

Corporate governance in Estonia: Intact despite 2007 amendment to Commercial Code

by John JA Burke

The Baltic Times in its 22-28 February 2007 edition published an article entitled "Experts: Estonia to become haven for shady corporations". The charge of attracting disreputable corporations purportedly would result from an amendment to Estonian law relaxing director liability, protecting any decision made in "good faith". Statements from local experts support the stories' spin. The publication and its expert commentary imply that Estonia has reached the bottom of the regulatory arbitrage barrel symbolised by Delaware Corporate Law. That implication does not withstand legal analysis and misrepresents the law of Delaware.

The publication states, "Under the changes, which will come into effect in March [2007, authors' addition], directors and board members cannot be prosecuted if their decisions were made in good faith". The Justice Minister is quoted as saying "the new corporate law was copied from the U.S. state of Delaware and was designed to attract more investment to Estonia". The sweeping statement follows: "Delaware is well known for its lax corporate laws, which allow company directors to absolve themselves of liability for any decisions, including those that adversely affect stock prices or even consumers."

An expert, the Vice-Dean of Business at International University Audentes, claims, "Delaware law brings Estonia into conflict with the European Commission." He elaborates, "Such laws allow boards to remove themselves of any sort of liability. They can hide behind the law in terms of product safety and fiducial (sic) responsibility." The Vice-Dean cites Enron and Worldcom in support of his views, and concludes: "Any place that has this law will be a major attraction, particularly for companies dealing with a product that has the potential to cause harm." Expert practitioners and statements from a Ministry of Justice spokesman fail to add any clarity.

The Delaware legislature adopted Article 102(b)(7) in response to the decision in *Smith v. Van Gorkom* that cracked the citadel of the "business judgment rule" under which directors were liable to shareholders under a theory of breach of due care only in extreme cases of managerial incompetence. The court in *Van Gorkom* required directors to actively acquire information to produce the best premiums for shareholders in connection with a sale of the company. The decision was regarded as applying a full-blooded version of the duty of care and was perceived as a threat to Delaware's reputation as the state of choice of incorporation.

Nevertheless, jurisprudence subsequent to *Van Gorkom*, has developed new doctrines to assess director liability given the diminishment of the duty of care standard. These standards often referred to as enhanced scrutiny for transactional duties are exemplified in decisions such as *Unocal Corp. v. Mesa Petroleum* [formulating standard of review, existing between business judgement rule and entire fairness rule, for action taken to respond to threat of corporate control], *Revlon v. MacAndrews & Forbes Holding, Inc.* [requiring directors to maximize company's value for sale over preservation of corporate entity when sale is a virtual certainty], and *In Re Caremark International, Inc.* [stretching duty of care to include a requirement that directors assure an adequate reporting system of information].

This trend continues unabated, addressing recent events, such as backdating options [*Ryan v. Gifford*, finding that when directors backdate options they cannot meet the busi-

ness judgment rule test thereby exposing them to director liability], and [*In Re Tyson Foods, Inc. Consol. S'holder Litig*, finding that where directors "spring-loaded" options, that is, timed them to take advantage of non-public, material information when granted potentially constitutes a breach of the duty of loyalty, given sufficient proof.

The Baltic Times' claims disintegrate before the facts. Estonia is not analogous to Delaware. The two regimes are the product of entirely different legal traditions, though Estonia may have "sampled" a Delaware provision. It is beyond dispute that Delaware has a court system and jurisprudence on corporate law that is pre-eminent in the world. The same cannot be said for Estonia. In addition, given Delaware's sophisticated jurisprudence, as well as federal and state law applicable to company activity, it is impossible to reduce to a single axiom the scope of director liability.

Consequently, the bald assertion that "Such laws [apparently Article 105(b)(7)] allow boards to remove themselves of any sort of liability" is false. Moreover, the subsequent assertion that "They [directors] can hide behind the law in terms of product safety and fiducial (sic) responsibility ... as long as their decisions were in good faith" is first difficult to interpret as Delaware litigation arises in the context of derivative shareholder suits. Product safety claims would come into play directly only if the company first were found to have violated a law and was ordered to pay damages. Under this scenario, a shareholder filing a derivative lawsuit would have to show oversight failure, a standard that if met exposes directors to potential liability. If the company intentionally violated the law, Article 105(b)(7) provides no protection.

Whether the Estonian amendment contravenes EU policy is a premature question as first the EU has not provided a definitive stance on the issue, and second, legal progress in this area moves with extreme caution. For the record, Enron was incorporated in Oregon and Worldcom was incorporated in Georgia.

More important, legal rules do not solve corporate control problems. It is shareholders that must undertake active roles in selecting directors and voting on management and company issues. This tactic is difficult but not impossible to achieve. In the United States, for example, minority shareholders have managed to place propositions on proxy statements to protect their interests. Even if these propositions fail to pass due to a lack of adequate votes, the fact that some propositions have generated substantial shareholder support sends a clear message to directors and officers: shareholders are watching, ready to act, and intolerant of abuse of authority.

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