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Impulse for Board of Directors for

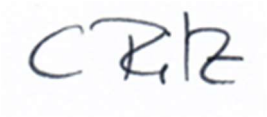
dealing with conflicts of interest.

Preface

Differing and opposing interests are part of our everyday social and business lives. Even in SMEs, in which the ownership and management roles are often held by one person or family, biases and conflicts of interest can occur. These are not prohibited, per se, and cannot be avoided entirely. However, conflicts of interest entail the risk of distorting the decision-making process within the company and damaging the company itself, which is why they must be identified, analysed and dealt with in good time. But what does that mean exactly?

Current law only provides indirect specifications for boards of directors regarding conflicts of interest. With the revision of stock corporation law, which is set to enter into force in 2023, conflicts of interest will now explicitly be addressed in law, whereby boards of directors will be granted ample organisational freedom. It is crucial that a board is sensibly structured in a first step so that it is possible to avoid conflicts of interest. If conflicts of interest nevertheless occur, they must be dealt with correctly in a second step, with the corresponding measures set out in the organisational regulations.

The following descriptions and recommendations are designed to serve boards of directors in fulfilling their responsibility with regard to (potential) conflicts of interest. Particular attention is paid to the corresponding duties laid out in the revised stock corporation law.



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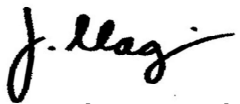

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Impulse for board of directors for dealing with conflicts of interest

Applicable law only provides the board of directors with indirect guidelines regarding how to deal with conflicts of interest. The duty of diligence and loyalty under company law (Art. 717 of the Swiss Code of Obligations) and, under some circumstances, duties of loyalty under labour and contract law advise BoD members to safeguard company interests. With the revision to stock corporation law, which aims to improve corporate governance, conflicts of interest are now explicitly addressed in law and a modus operandi is defined. The corresponding standard (Art. 717a Swiss Code of Obligations) was noticeably slimmed down in the legislative process. This is to ensure that the board of directors continues to possess sufficient flexibility when it comes to organisation.

1. No absolute neutrality requirements for board members

Board members are not judges or auditors, who must be entirely neutral and "conflict-free" as part of their professional activity. According to Eugen Huber, the founding father of the Swiss Civil Code, a "**conflict of interests**" is even intrinsic to the concept of a board of directors to a certain extent: Members of the board of directors wear various hats and should allow for different views and opinions during consultation, although these could also be based on interests outside the company. In some cases, even the law itself provides that members should be elected to the board for the purpose of institutionalised representation of special interests, for example of minority or common shareholders as well as public entities.

2. Types of conflict of interest

As long as the special interests of the board members only create a bias in relation to the company's interests, but do not oppose or restrict them, then this is deemed a mere "**interest bias**" for which the law does not intervene. In some cases, disclosure is advisable. However, measures are generally required only if there is actually a (potential) conflict of interest from a legal point of view.

Neither the (applicable nor future) stock corporation law nor other provisions addressing conflicts of interest define precisely what this is about. With a view to legal doctrine, a conflict of interest with regard to a certain topic has only then occurred if the board **safeguards own interests or third-party interests that oppose those of the company**. This is legally problematic only once the conflict of interest is severe enough to threaten unbiased voting and thus the **undistorted decision-making process** of the company. This is the case, for example, if a BoD is under pressure to prioritise a special interest (instead of the company's interest).

With regard to the issue of what a decisive company interest is, the views in doctrine and case law remain divided. The statutory purpose of the company is the guiding factor. However, the company interest is influenced both by shareholder interests as well as creditor and stakeholder interests; these must be carefully balanced.

Conflicts of interest can occur as individual cases or be of a structural nature, varying intensity and potential, latent or even acute. The underlying **reasons** of each individual board member are manifold:

- **Own interests**: Such are relevant especially in the case of self-contracting, in other words when the company concludes a contract with a BoD member or one of these alone or together with legal entities controlled by third parties (e.g. order/work contract for rendering a service, rental agreement, etc.). However, the decisions of the board of directors can otherwise have a direct impact on individual members (e.g decision regarding the launch of an investigation or (court) proceedings; decisions regarding a company in which a BoD member has a certain minimum holding (at least 5%)).
- **Close business and/or contractual relationships to third parties and multiple mandates**: These third parties can be business partners (e.g. customers, suppliers or service providers such as attorneys, architects, engineers, financial advisors, fiduciaries, etc.), but also competitors, although the latter is more problematic. However, such contractual dependencies do not necessarily lead to a conflict of interest, but rather may even entail ad-

vantages. There is nonetheless a conflict of interest, especially in the case of actual conflicts of obligations, if the board member is contractually and/or legally (and under threat of penalty) obliged to represent third-party interests. This is particularly the case if a BoD is also a managing body or employer of a competitor or a contractual party, and when making strategic decisions it handles information that it has only due to this contractual relationship, or otherwise would breach its (loyalty) duties.

- **Close personal relationships to third parties and ideological or moral dependency**: Even without contractual or legal obligations, the interests of related persons or organisations can influence the decision-making process of board members (e.g concluding contracts with family members).
- **Lack of time:** If the internal and external activities of a BoD are so work and time intensive that insufficient resources remain for a diligent execution of the tasks of the actual BoD mandate, then this can also lead to a (potentially long-term) conflict of interest.

3. Legal situation under currently applicable and future law

Conflicts of interest are expressly referred to in the **Takeover Ordinance** (Art. 32) as well as in corporate governance recommendations, such as the **Swiss Code of Best Practice** of economiesuisse (Art. 17), which many companies follow. The latter provides that a BoD member affected by a conflict of interest must notify the president of the BoD, after which the entire BoD must propose a measure in line with the degree of the conflict of interest. The entire BoD must jointly decide, with the affected member abstaining from the vote.

By contrast, **currently applicable stock corporation law** (as well as contract and labour law) does not explicitly govern conflicts of interest – but it does indirectly. Art. 717 of the Swiss Code of Obligations is paramount. This requires the board of directors to fulfil its tasks with all due diligence and to safeguard the company's interests in good faith. These obligations stipulate that own and third-party interests are subordinated and the board's conduct geared solely to the company's interests.

With the **revision of stock corporation law**, the general duty of loyalty in accordance with Art. 717 of the Swiss Code of Obligations is set out in detail and in Art. 717a, the approach for dealing with conflicts of interest is explicitly governed in a binding manner (even if this is only very rudimentary). Accordingly, BoD members must inform "the board of directors immediately and comprehensively regarding the conflict of interest that affects them" (para. 1), after which the board of directors "(takes) the measures necessary to safeguard the interests of the company" (para. 2).

4. Sensible organisation of the BoD to prevent conflicts of interest

In a first step, conflicts of interest should prevented by defining a sensible organisational structure and composition of the BoD. The various tasks of the BoD should be distributed in a way that prevents conflicts of interests to the greatest extent possible. Certain (management) tasks can be transferred to individual members or third parties. At least in larger boards, it may also be helpful to form committees for some subject areas and appoint "conflict-free" members. Both measures should be defined in the Organisational Regulations.

5. A correct approach to dealing with conflicts of interest, if such (nevertheless) occur

Conflicts of interest cannot always be prevented by a sound organisation. For this case, a correct approach to dealing with the conflicts of interests should be defined in advance (in the Organisational Regulations), distinguishing between the following steps:

A) Disclosure

It is crucial that the approach to dealing with conflicts of interest is based on a **culture of openness and transparency**, shaped by the president of the BoD and lived by all BoD members. All circumstances and interests which create a (situational or structural) bias against interests of the business should be disclosed. In general, this also relates to pure interest bias as well as potential conflicts of interest – regardless of their severity. In cases of doubt, the information should be disclosed.

The law does not answer the question of "**to whom**" the information should be disclosed or "**how**". The corresponding process must be defined in the Organisational Regulations and provide the BoD extensive flexibility:

- In general, it seems reasonable for the president of the BoD to be informed, particularly as they convene and lead BoD meetings. If the president is the affected member, then the information can be required to be disclosed to the vice-president or lead independent director, the chair of the audit committee or the entire BoD.

- For reasons of proof, written notification (even per email) or at least the documentation (BoD minutes / confirmation letter) of the oral or informal disclosure must be stipulated.

By contrast, the text of the law is clear when it comes to the "**when**" and "**to what extent**":

- Immediately (so that countermeasures can be taken in good time)
- and comprehensively (with all the facts required to assess the circumstances and take measures).

B) Assessment

Once the information has been disclosed, the facts regarding the type and severity must be assessed and determined whether a relevant and sufficiently severe conflict of interest (and not just an interest bias) has actually occurred. The Organisational Regulations must clearly define who is **responsible** (e.g. President of the BoD/vice-president/lead independent director/committee chair/entire BoD) for this analysis.

If the information is disclosed to the president of the BoD, then they can be given responsibility for initial triage and the decision of foregoing further disclosure of "clearly irrelevant" interest bias or conflicts of interest to the entire BoD. They should be required in any case to notify the entire BoD of all other conflicts of interests, although they can submit an appraisal of the situation as part of their assessment and bring forward a motion regarding whether (and what) action is required.

C) Taking measures

If the aforementioned assessment shows that there is actually a legally relevant conflict of interest, the BoD is obliged by law to take the measures necessary to safeguard the interest of the company. According to the view represented here, this is not a non-transferable and irrevocable competence of the entire BoD, which is why the BoD is granted a certain room for manoeuvre in **defining the procedure and competencies** (in the Organisational Regulations).

In especially urgent cases, in clear cases or if informing the entire BoD would thwart appropriate measures, the president of the BoD or the responsible contact can be granted the authority to unilaterally take measures. As a rule, it is advisable for the entire BoD (or potentially a committee formed for this purpose) to decide on any measures to be taken. The affected member must abstain from the corresponding vote (and shall be viewed as absent during the vote count).

Even in the case of **measures** taken, the BoD is granted a high level of flexibility. Various measures on various levels of severity can be considered:

- **Forgoing** measures
- **Fairness opinion / independent advice / market test**: To obtain a neutral assessment of a critical transaction (regarding conditions), for example.
- **Two-step vote:** A vote regarding the issue is first held in the entire BoD and then without the member affected by the conflict (or in the converse order), during which a decision is only deemed to be reached if both votes are passed.
- **Abstention:** The law does not stipulate a mandatory obligation to abstain. Moreover, it is not always advisable. Firstly, the knowledge of the affected BoD member may be especially important for the decision-making process of the company. And depending on the constellation, it could discharge the person of their responsibility. However, an abstention is justified if a BoD member must safeguard legal or contractual duties of confidentiality. Especially if the affected BoD member (solely) has the required expertise, it can be reasonable to allow them to participate in the consultation, but to exclude them from adoption of resolutions.
- **Approval from a coordinate or superior management body**: This could include a conflict-free special committee which would be reasonable to form if several BoD members are affected by one conflict of interest or if the conflict is of a structural nature. A consultation as part of the annual general meeting could also be considered, as well as a decision by executive management regarding the subject of tasks to be delegated.
- **Exclusion from all information**: This is a last measure which should only be considered if there are especially severe conflicts of interest and the affected BoD member could damage the company if they possessed the information.
- **Call for resignation**: This, too, is an "ultima ratio" and is generally only considered in the case of long-term conflicts of interest (e.g. chronic lack of time, structural dependencies).

It is recommended that the aforementioned assessment of (potential) conflicts of interest as well as the discussion regarding potential courses of action and the concrete measures ultimately taken be adequately documented in the minutes of the BoD.

6. Consequences of unlawful acts

If a board does not fulfil their above-mentioned obligations with regard to how they deal with conflicts of interest, this can have various legal consequences:

- **Responsibility for liability:** In general, if this (intentional or negligent) breach of duties causally leads to damage or loss, the company as well as the individual shareholders can claim compensation for damages from the responsible BoD member (with payment to the company) (Art. 754 et. seq. of the Swiss Code of Obligations). In the event of the insolvency of the damaged company, even the company's creditors would be entitled to request compensation payments (to the company) (Art. 757 of the Swiss Code of Obligations). In this regard, the Federal Supreme Court recognises the business judgement rule. According to this rule, when the courts subsequently assess business decisions, they must exercise restraint, provided that this assessment has been reached in a properly functioning, conflict-free decision-making process based on appropriate information. However, the latter also means that in the case of an inadequate approach to dealing with conflicts of interest, a stricter assessment standard must be applied, which increases the liability risk.
- **Criminal liability**: If there is damage or loss to the assets of the company in connection with the conflict of interest or due to an inadequate approach to dealing with the conflict, a criminal investigation and conviction for criminal mismanagement, can among other things, be considered (Art. 158 Swiss Criminal Code). This is punishable by a custodial sentence of up to three years (or five years in the case of a view to securing an unlawful financial gain).
- **Invalidity of BoD resolutions:** There are differing views in the literature regarding the issue of whether, and if yes, under what circumstances an inadequate approach to dealing with conflicts of interest leads to grounds to nullify the corresponding resolution. As a rule, the resolution is void if any defect could be remedied through the approval of the other members of the BoD or another management body of the company.

7. Conclusion and recommended action

Conflicts of interest can never be fully prevented and affect the day-to-day of every BoD. For this reason, it is essential to have the right approach in dealing with the issue:

The BoD should be sensibly structured and organised in the **Organisational Regulations** of the company so that conflicts of interest can be avoided to the greatest extent possible.

Moreover, who must disclose what (also with regard to interest bias or only clearly defined conflicts of interest?) to whom (BoD president/committee chair/entire BoD?), how (in writing/orally?), when (immediately) and to what extent (comprehensively) must be defined.

And in a concrete case, the assessment to be made of the circumstances and the measures to be taken must be clearly defined, especially with regard to the competencies and eligible actions, and concrete implementation documented for each individual case (to be included in the **minutes of the board of directors**).