), an 'incorrect course of action' (Section

8 See chapter 1 – numbers 2-4.
9 See chapters 2-4 – numbers 6-22.

2:354 DCC), an ‘obviously incorrect course of action’ (Section 2:355 DCC) and ‘elementary principles of proper entrepreneurship’. I also explore the way in which the Dutch Supreme Court and the Enterprise Chamber have applied these concepts throughout the years.[10]

Part 4

Based on my findings, and inspired by the corporate case law of Delaware, I then explain in six steps how, in my view, board conduct in matters of business judgment should be reviewed by the Enterprise Chamber in inquiry proceedings.

This involves the introduction of a Dutch business judgment rule, a standard of review which bears a strong resemblance, but is not identical, to the Delaware business judgment rule. In short, if the board is not affected by a conflict of interests, or if it is affected but a neutral decision-maker has adequately approved its business judgment, the board’s conduct in matters of business judgment (including both the preparation leading up to the business judgment and the substance of the business judgment) can only be reviewed for a lack of subjective good faith (i.e. disloyalty) or irrationality (i.e. lack of due care), not for reasonableness or fairness. The reasonableness and fairness tests are reserved for special circumstances which I specify in the study. In my view, this approach does justice to the underlying rationale for judicial deference to a board’s business judgments.

If the board’s conduct does not pass the Dutch business judgment rule test in an inquiry proceeding, and the board has thus by definition violated its standard of conduct, this falls within the scope of an ‘incorrect course of action’ but not necessarily within the scope of an ‘obviously incorrect course of action’. In my opinion, the latter category requires additional facts and circumstances of a sufficiently egregious nature, not merely the violation of a standard of conduct (even if that violation is culpable).[11]

After applying this method to six rulings of the Enterprise Chamber, which sometimes leads to different conclusions than those reached by the Enterprise Chamber, I explain how this method functions under Section 2:9 in determining whether a director is personally liable to the corporation based on the “improper performance of his duties.” I conclude the study with an analysis of the relationship between Section 2:9 DCC and Section 2:138/248 DCC.[12]

10 See chapter 5 – numbers 24-31.
11 See chapter 6 – numbers 33-39.
12 See chapter 7 – numbers 41-42.