

Consequences for Business Practice from the Middelhoff Decision by the Regional Court in Essen

The spectacular case against the former chairman of the board of directors of Arcandor Group again shows the monetary and penal consequences a legal representative might face.

It was one of the most spectacular corporate trials in the past few years in Germany: the trial of the former chairman of the board of management of Arcandor, Dr. Thomas Middelhoff, before the Regional Court (Landgericht – LG) in Essen. It ended just as it had begun: namely with a bang. Middelhoff was given a custodial sentence totaling three years for embezzlement in 27 cases and tax evasion in three cases. In addition to this an arrest warrant was issued against him in the court room after the trial since he was deemed a flight risk. Middelhoff had charged private helicopter flights to his employer, Arcandor AG, and the costs for an honorary publication for a former superior in the amount of EURO 180,000.00.

This case showed that the boundaries between business and private matters and therefore also between benefitting other people and self-serving aspects are blurred. Friends often become business partners in a long professional lifetime and vice versa. It can sometimes be difficult to decide what is business use and what is private use. It is precisely the uncertainty in the resulting “mixed situations” which should lead managers, board members and managing directors to seek legal advice in advance so that they do not run the risk of suffering the same fate as Middelhoff.

1. Consequences under Criminal Law

The sentence is proof that managers must also expect criminal investigations in future if business assets or other business resources are used in an unauthorized manner.

The offense of embezzlement which has been criticized for a long time since it offers such a wide scope of interpretation means that criminal law can cover many detrimental business decisions. Some opinions would even go so far as to say that the offense of embezzlement has become a “core standard in business criminal law”.

As in the Middelhoff case, for example, it can also include tax evasion since the company claiming non-existent travel expenses leads to tax evasion benefitting a third party.

2. Other Consequences

Apart from the consequences under criminal law the executive bodies are often also liable for infringements of the duty of care pursuant to the German Limited Liability Law (GmbH Gesetz – GmbHG) or stock corporation law. Employees are liable under civil law for the infringement of the employment agreement and/or for tortious liability. It should be noted here D & O insurance does not always help since it is limited to a certain amount and does not apply if the policy holder acted with intent.

In addition the employment agreement is often terminated without notice in almost all cases.

3. Regulations under Civil Law as a “Protective Shield”

Managers do also have some possibilities to avoid the above consequences, however, so that they are not paralyzed in their business decisions for fear of this liability risk. They can arm themselves in advance as long as they are aware of the liability risk.

The limits of embezzlement are specified under civil law by the employment agreement and also by the articles of association and rules of procedure for members of executive bodies (managing directors and board members). It is possible here to agree on regulations about which costs will be borne by the company. At the same time this would then also prevent damage which is the precondition for liability under civil law.

If there are no clear agreements, then any private use of business assets is generally prohibited. As the Middelhoff case showed, relying on the “actual practice in large corporate

groups" does not then help either.

On the other hand, if there are corresponding agreements, then it is possible to use a helicopter to travel between the workplace and home and the costs are borne by the company.

Furthermore it is recommended to have such regulations designed by an attorney since the manager bears the risk in the event of a misjudgment or false interpretation. The regulations should also be subjected to a thorough review on a regular basis and modified in accordance with current circumstances.

As soon as such regulations are included in the employment agreement, it is then up to the manager to compare his/her expenditure with the contractual conditions on an ongoing basis.

4. Compliance Systems as Double Protection

In the last few years the courts have placed ever higher demands on corporate compliance mechanisms which serve to prevent damage and monitor risks if such mechanisms are effective. As the Regional Court I in Munich also ascertained in the Siemens trial in 2013, it is within the scope of responsibility of the board of management to set up an effective compliance system (duty of organization). The board of management and management team should consider this not as a duty, however, but as an opportunity to give themselves double protection:

4.1. First Step: Precautions

If the compliance department is functioning properly, the first step is to establish contact so that a review can take place whether certain projects or expenditure qualify as business related or whether the boundary to private use has already been crossed.

4.2. Second Step: Defense

Should it come to a court proceeding, an effective compliance department can be consulted as a means of defense. The argument that the manager and/or board member wished to act in a law-abiding manner is supported here since the courts pay very careful attention to whether the manager wished to enrich himself/herself in a private manner or not. If the compliance department has looked into this beforehand, however, there is much to say for the fact that the manager did not wish to cause damage to the company intentionally. Negligent embezzlement does not exist. At least the "universal weapon" of embezzlement is thus taken out of action here.

If it goes well, good compliance can therefore prevent decisions which are relevant in criminal law; if it goes badly and there is a court proceeding, it can still be asserted that there was intent to act in a law-abiding manner, which can also be proven.

5. Conclusion

The Middelhoff case showed that it is of paramount importance for board members, managing directors and the management team to include regulations on travel expenses in the employment agreement and to set up an effective compliance system. Liability under criminal law or civil law can thus be avoided in comparable situations.

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